NEWSLETTER
LIFE AND PENSIONS

THE GENEVA ASSOCIATION

No. 54 March 2014

The Retirement System of China

By Hong Mao[+]

Introduction

China is an ageing society, with a low birth rate and an increasingly older population. The social security system lags seriously behind and is becoming a major problem for the future development of China. In the forthcoming 20–30 years, parents with only one child (because of the "one child" policy) will reach retirement age and the old-age population will increase even more with the arrival of greater numbers of elderly people. China is now facing a serious pension deficit. Why is this crisis occurring? In the following paragraphs, we will investigate the current retirement system in China and analyse the main problems the country is confronting.

The current retirement system in China

In China, the retirement system consists of three pillars: (1) the social security pension system, (2) enterprise annuities and (3) individual savings, the social security pension system being the most important component. The social security pension system makes up 89.5 per cent of the retirement system's total assets. The system is funded through an 8 per cent contribution out of employees' wages and another 20 per cent contribution from employers. The enterprise annuity is only 10.5 per cent. This scheme is very different from that in the U.S., where the social security pension is only 12.5 per cent, but the private annuity may be as high as 64 per cent. All pension payments from the social security system in China are tax-free, but enterprise annuities are taxed. The enterprise annuity was introduced in China as early as the 1990s, but its development up to 2005 was very slow. Average accumulative funds per year were only RMB4.5bn, but in 2004, the government issued a document on "The Performance Methods on Enterprises Annuity". Since then, the enterprise annuity scheme began to develop more rapidly, at an average annual growth rate of 32.55 per cent. But the number of enterprises and the population participating in it remained very small, with only 6.88 per cent of the total population. This was due to the great amount of money paid by enterprises to the social security pension system, which led to a lack of enthusiasm to support the enterprise annuity system. Therefore, some people think it necessary to lower the employers' rate of contribution to the social security pension system in order to foster the development of the enterprise annuity.

As regards the social security pension system, in 1995 China adopted a two-tier system that combines defined benefits and defined contributions. Participants will receive a defined benefit financed by pay-as-you-go contributions and also participate in a defined-contribution programme funded by both employers and employees. However, this combined two-tier system has not proven to be successful. The main problem is that the pay-as-you-go contributions—even at as high a rate as 28 per cent（18 per cent goes to pay-as-you-go pension payments and 10 per cent to individual accounts)—are far from enough to pay retirees' pensions. Funds need to be withdrawn from the individual accounts to compensate the deficits, thus leading to "empty" individual pension accounts. We will explain the main reasons in the next section.

It should also be mentioned that the systems for urban and rural areas are different; and even vary within urban areas themselves; there are also different pension systems for private-sector ("enterprise") employees and government staff. Government employees do not have to pay contributions and they receive a larger pension after retirement. No social security existed in rural areas until 2013 when it was first introduced, but with very low benefits (about RMB50 tax-free per month for each older person), which means that, even now, it is the responsibility of families to provide for their parents.

[+] Professor, Shanghai Second Polytechnic University, School of Economics and Management.

The Chinese have a tradition of relying on their savings—mainly in the form of deposit savings—for their future, but individual annuity and group annuity insurance have also developed somewhat. Up to 2010, there were more than 50 insurance companies offering several hundred different kinds of annuity insurance products including traditional annuities, participating annuities, investment-linked annuities and so on. In 2011, variable annuity insurance was allowed to be implemented in five cities (Beijing, Shanghai, Guangzhou, Xiamen and Shengzhen), but there were only two joint venture insurance companies selling this product, as most Chinese insurance companies consider variable annuities to be too risky due to high investment risk. Since 2011, the government has allowed insurance companies to issue tax-deferred annuity insurance (it has existed in Shanghai since 2009). Hopefully, people will have the motivation to buy more annuity insurance following a series of incentives issued by the Chinese government.

Main problems and their causes

Low collection rate

Although there is an increase in the number of participants to the social security pension system, the collection rate has dropped from 25.1 per cent in 2008 to 17.1 per cent in 2010 （the collection rate is the ratio of the population paying the contribution to the population not paying the contribution but participating in the social security pension system). The main reason is that the contribution rate is too high and the transfer procedure overly complicated; furthermore, if persons change workplaces, they are withdrawn from the social security pension system.

