Extending Old-age Insurance Coverage in the People's Republic of China

Report
by a Study Team of the
International Labour Office

International Labour Office
Sub-regional Office for East Asia, Bangkok

January 2006

Foreword

In the 2004-2005 biennium, the Sub-regional Office for East Asia of the International Labour Office (ILO) undertook a study, in cooperation with the Ministry of Labour and Social Security (MOLSS) of the People's Republic of China, to identify ways to extend the coverage of China's old-age insurance system.

The study was prompted by the *Resolutions and Conclusions concerning Social Security* adopted by the 89th Session of the International Labour Conference, held in Geneva, Switzerland, in June 2001. At that session, the Conference called for "a renewed campaign by the ILO to improve and extend social security coverage to all those in need of such protection." [1] Extension of social security coverage is an integral part of the ILO's Decent Work agenda whose overriding goal is "to promote opportunities for women and men to obtain decent and productive work, in conditions of freedom, equity, security and human dignity".[2]

China has one-fifth of the world's population. Thus, extending the coverage of China's old-age insurance system is a key part of achieving the International Labour Conference's call for extending social security coverage to all persons in need of such protection.

The Constitution of the People's Republic of China provides that "the State shall establish a sound social security system compatible with the level of economic development."[3] Primary responsibility for carrying out this constitutional mandate rests with the MOLSS, which oversees the development of China's social security system at the national level. The MOLSS works with provincial Departments of Labour and Social Security responsible for the implementation and administration of the social security system in each province[4] of China.

The ILO study consisted of three parts. The first was the preparation of a report entitled *Evaluation of the Social Security System in China and the Plan for Extending Social Security Coverage*. This report, compiled by a team from the MOLSS, documented the development and current status of social security in China as a whole and in Fujian province in particular. It served as

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[1] ILO. *Social security: A new consensus.* Geneva, 2001. Page 1.

[2] ILO Director General Juan Somavia.

[3] Article 14, as amended on 14 March 2004 by the 10th National People's Congress at its 2nd Session. Accessed on 10 January 2006 from the website of the *People's Daily Online* at http://english.people.com.cn/constitution/constitution.html.

[4] When the terms "province" and "provincial" are used in this report, they refer not only to the actual provinces of China but also to the four municipalities which have the same legal status as provinces (Beijing, Chongqing, Shanghai and Tianjin) as well as to China's autonomous regions. The terms do not, however, refer to the Special Administrative Regions of Hong Kong and Macau.

a background paper for the second part of the study, which consisted of a mission to China by a Study Team of international experts.

The ILO Study Team was headed by Mr. Hiroshi Yamabana, the Social Security Specialist in the ILO's Sub-regional office for East Asia in Bangkok. Its other members were Mr. Rüdiger Knop, a former official of the ILO's Social Security Department in Geneva and a retired senior official of the Ministry of Labour and Social Affairs of the Federal Republic of Germany, and Mr. Edward Tamagno, a retired senior official of the Department of Social Development of Canada with extensive involvement in the International Social Security Association (ISSA).

From 25 October to 3 November 2005, the ILO Study Team visited Beijing and Fuzhou City to meet with social security experts from the central government (MOLSS and the Ministry of Finance), the Fujian provincial government, and the government of Fuzhou prefecture. On the basis of the background report and information gathered during the mission to China, the Study Team formulated its preliminary observations and recommendations.

These preliminary observations and recommendations were presented at a seminar held near Beijing on 14-15 December 2005. The seminar, which was the third part of the ILO study, brought together government officials as well as academic and trade union representatives specializing in the field of social security. Following the seminar, the ILO Study Team finalized its report, which follows. The report consists of the Study Team's recommendations as well as a summary of the Chinese old-age insurance system for workers in urban and rural areas.

The members of the Study Team express their appreciation to all the officials in Beijing and Fuzhou City who made themselves available for meetings during the Study Team's mission to China and who provided invaluable insights into the current status of China's old-age insurance system and its possible future directions. Their openness and spirit of cooperation greatly facilitated the Study Team's work. The Study Team also expresses its appreciation to the participants in the seminar at which its preliminary observations and recommendations were presented.

The members of the Study Team wish to express their particular appreciation to Mr. Changyou Zhu and Ms. Rulian Wu of the Beijing office of the ILO, and Mr. Genghua Liu of the Chinese Academy of Labour and Social Security, for their especially invaluable assistance before, during and after the mission to China. Each contributed significantly to the project.

