

Realizing the Potential of China's Social Security Pension System

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China, like many of the world's nations, faces significant fiscal challenges from the aging of its population. These challenges are more complicated in China than in most other countries because they are closely linked to China's efforts to transform state owned enterprises and facilitate rural to urban migration. But in undertaking social security reform, China has three advantages that most countries do not share:

First, China has designed a very attractive social security pension system, combining a basic social pooling benefit and a personal account benefit that reflects individual earnings histories.

Second, the current economic environment is uniquely favorable for solving the fiscal challenge created by population aging because economic growth is very rapid, and national savings and international reserves are extraordinarily high.

Third, if correctly implemented, social security reform can contribute to the modernization of the Chinese economy by:

- enabling workers from the former state owned enterprises and from agriculture to make the transition into the market economy and
- helping to speed the development of China's financial system.

It is essential that China move rapidly to realize the potential of its well-designed social security system. The problem will be much harder to solve if the country waits until a time when the population has aged further and the economic environment is not as favorable.

To help China realize the potential of its social security system we recommend four steps:

1. The legacy costs of providing pensions to people who participated in the old economic system should be separated from the new social security pension system. These legacy costs should be treated as inherited national debt and financed at a low current cost.
2. The administration of the social security system should be improved. Steps must be taken to increase collections of payroll contributions and to expand the number of workers covered by the system.
3. Payroll tax rates should be significantly reduced. China's payroll tax rates are much higher than those of most other countries. These high rates cause firms to evade their required contributions, and they reduce the efficiency of the economy. They can be reduced while still meeting the financing needs of the program
4. China should start funding investment-based individual accounts now. Investment-based accounts are needed to build worker confidence in the system and to keep tax rates low in the long run.

1. Separating legacy costs

Nearly all of current pension expenditures represent legacy costs – payments to former employees of state owned enterprises whose careers occurred under the old economic system and who have not participated as workers in the current social security pension system for more than a few years. The costs of providing social pooling benefits to these workers are part of the costs of making the transition to a market-based economy. Since the benefits of this transition will be shared by many future generations, it is appropriate to share the costs over many generations as well. This is particularly true in China's case because economic growth is so rapid, implying that future generations will be much richer than current generations. Therefore, these legacy costs should be separated from the social security pension system and treated as inherited national debt. In addition, the current approach – in which today's workers bear all of the burden of financing these legacy costs – leads current workers to feel that they are getting a bad deal from the Social Security system and to be reluctant to participate in it.

There is no need to finance all of this debt as the obligations come due. Instead, the interest on the debt can be serviced at a small annual cost so that the debt remains constant or gradually shrinks as a share of GDP over time. It would also be possible to reduce this debt by selling government assets, including state owned enterprises, land, and foreign exchange reserves.

The opportunity to use these alternative revenue sources exists because China currently has a low national debt, high rates of national savings, and large international reserves. These conditions may not exist in the future. Therefore, it is important to move as quickly as possible to fully implement the new system so that it can be self-sustaining in the long run.

2. Improving the management of the system.

Currently, many workers do not participate in the system and many firms avoid some or all of their required contributions. Low participation rates and low compliance rates keep current tax rates unnecessarily high.

The most important thing that can be done to improve payroll tax compliance is to reduce the payroll tax rate by separating the legacy costs and funding the social pooling benefit with a different revenue source (as discussed in section 1 above and section 3 below). Other needed reforms include 1) creating a single national pension administration which receives all pension revenue and delivers pensions; 2) having the tax authority collect payroll contributions; and 3) undertaking a systematic effort at enforcement and coverage expansion, starting with the largest firms and then extending to all firms. These recommendations are consistent with the findings of experts who have studied the Liaoning Pilot.

In addition, in many Chinese firms, a large fraction of employee compensation is in non-wage forms such as housing benefits and special cash payments. It is important that the payroll tax base include all of employee cash compensation, not just wages. Without this step, retirement pensions will be too low and opportunities to evade the payroll tax by shifting compensation to non-wage forms will be too great.

3. Reducing payroll tax rates

In China today, firms pay a payroll tax rate of around 20 percent and workers pay a tax rate of around 8 percent to finance the pension portion of the Social Security system. This combined rate of 28 percent is much higher than the rate in most other countries and is a major barrier to the successful operation of the Social Security system. The high tax rate causes firms to avoid required payments, encourages compensation to be structured in ways that are not counted as wages, and reduces economic efficiency.

We recommend that the payroll tax rate be reduced to 8 percent with all of the revenue directed to investment-based individual accounts. Our calculations show that individual accounts of this size will be more than sufficient to achieve the government's objective of a replacement rate equal to 35 percent of a worker's average wage.