The elderly population is increasing, resulting in an increase in pension payments

China has entered the stage of an ageing society. The over-65 population, currently at about 9 per cent, is growing rapidly. It is expected to reach 30 per cent in 2065. The number of retirees will peak in 2050; meanwhile, the portion of the population aged 15–64 will rapidly decrease to 56 per cent. At the same time, the “one child” policy in force since the 1970s will limit the size of the workforce. The main reason may be that the baby-boomers will begin to retire over the next decades. Therefore, as the following data show, while the working population will diminish, the beneficiary population will increase more and more rapidly, thus heavily burdening the pension system. In 1982, for every retiree in urban areas receiving a pension, 15 persons were paying contributions, but in 2012, this ratio decreased to 3.6. This may be one of the main reasons for the Chinese pension scheme’s high deficit. The Social Security Bureau is now considering the possibility of raising the retirement age in order to reduce the pressure of excessive pension payments.

The imbalance between the replacement rate and the contribution rate

In China, the wage growth rate is very high. In 2007 the average wage was 5.5 times that of 1994. The average annual wage growth rate was as high as 14 per cent during this period. Table 1 shows the average replacement rate (rate for pension calculation based on salary), the average pension income of each retiree and the average wage. We can see that the replacement rate was higher in the period 2002 to 2008, but has been lower in recent years. Even at lower replacement rates, the pension deficit is still increasing, from RMB1,700bn in 2011 to an anticipated RMB1,830bn in 2012. However, the contribution rate is as high as 28 per cent and, at the same time, the government provided a partial subsidy each year. For example, in 2010, the total pension payment subsidy was RMB193.4bn, which represents 14.6 per cent of the total pension payment for that year. On the one hand, the pension income of retirees is low; on the other hand, the contribution rate is very high and places an excessively heavy burden on the working force.

Table 1. Imbalance between replacement rate and contribution rate

Years	2002	2003	2004	2005	2006	2007	2008	2009	2010
Average replacement rate (%)	63	57	53	50	45	42	44	45	44
Average monthly pension income for each retiree (RMB)	652	667	708	765	788	873	1072	1225	1362
Average wage (RMB)	12,422	14,040	16,024	18,364	21,001	24,932	29,229	32,738	37,147
The growth rate of average pension income for each retiree	14	2	6	8	3	11	23	15	11
Average growth rate of wages (%)	14.3	13	14.1	14.6	14.4	18.7	17.2	12.0	13.5

The social security of older-aged people lacks diversity

In China, social security pensions are the main source of the income of retirees in urban areas, representing 45.4 per cent of their total income, with 37 per cent coming from their children (other sources of income are returns on investments and part- or full-time work post-retirement). In rural areas, elderly people are mainly supported by their children. On the whole, the livelihood of retirees in their older years mainly depends on their family, especially in rural areas. The Chinese constitution provides that family members have the responsibility to support their parents in old age.

Government employees versus private-sector employees

The two different systems of social security for private-sector employees and government employees respectively cause great resentment among people working in enterprises. People working for the government do not contribute, but their replacement rate can be as high as 80 per cent, compared to only 40 per cent for the workforce of enterprises.

Low return of pension fund investments

The government strictly regulates the different forms of investment and the percentage allowed to be invested in each asset class by pension funds. Currently, the percentages of fixed income investment, short-term and long-term equity investment are 51 per cent, 38 per cent and 11 per cent respectively. The weighted return rate of these assets was only 3.41 per cent in 2010, which was even lower than the inflation rate of 5.4 per cent in that year.

Conclusion

In this article, we presented the current retirement system in China and analysed the main problems it is facing, such as: the ageing of the population, the low return of pension fund investments, problems resulting from the "one child policy", "empty account" and the pension system's large deficit due to the imbalance balance between the replacement contribution rates. Further study should be done on the design of a four-pillar retirement system so as to decrease or avoid pension deficit, increase the benefit of retirees and improve their life quality.

References

Fang, L. (2012, 21 March). The financial hidden trouble in social security pension of China needs to be solved urgently. *The News Paper of China Security*.

National Bureau of Statistics of the People's Republic of China. Available at www.stats.gov.cn.

Feldstein, M. (1999). Social security pension reform in China, *China Economic Review*, 10(2): 99–107.

http://dash.harvard.edu/bitstream/handle/1/2794835/feldstein_china.pdf?sequence=2

Ni, J. (2012). Why are enterprise annuities and individual pension edged out? *Newspaper of Sheng Zhen Business*, 6 July, edited by Yan Liu.

Hu, Y. (2012). How dangerous is China's Pension System? *The Day Paper of Wall Street* (in Chinese), 5 June.

Zhang, Y. (2012, 9 February). The reform of the pension system in China and the situation of its marketisationwww.howbuy.com

The development of annuity insurance in China is still slow and the driving force of developing variable annuity insurance is not enough (2012, 1 February). *Times of Finance*.