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1. *Introduction*

The Government of the People's Republic of China has identified building an harmonious society as one of its foremost priorities. A foundation stone of an harmonious society is a robust and financially sustainable social security system that responds to the needs of citizens when they encounter contingencies such as old age and sickness which are beyond their control. China has decided that its social security system should balance solidarity and self-reliance, and that it must take into account both the evolving state of economic development in the country as a whole and the significant differences between China's urban and rural areas and among its provinces.

Old-age insurance is a critical part of a social security system. Great effort has been made in China over the past two decades to develop, on a step-by-step basis, an old-age insurance system which, when complete, will ensure that the elderly, who have made enormous personal contributions to the development of China and its economy during their working years, will be able to live their old-age in dignity and with a sufficient income to meet their needs. Achieving such an old-age insurance system is, at the same time, both a goal China shares with all other countries committed to social justice and a reflection of the particular respect that the Chinese people have traditionally shown to their elderly.

China has made notable progress in building its old-age insurance system. This accomplishment should not be underestimated. It is a tangible demonstration of the commitment of governments at the central, provincial, municipal, county and district levels to protecting the well-being of their citizens when they reach old age.

The work, however, is not yet finished. In particular, efforts must be continued and intensified to extend the coverage of the old-age insurance system to the large numbers of workers who are not now covered. This is one of the principal challenges facing China today.

The objective of the Study Team of the International Labour Office (ILO) was to suggest specific ways to realize the extension of coverage. The observations and recommendations in this report are put forward to this end.[5]

2. *Prerequisites for extending coverage*

In order for the extension of the coverage of China's old-age insurance system to be successful, the ILO Study Team believes that there are eight cross-cutting issues that must be addressed in parallel with the implementation of the specific measures to extend coverage proposed in

[5] The conclusions and recommendations in this paper are those of the members of the Study Team, and do not necessarily represent the position of the International Labour Office.

sections 3 and 4 of this paper. These cross-cutting issues are inter-related, and each requires urgent attention both on its own merits and as part of a comprehensive set of initiatives to strengthen and extend China's old-age insurance system.

2.1 Adopting a clear law governing old-age insurance

There has been extensive experimentation in China over the past two decades with different approaches to old-age insurance. From this experimentation, a model has emerged which underlies old-age insurance throughout China, although with some significant differences between and even within provinces.

The legal basis of the old-age insurance system is a series of decisions of the State Council setting out in varying degrees of detail the elements of the system. These decisions are supplemented by regulations of the provincial governments for implementing those decisions within each of China's provinces. This approach has allowed considerable flexibility to modify different elements of the evolving old-age insurance system as practical experience has been gained. However, now that the architecture of the old-age insurance system has been decided, the uncertainty resulting from the absence of a definitive legal framework, in the form of a national law, threatens to impede the further development of the system and, in particular, the extension of its coverage.

> ***Recommendation 1:*** *The National People's Congress should be requested to adopt a law as soon as possible that will provide a definitive yet flexible legal framework for the old-age insurance system.*

The law should address, in particular, the question of which categories of workers and their employers are subject on a mandatory basis to old-age insurance, and which are subject on a voluntary basis. It should also establish the other fundamental parameters of the old-age insurance system, including the retirement age (the age of entitlement to a pension), the contribution rate, the contribution base (the earnings subject to contributions), the formula for calculating benefits, and the method for regularly adjusting (indexing) benefits in payment.[6] As well, the law should address the issue of

[6] Although adjusting (indexing) benefits in payment is outside the *direct* scope of the ILO Study Team's focus, which is the extension of the coverage of the old-age insurance system, the Study Team nonetheless believes that the method of adjusting benefits has a bearing on the extension of coverage since it affects the adequacy of the benefits provided by the system and, therefore, the confidence that workers have in the system. Confidence in the system is an intangible element that influences the extent to which workers will make, or avoid making, contributions – in other words, whether they will seek coverage or try to avoid coverage. According to information provided to the Study Team, benefits in payment in the urban scheme are adjusted on an ad hoc basis that generally takes account of only part of the increase in average wages (usually 40 to 60 percent), as recommended by the State Council.

pooling and the necessity of achieving pooling at least at the provincial level throughout China (see section 2.4 and recommendation 6).

