

China's Social Security Reforms: The Institutional Arrangements

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1. The choice on the social security mode in China has been the significant issue in the course of the reforms and the development

1.1 The understanding of the social security modes

The establishment of market economy in China requires the establishment of the correspondent social security. Therefore, during the transition period, the transition of social security system should be completed accordingly. In my research on the SOE reform: the mode and the supplementary reforms, I began to pay attention to the role that the social security plays in the reform of SOE.

Within the context of the whole world, there are two basic social security modes: pay-as-you-go system and the individual provident fund system. The former is typical in Germany and therefore, it is called "German style". This mode is characterized by the so-called "pay as you go" and the cost of the social security is transferred between the different generations. It means that the current employees should contribute to finance social security to the retirees, and the social security fund is transferred simultaneously between the contributor and the beneficiary. This system requires that there is the small aging population, average young population, relatively strong economic foundations and relatively complete tax system. However, under this system, the fund demanded will grow with the time and there is almost no accumulation of the funds for the social security.

The latter is the individual provident fund system. It pays special attentions to the personal contribution and the accumulation of individual funds. When retiring, the retiree can be guaranteed by his contribution to his own accounts during his working years. The fund accumulated can be operated by the investment funds. This system is typical in Chile. The accumulation and the return on the fund guarantee the stability for the supply of funds and can strengthen the resistance against the economic turbulence.

In fact, in the former system, the general government acted as the debtor to the social security although in most cases implicitly, which put some pressure on the budget. With the growth of the fund demand, the government will be forced to raise the

contribution ratio, which in turn will dampen the economic performance and twisted the incentives in the economy. Based on the above-mentioned reasons, more and more governments, not only the developing countries under demographic pressure but also the developed countries without much pressure or with strong economic foundations begin to notice the negative effects of this system. To certain extent, this system has led to the "welfare problems" in some European countries. So there are more governments turning to the latter mode of social security system.

1.2. The evolution of the social security system in China

In the 1950s, the public pension system was established for the employees in the enterprises. This system took the enterprises as the basic entity and followed the "pay-as-you-go" very much and the cost of social security has been transferred between the generations. This system was justified during that time for two reasons: first, the population was relatively young on average and second this system could be guaranteed by the planning economy. However, with the establishing market economy in China and with the aging population, the problems in the existing social security system began to attract the attention. In June 1991, the State Council issued the Resolution on Reforming the Pension System for the Employees, which signified the start of the reforms in the social security system. The 3rd plenary meeting of the 14th national congress of communist party clearly decided to establish the pension system which combines the individual retirement plans with unified financing of social funds for the employees. The basic idea is to gradually establish the individual provident fund system by collecting funds from both the enterprises and the individuals. The idea were triple targeted: firstly, to ease the conflict between the aging population and the "pay-as-you-go" system; secondly, to oblige the individuals to share the cost of the social security and thirdly, to relax the pressures on the enterprises. Within the context of the above, the social security ministry and related agencies have been setting out to enlarge the coverage of the new system such as covering the employees in the private-owned firms or the farmers in some regions in the new system.

Unfortunately the current new system is the factual "pay-as-you-go" although it is called "individual provident fund". In the current practices, the funds on the individual provident funds are nothing but the book value because the funds booked in the individual provident funds have been transferred to pay the cost of the social securities simultaneously. Compared with the old system, the new system only transfers the payment risks from the enterprises to the local governments. Another disadvantage of the system is the employees at current stage take the cost of the social security not only of themselves but also that of the former generations. In summary, the new system is the nominal individual provident fund system on book value but the factual pay-as-you-go system with high standard and high burden.

1.3. The newly implemented social security system is unsuitable for the economic

reforms or the development.

Though we have taken efforts to design and implement the new social security system, the newly implemented social security system is far from suitable for the economic reforms or the development. In our views, the efficient social security should achieve the following targets. (1) The establishment of the social security net; (2) the means of savings and the accumulations in the society; (3) the sound incentive mechanism; (4) the active influence on the ownership changes; (5) the establishment of the cost-effective and high efficient administration; (6) the appropriate income distribution and (7) the solution to unemployment relieves and the solution to the mobility of employees. From these points of views, the newly implemented system has been the critical issue that restricted the economic reform or the economic development.

