

Banking, Budgets, and Pensions: Some Priorities for Chinese Policy

Martin Feldstein

Professor of Economics , Harvard University
President, The National Bureau of Economic Research

Remarks presented at the China Development Forum 2003
of the Development Research Center
of the State Council of the People s Republic of China

Thank you. I am very pleased to participate again in a Forum sponsored by the Development Research Center. I am honored by your invitation to speak about some of the economic policy choices facing China at this time. It is a particular pleasure to do so now, soon after the appointment of many new key policy officials.

I will focus my remarks on what I see as the primary fiscal problems facing China. More specifically, I will talk about the banking systems nonperforming loans, about the budget deficit, pension finance, and the structure of taxes.

It is of course somewhat foolhardy for a foreigner to offer advice on economic policy in a country with such complex institutions and problems as China. This is especially so for someone like myself who is not a specialist on the Chinese economy. But I know from experience that you will forgive my errors and seek out whatever useful suggestions there are in my comments.

Before turning to my specific subject, let me say how greatly impressed I am with China s economic and social progress in the past two decades. I first came to China in 1982 and spent several weeks traveling around the country. The economic growth since then and the resulting rise in the standard of living of the Chinese people are among the most remarkable and gratifying achievements in the economic history of the world.

Last year, in order to see for myself how much these achievements had spread to poorer regions of China, I traveled for several days in Shanxi province from Beijing to Taiyuan. Although this is a province with below average income, I was very impressed with the dramatic pace of road building, housing construction, and other signs of transformation. And in Taiyuan, the provincial capital, I found a thriving city in which the stores were full of a wide array of modern products.

Of course, China continues to face serious problems, including the problems of poverty, of rural development, of regional inequality, and of inefficient state owned industries. But I am convinced that China will proceed to tackle these problems in the same pragmatic and successful way that has brought about the remarkable changes during the past two decades.

Nonperforming Loans at China's Banks

I want to begin my discussion of China's fiscal problems by commenting on the problem of the banks' nonperforming loans. Some observers of the Chinese economy worry that the weakness of the banking system threatens the very future of the economy. We have certainly witnessed many countries in recent years where a weak banking system led to a financial crisis which then turned into a general economic crisis.

In my judgement, this will not happen in China. As you know, the major banks here are not private commercial banks in the same way that they are in the United States and in many developing countries. Until recently, the banks here have been essentially a part of the government system, financing investments, wages, and the pension costs of state owned enterprises that are often not able to repay those debts.

The resulting bad loans, although technically problems of the national banking system, are effectively a fiscal problem. The banks will not be allowed to default on their deposits and the only way that such default can be avoided is by an injection of government funds equal to the difference between the deposit liability and the amount that the borrowers can realistically be expected to repay.

The United States had a similar problem in the 1990s when a large number of our savings banks (also known as saving and loan associations or thrifts) came to have deposit liabilities that substantially exceeded the true value of their loan portfolios. These banks had provided long-term mortgage loans at fixed interest rates. When short-term interest rates rose sharply, the banks had to pay more on their deposits than they were receiving on those mortgages. The U.S. government stepped in and made up the difference between the value of the banks' liabilities and the reduced value of their assets. In most cases, there was also a sale of the troubled bank to another healthier bank.

Although the source of the banking problem in China is very different, the principle is the same. Once the problem is recognized, it inevitably becomes an obligation of the government. It should of course be managed in a way that encourages the banks to collect as much as possible of the money that they are owed and to avoid actions that will add to the volume of bad loans. This requires giving the right incentives to the banks and to their executives.

The problem is much larger in China relative to your GDP than it was in the United States. I have seen a variety of estimates, including a calculation by Standard and Poors, the U.S.

rating agency, that it would take about \$500 billion (or more than 4000 billion Rmb) to make up the bank asset shortfall, an amount equal to about 40 percent of China's current GDP.

The process of recognizing the fiscal nature of this problem here in China began with the creation of the asset management companies, the transfer of bad loans to those institutions, and the injection of government funds into the banks to replace the bad loans. This is very similar to the strategy adopted in the United States with the Resolution Trust Company which received the assets of failing U.S. banks.

The problem in China is not only larger but also much more complex than the one faced in the United States where the bad loans were backed by home mortgages and residential real estate, assets that were much easier to value and sell than claims on loss-making state owned enterprises, many of which have little or no potential market value.

My main point about the nonperforming loans is that the difference between the assets and liabilities of the banking system should be recognized as part of the national debt, a reflection of the past losses. Because of this large banking system national debt, it is fortunate that the traditional debt of the Chinese government is relatively small, only about 16 percent of GDP at the end of last year. To get an accurate picture of the total debt of the Chinese government, the traditional debt must be combined with the net liabilities of the banking system, bringing the total to nearly 60 percent of GDP. (There is also the unfunded obligations of the pension system, a subject to which I will return in a few minutes.)

Although a high ratio of national debt to GDP can lead to serious financial and economic problems, this will not happen in China if the government acts prudently. Why? First, unlike some countries that have gotten into trouble because of high debt levels, China's debt is to domestic savers and not to foreign lenders. There is no danger to China of a currency crisis that results from an unwillingness of foreign lenders to roll over debt.