In addition, the law should contain a formula for determining the amount of subsidies that provincial governments can expect to receive from the central government for purposes of covering the unfunded liabilities arising in particular from the pre-1996 pension system and for gradually converting the nominal (empty) individual accounts of the current system into real (funded) accounts (see section 2.7 and recommendation 9). The amount of subsidy to which a province would be entitled should take into account several factors, including the average gross domestic product (GDP) of the province, the fiscal capacity of the provincial government, and the province's demographic (contributor-to-pensioner) ratio. Additional transitional subsidies may be required by some provinces during the period in which they move pooling up to the provincial level (see section 2.4 and recommendation 6) as well as for strengthening administrative capacity (see section 2.2 and recommendation 4).

Given the significant variations in economic development across China and the different fiscal capacities of the provinces, the national law should be sufficiently flexible to allow a reasonable degree of provincial variation, within limits established in the law and subject to the adoption of regulations by provincial People's Congresses. Once the national law has been approved, each province should be requested to develop and implement a plan to make the transition, as required, from the old-age insurance scheme currently in place in the province and the system mandated in the law. A reasonable period of time (for example, five years) should be allowed for the transition.

Recommendation 2: *Within a prescribed period from the adoption of the national law (for example, two years), the People's Congress of each province should be requested to approve regulations for the complete implementation of the national law in the province within the transition period specified in the national law.*

If a province fails to adopt a transition plan within the prescribed period, or if a province fails to carry out the transition plan, part of the subsidy which the province would otherwise receive from the central government in accordance

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Provinces, according to their financial capacity, can implement the increases recommended by the State Council or make larger increases. In Fujian province, for example, benefits in payment are adjusted annually in accordance with the average of two factors: the increase in local average wages, and the increase in average contributory wages (wages subject to contributions). In regard to the rural old-age insurance scheme, the Study Team was told that benefits in payment are generally not adjusted. This means that their real value, whether measured in terms of purchasing power or in comparison with the average wages of rural workers, declines over time.

with the national law should be withheld until such time as the province has taken the necessary corrective measures.

2.2 Strengthening administrative capacity

Adopting a national law that provides a clear legal framework for the old-age insurance system and adopting equally clear provincial regulations for the implementation of that law are necessary first steps to achieving a lasting extension of coverage. However, they are not, by themselves, enough. There must also be the administrative capacity at the central, provincial, city, county and district levels to ensure that the law and regulations can be fully and effectively implemented and administered.

The time allotted to the ILO Study Team did not allow it to come to any definitive conclusions regarding the existing administrative capacity or the capacity required to effectively implement and administer a national law and provincial regulations. However, from the information contained in the national report that was prepared as a basis for the work of the Study Team as well as from information in other studies, it seems clear that the existing administrative capacity needs to be strengthened. Comments made to the Study Team at meetings with officials of both the central government and the government of Fujian province confirmed this view.

Recommendation 3: *The MOLSS should carry out a study in a small (representative) sample of provinces to (a) determine the administrative capacity required at each level of government (central, provincial, city, county and district) to effectively implement, administer and oversee the application of the national law and provincial regulations; (b) document the existing administrative capacity; and (c) identify gaps between what currently exists and what is required. On the basis of this study, the MOLSS should develop a detailed plan, with cost estimates, for addressing the gaps.*

Administrative capacity has several facets. It includes, in particular, ensuring that there are a sufficient number of trained staff with the skills and knowledge required to implement, administer and oversee the application of the national law and provincial regulations. Particular attention should be given to strengthening the administrative capacity of provincial Departments of Labour and Social Security, where policies for the implementation and administration of the system in each province are developed, as well as that of the MOLSS, where oversight of the nationwide old-age insurance system must be carried out.

As well, the staff must be supported by the necessary tools and systems – especially by a computerized information technology (IT) system that gives staff access to records regarding contributors, their contributions, and benefits in payment. The development of such an IT system at the province-wide level should be a high priority in all provinces in which its does not already exist, since, together with appropriate procedures for registering and de-registering employees, this is the sole means of keeping accurate insurance records of workers who change jobs from one employer to another, whether in the same city or from one city to another.