Firstly, the newly implemented system does not take the demographic changes into full consideration. The current population structure in China and the policy of "one family one child" reflect that the aging society is coming in the nearer future. If the individual provident fund system was not to be established in due course when the population is relatively young, it would be very difficult for Chinese government to take the growing burden of social security. If Chinese would go into the aging society when China is still under development, Chinese government would have to spend more to solve the problems in social security. Based on the prior estimation, China's pace into the aging society has been accelerating. By the year of 2000, most probably China will become one of the aging countries (with the aged to the gross population as 8%). By the year of 2003, the aging population will reach 30 million, equivalent to the aged in the Europe. By the estimation of the related ministries responsible for the social security, if we still have the current social security system, the basic pension needed annually since 2025 by Chinese government will be RMB500 billion to 1400 billion when taking into the prices into consideration . It is obvious that by the middle of next century, the sustainability of Chinese economy would be threatened if we adhere to the current system of social security.

Secondly, the current social security mode twists the active incentives in the aging society. If we have the "pay-as-you-go" when the aging population is big, it means that the employees must bear the cost of social security both for themselves and for the retired after they pay tax. Therefore, the disposable income ratio would be decreased. For the big countries like China, the cost borne by the employees would be very high. It is estimated that by the year of 2020, the 32.3% of the income will be paid to the social security and by the end of 2040, the 40.2% in accordance with the current living standard of the employees in the cities.

Even in the developed countries like Germany, there are the problems of heavy burden of social security and the twisting of incentives. In 1997, the unemployment reached 4.39 million and the unemployment rate was 11.4%. One reason for the high employment was the high social security twisted the incentive mechanism. According

to the statistics of Bundesbank, if we compare the lowest disposable income of an employee in the catering industry with the income of one receiving the social relieves, we will find that the former had DM 276 more than the latter if the former has no kids. If the former had one or two kids, the former would have DM41 or DM 573 less than the latter. The high standard of social security even resulted in that the relief exceeded the income by working and directly led to the disorder in the social incentives. By contrast, the social security system in Singapore is worth learning. The Central Provident Fund System in Singapore encourages the hard working and combines the active incentives and the sound social security system.

Thirdly, the current social security in China does not take the technology advances into consideration. In order to control the cost of social security, we set the limits on the consumption or on the Medicare, such as the limits on the reimbursement of the Medicare. However, there have been the technological advances in the biochemistry, in the medical appliance and in the information technology. The advances create more favorable conditions for the retirees to promote their consumption and to improve their Medicare. Even the government sets limits on the reimbursement for employing such advances. Due to the kinship and the social conscience, however, the family, and the enterprise of the retirees still will actively create the conditions for the retirees to employ the new advances, which will lead to the further growing of the social security cost.

Fourthly, in the "pay-as-you-go" system, the enterprises carry out part of the social security that will hinder the reforms of the enterprises. As we noted in the book, the SOE reform: the mode and the supplementary reforms, social security system has been the heavy burden for the enterprises, and "the fundamental mistake is the "pay-as-you-go" pension system". In practice, the heavy cost of social security has been one of the reasons for the difficulty in the enterprises. In fact, we have met plenty of cases in this respect. Therefore, by comparing the different systems of social security, we pilot to take the part of the shares of the enterprises to be listed in the future as the fund for the employees to establish individual provident funds, aiming at liberalize the enterprises from the burden of the social security. This pilot project reflects our thoughts and operational proposals on the reform of social security system in China. I will talk about it later.

Fifthly, the current social security system will increase the uncertainty of expenditures by the households, so the household will increase their saving preference. The expectations and the behavior of the households will set strict constraints on implementation effects of the domestic macroeconomic policies.

At last but not at least, the current social security system will lead to the unfavorable saving and accumulation for the whole society.

2. China's choice on the social security mode and the scenario

2.1 Take individual provident funds system as the dominant part of social security

2.1.1 the social security arrangements in our views

Based on the above, we will find that no parties in the current social security system is happy with it. The government took the most cost of the social security. The enterprises can not proceed the reforms due to the constraints on the cost of social security. The retirees can not have their pension guaranteed and the current employees need to take the unbearable cost for the society. The current social security system must be reformed. But how? After we comprehensively take the demographic structure, the strength of the state budget and the complexity in China into consideration, we think that we should establish the combined social security system but with the individual provident fund as the dominant part. To be exact, we should establish the mandatory individual provident fund system on the large scale, while keeping the current "pay-as-you-go" as the bottom line. For some high-income individuals, they can upgrade their security standard by purchasing the commercial insurance products.

Firstly, implement the individual provident fund system for the employees on the large scale and coverage, treat the individual provident fund system as the dominant part. The system is characterized by the mandate, the tax rebate and the strict contribution ratio and the strict guidelines for the fund management.

Secondly, keep the current "pay-as-you-go" to meet the basic demands of the society. Owing to the limited population of low-income individuals, the budgetary burden for this part is accordingly limited.

Thirdly, encourage some high-income individual to purchase the extra commercial insurance products.