We recommend that future social pooling costs be financed with a broad-based tax such as the value added tax. While short term social pooling costs are legacy costs that should be debt financed, the costs of providing social pooling benefits to workers who have participated in the new social security system for at least 15 years should be tax financed on a pay-as-you-go basis. Currently, payroll tax administration is very inefficient. Tax evasion has produced a small tax base and very high tax rates. If this continues to be the case in the future, then social pooling should be financed with a broader-based tax such as the value added tax (VAT). Using a tax with higher compliance would be more efficient and would permit lower tax rates than is possible with the payroll tax. If the VAT were used today to finance social pooling, there would be serious distributional concerns about using a tax whose burden is borne by the entire population to finance benefits for the small subset of the population covered by the pension system. But as coverage rates expand, this important distributional concern will be less significant. If payroll tax administration becomes as efficient as administration of the VAT, then it would instead be appropriate to use the payroll tax to finance the social pooling benefit.

We recommend that social pooling be redesigned by the time today's younger workers retire. It is important that a redistributive pay-as-you go component like social pooling be part of the overall Social Security system, especially as the system is expanded to cover a larger portion of the population. However, when combined with the retirement income produced by the individual accounts, the current target of providing a benefit throughout retirement equal to 25 percent of the provincial average wage will produce replacement rates that are very high relative to world standards. And as the population ages, this generous benefit level means that future payroll tax rates will need to be very high – possibly around 20 percent for the social pooling benefit alone. Therefore we suggest careful study of ways to redesign social pooling.

Possibilities include:

- Reducing expenditures by raising retirement ages (thereby reducing the number of years that people receive this benefit).
- Reducing expenditures by maintaining benefits at the age of retirement at 25 % of the average provincial wage, but permitting benefits at later ages to grow more slowly than would be implied by maintaining this target throughout retirement.
- Replacing the social pooling benefit with a better targeted supplement to the individual account benefits. Current social pooling gives benefits to those with above-average incomes as well as to lower-income individuals. Instead, social pooling could be used to provide a floor on the retirement income coming from

individual accounts or to provide a means-tested benefit that reflects people's other retirement resources as well.

4. Funding investment-based individual accounts

We believe that China's decision to create investment-based individual accounts was a wise one.

- Investment-based accounts make the promise of future benefits credible and the link between tax payments and future benefits transparent. These two features are essential for raising compliance with the payroll tax and therefore to expanding coverage of the system to a larger portion of China's population.
- Investment-based accounts will also keep long-run tax rates much lower than would be possible in a pay-as-you-go system like a notional accounts system.
- Investment-based accounts will contribute to the development of the Chinese financial system.

Some foreign experts have recently suggested that China should follow an alternative approach and adopt an unfunded notional account system in which people's individual accounts are just a record-keeping device. Such an approach has four serious drawbacks for a country like China:

- First, because the accounts will be permanently empty, workers and firms will not have confidence that the government will actually pay benefits. Many will therefore continue to be reluctant to pay payroll taxes.
- Second, because such a system produces revenue in the short run that is not needed to pay benefits (since no money is placed into accounts), local and provincial governments will become accustomed to using this revenue for other purposes making it hard to establish a clear principal that payroll tax revenue be devoted to retirement benefits. This will further undermine worker confidence in the system.
- Third, because a notional defined contribution system is a pay-as-you-go system, tax rates in the long run will have to be very high. An investment-based system can produce a benefit equal to 35 percent of a worker's final wage using a contribution rate of between 4 and 8 percent (depending on the rate of return earned by the investment-based accounts). Over the next 15 years the ratio of retirees per active worker is projected to fall from 3 to 1 down to below 2 to 1. Under this scenario, a pay-as-you-go system such as a notional defined benefit system would require a future tax rate that is substantially higher than that in an investment-based system.
- Fourth, while Chinese savings rates are currently very high, this may not be the case in the future. An unfunded system like a notional defined contribution

system reduces national saving and therefore the size of the economy.

We believe China should fully implement its investment-based system as soon as possible.

- At this time, the Chinese financial system is still relatively new, and returns on market investments have not been as high as the return on physical investments. The real rate of return on physical assets (i.e. business equipment and structures) is difficult to estimate for the Chinese economy. In the U.S. that rate is about 10 percent. Because China has so many investment opportunities and a high ratio of labor to capital, the real rate of return in China should be higher than in the U.S., perhaps 15 percent. Financial markets are improving rapidly and financial rates of return over the next decade should start to be in line with the high real return on physical capital.
- Moreover, annual individual account investments from an 8 percent tax on the wages of urban workers would be a small percentage of China's GDP and small relative to existing investments in business capital stock and housing. Even in its current state, the Chinese financial markets can easily absorb additional investments of this magnitude. Some portion of the investment based account accumulations could also be invested internationally since China has a large current account surplus. Thus, there is no need to postpone implementation of the investment-based system until after financial markets are more developed.

By taking these four steps to achieve the full potential of its social security system, China will successfully handle the aging of its population and speed the modernization of its economy.