When improving existing IT systems and developing new ones, consideration should be given to the importance of ensuring the compatibility of provincial IT systems with one another – that is, the capacity to communicate and transmit data between systems. This is critical for several purposes, especially in protecting the accrued (and accruing) pension rights of workers who move between provinces (see section 2.5 and recommendation 7). Consideration should also be given to the importance of ensuring that provincial IT systems all produce a core set of consistent and reliable data on the persons covered in each province and on the revenues and expenditures of the old-age insurance system in the province, so these can be used to oversee the system as a whole across China and, in particular, to determine the subsidies to which each province is entitled from the central government.

Recommendation 4: *The central and provincial governments should jointly provide the additional financial resources needed at the central, provincial, city, county and district levels to implement the plan described in recommendation 3, especially the costs related to recruiting the new staff who will be required to implement, administer and oversee the application of the national law and provincial regulations, training both current and new staff, and developing new or enhanced IT systems. In regard to provincial IT systems, compatibility should be a key consideration along with ensuring the production of a core set of consistent data that can be used to oversee the system as a whole at the national level.*

Those provinces with the financial capacity (the so-called "G-7" eastern provinces) could be expected to bear all or most of the costs from their own funds. Other provinces would likely require subsidies from the central government.

2.3 Strengthening compliance and verification mechanisms

Closely related to strengthening administrative capacity is strengthening the mechanisms to ensure compliance with the requirements of the national law and provincial regulations governing old-age insurance – in particular, the collection and payment of contributions on time, in the full amount, and for all employees who should be covered in accordance with the law and regulations.

Information contained in the national report that was prepared as a basis for the work of the Study Team, information from other studies, and comments made to the Study Team at its meetings with officials of the central and Fujian governments all suggest that there is considerable non-compliance with current legal provisions regarding the payment of old-age insurance contributions. This non-compliance takes the form of enterprises failing to report all the employees for whom contributions should be made and of enterprises under-reporting the wages of their employees in order to reduce the amount of contributions due.

Recommendation 5: *The central and provincial governments should jointly provide, as a high priority, the additional financial resources needed by provincial, city, county and district Social Insurance Agencies and/or Tax Offices for the recruitment and training of additional staff devoted to the collection of old-age insurance contributions. The objective should be to ensure that the legal provisions regarding the payment of contributions are fully and strictly enforced, and that the evasion of contributions is minimized. When instances of evasion of contributions are found, suitable financial penalties should be levied against the enterprises concerned.*

In addition, verification mechanisms should be put in place at the central and provincial level to audit the execution of the compliance function. The provincial units responsible for verification should be organizationally independent from the units responsible for compliance.

2.4 Achieving pooling at the provincial level

For a number of years, it has been the policy of the central government that pooling for the urban old-age insurance scheme should be brought up to the provincial level throughout China. Some provinces have achieved this goal. Others have not.

Pooling at the provincial level is essential for the extension of the coverage of the urban old-age insurance system. This is especially the case in regard to migrant workers and flexible employees, who are likely to change jobs frequently from one city to another within a province, depending on the availability of work.

In its meetings with officials of the central government, the Study Team was told that, in theory, when a worker changes jobs from one city to another (say from City A to City B), the balance in his/her individual account should be transferred from City A to City B. As well, City B should assume the liability for the entire base amount (pooling part) of the worker's eventual pension, including the portion arising from the worker's period of contribution in City A,[7] but without a transfer of resources from City A to City B for the latter.

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[7] In other words, if the worker reaches retirement age in City B, that city should determine the worker's entitlement to a pension by taking into account periods of contribution

In practice in a province without pooling at the provincial level, City B would not want to assume the liability for the entire base amount of the worker's pension because it would have to pay for this entirely from its own funds, but without having previously received the employer's contributions (which were made to City A and remain there). Faced with this situation, the worker is likely to request a refund of contributions at the end of employment in City A. This is to City A's advantage, because it has received the employer's contributions for the worker but will not have any liability arising from those contributions. It is the worker who ultimately has to suffer the consequences, in the form of not accruing rights to an old-age pension.

Recommendation 6: *Provinces that have not yet achieved pooling at the provincial level should be requested by the central government to develop a plan to achieve such pooling within a prescribed period of time (e.g. within five years). The central government should consider targeted subsidies, payable under prescribed circumstances, to provinces (especially those in central and western China) that may encounter particular financial difficulties in achieving pooling at the provincial level.*

2.5 Ensuring portability of accrued (and accruing) rights to benefits

Mobility of labour is an essential component of a robust and growing economy. An important mechanism for facilitating labour mobility is to ensure the portability of accrued (and accruing) rights to a pension when a worker moves from one city to another within a province or between provinces. Portability should apply both to the balance in the worker's individual account as well as to the accrued (or accruing) right to the base amount (pooling part) of a pension.