In summary, the key is that the individual provident fund system must play the dominant role in this combined system while the commercial insurance and the "pay-as-you-go" play the supplementary role.

As for comparing the "pay-as-you-go" with the individual provident fund system, the scholars have reached the mutual understanding. However, there are some confusion between the social security and the commercial insurance to be clarified.

2.1.2 take the proper handling of the commercial insurance in the social security system

We have paid much emphasis on the supplementary role of commercial insurance in the build-up of the social security system in China. This conclusion was drawn because of the inherent weakness and limitations that the commercial insurance possesses.

Firstly, the commercial insurance supports the minority by the premium funds of the majority. It has the apparent features of re-distribution and the egalitarianism. There is no clear, stable or active incentive for the hard working and individual accumulation.

Secondly, the commercial insurance is not mandatory to the employees but the voluntary behavior. However, the funds of the social security can be maintained and guaranteed by the mandatory contribution in the individual provident fund system.

Thirdly, in most countries, there is the tax rebate for the contribution to the social security. However, there are no tax incentives in the commercial insurance. To be specific, many insurance products resemble much the savings account in the banks, in other word; it is the variant of the bank savings. If the commercial insurance were tax-exempt there would lead to the uneven playing fields for the banking and the insurance.

Fourthly, there are the strict contribution ratios in most countries, however, it can not be guaranteed in the commercial insurance.

Fifthly, the product design in the commercial insurance can not meet the demands of the social security but control the risks in some areas. The operational features and the nature of the commercial insurance determine this.

Sixthly, in the countries that succeeded in the transition of social security such as Singapore, the governments always take cautious attitude to introducing the commercial insurance into the social security. Not until Singapore became the newly developed economy, the government did not have the commercial insurance in the social security. In general, the social security provided by the insurance is very limited.

Thus, the commercial insurance can only play the supplementary role in the social security system as well as the active role in preventing certain risks. " In the low-income countries like China, it is not appropriate to resort to the commercial insurance for social security. Instead, we must pay much attention to the relations between the social security, the saving and the incentives."

2.2 choose the SOE groups as the breakthrough for the implementation of the individual provident fund system

2.2.1.it is difficult for the state budget to take the transition cost of the social security

After we clarified that we need to establish the individual provident fund system, we need to take steps to make it true in China. We will have to face the transition difficulties.

The first problem is how to calculate, confirm and compensate the employees under the old "pay-as-you-go" system. In the old system, the employees made the contribution to the social security, which formed the assets or interests of the contributors as well as the factual and implicit liabilities of the government to the employees. Since the social security funds had been deducted from the salary, the low salary system has been working for quite a long period. Under the "pay-as-you-go" system, the fund contributed was not accumulated in the form of investment fund but in the form of fixed investment in the state-owned enterprises. It is inevitable to unveil the implicit liabilities of the government to the employees during the transition.

The best scenario during the transition is that the government takes all the liabilities for the social security, which will pave for the establishment of the individual provident fund system. Evidence shows that the major factor that led Chile into successful transition of social security was the government's willingness to take all the liabilities and pouring into large supporting funds. It is estimated that the liabilities taken by the government of Chile was around 80% of the GDP in 1981. In the peaking years, the ratio was 4.8%; then the ratio declines in the following years. By the year of 2025, the government of Chile will pay for the liabilities. Taking the security standard and the demographic structure into consideration, the World Bank estimated that the liabilities of Chinese government would be less than that of that of the Chile.

However, it is still difficult for Chinese government to take the liabilities if we compare the liabilities with the current state budget. In fact, it explains the rationale that Chinese government chose the factual "pay-as-you-go" system (due to the restriction of the potential government liabilities)

2.2.2 take the SOE groups as the breakthrough point

The potential liabilities to the employees put the restrictions on government's alternatives of social security system. Then whether is it true that Chinese government has nothing to do? By our analysis and the empirical exploration, we think that we can take the SOE groups as the breakthrough point to implement the individual provident fund system gradually.

This proposal is well founded on the following grounds:

1. The government's commitments of the social security system to different labor

forces in government, in the enterprises of different ownership, in urban and in rural are different. In terms of ranking from the stronger to the weaker, it should be the commitment to the employees in government, then in the SOE, then the collective forms, etc. The state-owned enterprises have been the dominant part in the state economy and played very important role in the economy. The government's commitment to the employees on the social security is very strong. In general, it can be generally understood by the society if we take the state enterprises as the breakthrough point to implement the individual provident fund system.