Of course, even a country with domestic debt can get into trouble if the debt is growing relative to GDP. Interest bearing debt grows automatically as interest accrues and the ratio of debt to GDP may rise if the rate of interest exceeds the rate of economic growth. Fortunately, and this is my second reason for optimism about China's ability to cope with its national debt, China's strong rate of economic growth prevents the debt-to-GDP ratio from rising as long as new deficits remain small or can be turned into surpluses by prudent tax, spending, and banking practices.

More specifically, if China grows at 7 percent this year and pays an average interest rate of 3 percent on its bonds and on the deposits in commercial banks, the debt to GDP ratio will decline if the budget deficit excluding interest payments—the so-called primary budget deficit

is kept to less than three percent of GDP.* The relevant measure of the primary deficit must include not only the traditional budget but also the increase in the value of bad loans that is not due to the interest on the existing bad loans. So the challenge to keep the primary deficit low is a difficult one. But with China's strong rate of economic growth and modest interest rates, China has the ability to keep the debt to GDP ratio from rising and certainly to keep it from rising rapidly. And when the problems that give rise to the nonperforming loans are reduced or eliminated, the debt to GDP ratio should begin to fall.

Even if the restructuring of the state owned enterprises implies increases in the total volume of nonperforming loans over the next decade, it is possible to stabilize the full debt to GDP ratio if there are surpluses or only small deficits in the traditional government budget. The rapid growth in China's tax revenue (up some 15 percent last year or twice the rate of GDP growth), coming primarily from the value added tax, can lead to budget surpluses or to small budget deficits.

This brings me to the third piece of the national debt, the need to finance retirement pensions for those who are now retired or will soon retire.

Current and Future Pension Benefits

Every nation faces the problem of how to provide income for those who are too old to work. While individuals in a market economy might be expected to provide for their own retirement years by saving while they are young, experience shows that it is necessary for the government to supplement this individual saving even in affluent countries. In China, with a history in which SOEs provided retirement income for lifetime employees, there is a current need for substantial state-provided retirement pensions. The closing of SOEs leaves many retirees dependent on state financed pensions. Moreover, the ability to close money losing SOEs, and therefore to stop the growth of nonperforming loans, depends on being able to provide for those who will lack retirement income as a result of the closing of the enterprise.

As many of you know, the Chinese government decided some years ago to create a pension system that combines a taxpayer financed basic benefit with mandatory individual investment-based accounts. The basic benefit, known as the "social pooling" benefit, is intended to be equal to some 25 percent of the regional average wage. The individual accounts are intended to finance an annuity equal to 35 percent of the final level of earnings for someone who has contributed for a full working life. The combination of the two would thus provide benefits

*The precise statement is that the debt to GDP ratio will decline if the deficit as a percent of GDP is less than 60 percent of the difference between the nominal rate of growth and the nominal rate of interest. With a nominal rate of growth of 8 percent – real growth at 7 percent plus one percent inflation – and an interest rate of 3 percent, the debt to GDP ratio will fall if the primary deficit is less than three percent. (The 60 percent in this calculation reflects the fact that the debt to GDP ratio is currently 60 percent.)

equal to 60 percent of final earnings for an average worker and more for those with below average earnings.

In my judgement, this was a very wise decision. When it is fully phased in, it will permit maintaining high levels of retirement consumption without correspondingly high taxes. It is a good system not only for China but for other countries as well, including the United States. But despite this appropriate structure, the Chinese system has not worked as well in practice as the system appears on paper. The primary problem has been the government's general failure to collect the revenue needed to finance this pension program in the way that is called for by the program's design.

More specifically, the pension system is supposed to collect about 24 percent of employee earnings (the amount varying slightly from province to province) from enterprises plus an additional 8 percent of the employees' earnings from the individual employees themselves. These funds are to be used to finance both the payments to existing retirees and the accumulation in individual accounts. In practice, however, the revenue collected in this way has been only enough to finance the benefits for existing retirees and, in some regions, not even enough for that. As a result, no money is available for contributing to the individual accounts. Individuals do have individual pension accounts and funds are credited to the accounts but everyone recognizes that these are simply notional deposits which accrue an accounting rate of return but which do not represent any real asset ownership by the individuals.*

In short, the current Chinese system has the structure of a mixed system with a substantial investment based component but it is in fact a pay as you go system that is using all of the current collections to finance the benefits of current retirees. If this is not changed, the long term cost of the program will rise as the population ages and as the incomes on which benefits are based also increase.

I believe that the basic reason for this problem of inadequate collection of funds is that there is widespread evasion of the payroll taxes or pension contributions that are supposed to finance both current benefits and the contribution to the individual accounts. The revenue that is actually collected is less than one-third of what would be expected at the tax rates that are currently being used. Because of these very high rates, individuals and companies either refuse to participate or, more commonly, understate their full income.