Achieving pooling at the provincial level, as proposed in recommendation 6, will protect the pension rights of workers who move from one city to another within the same province. However, pooling at the provincial level will not, by itself, protect the rights of workers who move between provinces. Other means will be required to realize this goal.

There are well-established mechanisms, widely used by countries around the world, for ensuring the portability of accrued (and accruing) rights to a pension when a worker moves from one jurisdiction to another. These mechanisms can be grouped into two categories, coordination and harmonization.

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in both City A and City B. If these periods total at least the 15 years required for entitlement to a pension, City B should pay the entire base amount (pooling part) of the worker's pension out of its own funds.

Both coordination and harmonization begin by totalizing (adding together) periods of contributions in two (or more) jurisdictions to determine if a worker meets the contributory requirement for a pension (in the case of China, the 15-year requirement for entitlement to the base amount of a pension). Under coordination, if the contributory requirement is met through totalizing, each jurisdiction pays the worker a pension that is proportional to the period of contributions actually completed in that jurisdiction. Under harmonization, on the other hand, one jurisdiction pays the pension based on the combined periods in the two (or more) jurisdictions.

Examples of bilateral coordination include the social security agreements which many countries around the world have concluded with one another. A noteworthy example of multilateral coordination is the European Union's Regulation 72/1408 which links the social security systems of the Union's 25 member-states. An example of harmonization is provided by Canada, where one province, Quebec, has its own pension plan while all the other provinces participate in a pension plan administered by the federal (national) government. Agreements between the Canadian federal government and the government of the province of Quebec ensure that persons who have contributed to both plans will receive their full pension from one plan or the other.

Inter-provincial agreements are not the only way to ensure the portability of pension rights for workers who move between provinces. An alternative means would be to bring pooling to the national level. However, national pooling, if it were to be achieved, would be many years in the future, so it is unlikely to provide a solution to the portability issue in the short or medium term.

Recommendation 7: *The MOLSS should conduct a study to identify options for protecting the accrued (and accruing) rights to a pension of workers who move from one province of China to another in the course of their working lives.*

2.6 Ensuring the financial sustainability of the old-age insurance system

The existing old-age insurance scheme for urban workers is financially unsustainable at the current contribution rates. As a recent World Bank study[8] has shown, either the future contribution rate will have to be dramatically increased (perhaps to as much as 40 percent of earnings), or subsidies from governments will have to be raised significantly from their

[8] Sin, Yvonne. *China: Pension Liabilities and Reform Options for Old-Age Insurance*. World Bank: Washington, 2005. Available on the World Bank's web site at www.worldbank.org.

already high levels,[9] or costs will have to be reduced through parametric changes to the urban pension scheme.

It does not appear feasible to contemplate contribution rates that are substantially higher than the current rates because this could negatively affect job creation and economic development as well as China's international competitiveness. Equally, it does not appear feasible, nor would it be sound economic policy, to significantly increase subsidies to the existing system (i.e. the system as it is now, without parametric changes) rather than target scarce government resources on specific activities and programs that advance national priorities. This leaves parametric changes to the urban pension system as the only realistic option.

Among the parametric changes that could be considered are the following:

- *Equalizing the retirement age for men and women, and raising both.* The current retirement age, especially for women, is low. Raising the retirement age would reflect increasing life expectancy.[10] In terms of the financial sustainability of the old-age insurance system, it would substantially increase the system's future revenues (by prolonging the period during which workers and their employers make contributions) while reducing future costs (by postponing the start of payment of pensions).

- *Strictly limiting the circumstances under which a worker can become eligible for an early old-age pension (a pension that starts to be paid before the usual retirement age).* If it is deemed necessary or desirable to pay an early old-age pension to certain groups of workers (for example, those engaged in hazardous occupations such as coal mining), the incremental costs of the early pensions should be paid by the enterprises or industries concerned or, if the enterprises or industries are not able to bear the costs, from government subsidies. The costs should not be borne by contributors and enterprises in general through their contributions.