2. In the current stage of SOE reform, the "cut in labor and the growth of efficiency" has been used extensively. In fact, the enterprises have taken efforts and spent lot to re-employ the laid-offs. These efforts are mainly the costs in the social security for the employees. Therefore, by establishing the individual funded, the expenditures can be standardized.

3. So far, there have been some enterprises with good performance, and they can afford to implement the social security reform; therefore, we could set aside 5%-10% of the total assets of these enterprises for the employees in there enterprises to establish their individual provident funds.

4. In fact, when we restructure some enterprises for listing, we have set some pilot project in this respect.

5. Taking the SOE groups as the breakthrough point for the individual provident fund establishment can be used for an example due to the coordination from the enterprises. By contrast, in the current "the combination of social contribution and the individual provident fund" mode, some enterprises have been contributing less even nothing due to the growing contribution ratio or the unreasonable distribution. Some enterprises with high burden actively joined in the current system, however some enterprises with low burden try to avoid joining in the system.

6. If the re-employment, the Medicare and the pension still were the responsibilities, they will impose great pressure for the enterprises. However, by setting aside part of the enterprises' assets for the transition of the social security, the social security and the relevant risks can be diversified in the society and the enterprises can compete with others in the market with profit orientation by no social security functions any more.

There is no doubt that there are some shortcomings for taking SOE groups as the breakthrough point. In fact due to the different performance of different enterprises, the pace for the implementation of individual provident fund system will be effected. The playing field for the enterprises in different regions will be not even. In addition, the setting aside of enterprises assets for the individual provident funds does not diversify the risks of social security cost, on the contrary, the social security cost will

still be kept within the enterprises. It takes time for the enterprises to sell its shares at the favorable timing.

2.2.3. Establish the efficient and market-oriented fund management system

After the individual provident fund system being established as the basic mode, the next issue of great significance then comes into the surface. It is how to establish the efficient and market-oriented fund management system and the fund operation system. In fact, the fund management system and its operation will determine the success of the new social security system.

When designing the operation mechanism for the social security fund, we must take the following into consideration.

1. There should be one authorized quasi-government agency responsible for the administration of the social security fund. This agency has the uniform and mandatory administration on the social security fund. This agency centralizes the data for each individual such as his working experience, his contribution, etc. Since the data management is technology-intensive and involves the data collection, check or even the processing, the quasi-government agency may authorize some commercial banks to share the data management work.
2. Since the commercial banks are strong at the account management, the quasi-government agency could entitle the daily operational work of individual provident fund management to the commercial banks and entrust the fund to the banks for custody.
3. By establishing several competitive fund management companies, the social security funds can be incremented and the capital market can be developed. These fund management companies can get the fund from banks rather than collecting the fund directly from individuals.

In general, the mode we design operates as the following. The mandatory quasi-government agency responsible for the administration of social security, then it entrust the fund to the banks for custody, then the fund management companies responsible for the increment of the fund.

In comparison with the Chile style, what we design has the following advantages.

1. It fully employs the strength of different institutions and enhances the efficiency of the fund management. For example, the banks are strong at account management while the fund management company at the investment.

2. It significantly cuts the operational costs for the fund management. In Chile, due to the direct collection from the public, the fund management companies spent 29% of the total fund for marketing and advertisement on average. However, our mode will ensure the fund management companies can get the fund from the banks at low costs, therefore to stimulate the companies to be devoted to their investment performance in order to attract the voting of public. During this process, the social security fund will nurture the mature institutional investors therefore to promote the capital market development.

3. It stimulates the commercial banks to increase the fee-based income, to expand the custody services, therefore, to promote the performance. With their extensive branches network and the relatively advanced IT, the banks can profit from the fee-based services such as the custody. When the public put their fund in the banks for management, the public can freely choose the fund management company, or can be recommended by the banks, even the banks can act as the agent for the portfolio.

4. The fund management adheres to the market principles and will promote the efficiency. In fact, the principle of competition can be reflected in every part of the fund management from the fund sourcing to the fund investment.

5. The mode adheres to the principle of interaction and the fund management will be stricter and standardized compared with the current management.

Conclusion

Based on the analysis of the aging population and the economic development stage in China, we must speed the transition from the current "pay-as-you-go" to the "individual provident fund system" in the future. By taking the enterprises group as the breakthrough point, we could start to implement the individual provident fund system extensively. In the course, it is very important to establish the market-oriented fund management system with high efficiency.

Appendix

1. Zhou xiaochuan, the SOE reform: the mode and the supplementary reforms, China economy publishing house, 1994.

2. Martin feldstein, "the reforms in the pension system in China", the comparison on the social and economic system, 1999.2.

3. The research group of the ministry of labor, the establishment and improvements in China's social security system, China economy publishing house, 1994.