Tougher enforcement of the existing law could no doubt improve collections, especially from firms that now refuse to pay at all. But the real problem is that both the individual employees and their employers have a strong incentive to evade the high marginal tax rate. The firms regard their payments as a payroll tax that is not automatically offset by lower wages. For any individual firm, evading such a tax does not change the wage bill and therefore adds directly

*An exception to this description is the experiment recently begun in Liaoning province where a special central government subsidy permits actual funding of individual accounts.

to the firm's profits. Individual employees have no reason to encourage their employers to make the required tax payments since almost all of those funds would be used to finance the benefits of existing retirees. Even the funds that are specifically earmarked to go into the individual accounts are often evaded because the deposits are simply notional amounts with no real investment and a quite low of notional rate of return.

Fortunately, there is a solution to this problem. The solution starts by recognizing the important difference in incentives between collecting funds for an individual's own retirement account and collecting funds to pay benefits to existing retirees or to finance the so-called Social Pooling expenditures.

In my judgement, the tax based on individual earnings should be used only to finance the contributions to individual accounts. If individuals know that they are contributing to their own accounts and that they will receive a rate of return in those accounts that is at least as high as the return that they can get elsewhere, the level of compliance will be much higher than it is today. Individuals will not only willingly contribute to their own accounts but will also put pressure on their employers to make the employer contribution to the individual account. With a high level of compliance and a reasonable rate of return, the tax rate needed to finance a retirement annuity equal to the target of 35 percent of final year earnings would be much less than the current rate of payroll tax.

That still leaves the question of how to finance the current and future social pooling benefits equal to 25 per cent of the regional average wage plus the transition benefits of current retirees who have not had time to accumulate funds in individual accounts and who will not receive funds from the SOE where they have been employed. It is useful to consider each of these two separately.

The social pooling benefits are a permanent feature of the pension program and need to have a permanent source of finance. I think the value added tax is the appropriate source of revenue for this purpose. China already has a successful value added tax with a high rate of compliance. It is probably the least distorting tax that China has or can have in the future, especially after the planned shift from the current income type VAT to a consumption VAT. Unlike the tax on wages, employers find it much harder to evade the VAT than they would to evade a tax on wages (because the VAT is based on the value of output and the next level customer will help to enforce the tax by demanding a receipt.)*

What about the transition costs for existing retirees and for those who will retire in the future with inadequate accumulation of funds? This should be regarded as a form of government debt and should be funded in the same way as other government debt. Although the

*. To the extent that a higher VAT rate leads to price increase that impose an inappropriate burden on rural households that will not benefit from the pension program, it should be possible to offset this by direct grants to rural areas.

debt is now implicit, when benefits have to be paid, the government will convert this implicit debt to explicit debt by using new bonds to raise the funds to pay for the benefits.

There are three options for dealing with this debt. First, the bonds that correspond to the pension payments could simply remain a permanent part of the national debt. Although the absolute amount would remain unchanged, the relative amount would decline as the economy grows. A second option is to sell existing government assets, particularly the shares in profitable state owned enterprises, and use the proceeds to reduce the existing debt, or to build a fund to meet future pension obligations as they come due. The key point is that the pension debt is not different from the traditional outstanding debt or from the net obligations of the banking system. The proceeds of asset sales could therefore be used to reduce any of these three forms of debt. Finally, there is the third option of raising additional tax revenue to reduce the national debt now or to prevent it from growing as pension benefits are paid.

These three kinds of options – allowing the debt to remain unchanged, using asset sales to finance the debt, and using taxes to reduce debt – have different effects on current and future taxpayers and on the role of the government in the economy. I will not try to advise among them. My key point is that these transition benefits should be treated as a form of national debt and therefore need not be financed on a current basis as the government is now trying to do by using the payroll tax for that purpose.

This brings me back to the original focus of my remarks on the size of the national debt relative to GDP. If the value added tax is used to pay the current and future cost of the social pooling benefits and payroll contributions are used to build individual retirement accounts, the size of the pension debt will decline relative to GDP even if transition obligations are financed with new bonds as the benefits are paid.

With the relative size of the pension debt declining in the way, the total debt – including the traditional government debt and the net obligations of the banking system – will also decline as long as the tax receipts are at least equal to the sum of the non-interest costs of the government plus any additions to the stock of the banks' bad debt. Fortunately, China's VAT collections are rising rapidly as the products that are subject to the VAT increase as a share of GDP.

Let me conclude by summarizing the main points that I have made in these remarks:

First, it is important to avoid the danger of a growing ratio of debt to GDP, where debt is measured to include not only the traditional government debt but also the net obligations of the banking system and the future pension obligations

Second, China is in a good position to achieve this because of China's high rate of economic growth, its reliance on domestic borrowing to finance the government debt, and the relatively low rate of interest on that debt.

Third, the mixed Social Security pension system is well designed but should be implemented by using payroll taxes only to fund the personal retirement accounts.

Fourth, the pension benefits to be paid during the transition should be regarded as a part of the national debt rather than as something that must be funded with concurrent taxes.

Finally , I want to restate my admiration for the economic achievement of China in the past two decades and my optimism that China will choose the right policies for the future. I hope that these remarks will help as you make these choices..

END