- *Converting the individual-account amount of a pension (the part financed out of the balance in a worker's individual account) into a true annuity, using life expectancy at time of retirement and projected real rates of return on investments to determine the monthly amount to be paid in place of the current method of dividing the balance in the individual account by 120.* Life expectancy in China on reaching

[9] At a meeting with officials of the Ministry of Finance (MOF) in Beijing, the ILO Study Team was told that the central government's subsidies to the old-age insurance system had increased from CNY 9.2 billion in 1998 to CNY 52.4 billion in 2004. Overall, the central government provides about 90 percent of the total subsidies to the old-age insurance system, with provincial and local governments providing the remaining 10 percent. According to the MOF officials, the central government's share of the subsidies of the old-age insurance system is higher than any other area subsidized jointly by the various levels of government.

[10] See footnote below for estimates of life expectancy.

retirement age is already considerably more than 10 years, and it will increase further in future years.[11] Particularly if the current nominal individual accounts are made real (see recommendation 9), maintaining the factor of 120 rather than actual life expectancy on reaching the age of retirement will place severe cost pressures on the urban old-age insurance scheme because a substantial part of the costs of the individual-account amount will need to be paid out of the pooling fund.

Parametric changes such as those described above will result in smaller benefits being paid than if the changes were not made. Time, therefore, will be required to develop a consensus around the need for the changes. As well, some of the changes (e.g. raising the age of retirement and increasing the factor used in calculating the individual-account amount of a pension from 120 to actual life expectancy at retirement) should be implemented over a transitional period of several years so as not to create excessive disruptions for persons who are close to retirement age. For example, the retirement age could be increased by six months a year until it reaches the new retirement age. The factor used in calculating the individual-account amount could be increased to 125 in the first year following the adoption of the changes, and then by an additional 5 each year thereafter, until it reflects actual and future life expectancy at retirement.

Parametric changes, it should be noted, do not all have to involve reductions in benefits. Including some changes that will increase benefits to make the pension system more fair could be a useful strategy for gaining acceptance of a package of parametric changes.

One such possible change would be to link the base amount of a worker's pension (the amount which is currently 20 percent of the local average wage in the year prior to retirement) with the worker's number of years of contributions. Under such a change, persons who have contributed more than 15 years would get a larger base amount. This has been part of the pilot program in Liaoning province, where the base amount is increased by 0.6 percent for each year of contributions more than 15. It has reportedly been well received by workers. In addition, as discussed later in this paper on ways to extend the coverage of migrant workers (see section 4.3), the 15 years of contributions currently required for entitlement to the base amount of a pension could be lowered to five years, and a proportionately reduced base amount could be paid to workers with less than 15 years of contributions. For example, a worker who has contributed for only five years would receive a base amount equal to 6.67 percent of the local average wage in the year before retirement [6.67 = (5 / 15) x 20]. A worker who has contributed for 10 years would receive a base amount of 13.33 percent [13.33 = (10 / 15) x 20].

[11] According to estimates by the Population Division of the United Nations Department of Economic and Social Affairs (*World Population Ageing 1950-2050*), current life expectancy at age 60 in China is 18.1 years. At age 65 it is 14.5 years. By 2025-2030, these are projected to increase to 20.6 and 16.7 years respectively.

Recommendation 8: *The MOLSS, on a priority basis, should analyze possible parametric changes to the old-age insurance scheme for urban workers, with the objective of developing a set of proposals which, if implemented, will contribute to ensuring the long-term financial sustainability of the scheme at a cost that is deemed by government and stakeholders to be reasonable in the light of China's current and projected state of economic development.*

One additional observation is in order: It may be tempting to see the extension of coverage as a short-term solution to the financial problems of the current urban old-age insurance system. In the short term, extension of coverage will, in fact, increase the revenues of the system (through the additional contributions of the new contributors and their employers) without significantly affecting the system's expenditures (since pensions will not need to be paid for years to come, until the new contributors reach retirement age). However, in the medium and long term, additional pensions will ultimately need to be paid as a result of extending coverage and, in the absence of parametric changes to the existing system, the cost of those pensions will compound even further the financial pressures on the urban old-age insurance system. Therefore, the temptation to view extension of coverage, by itself, as a short-term solution must be avoided. Viable extension of coverage requires that it be done in tandem with parametric changes to ensure the long-term financial sustainability of the system.

2.7 Making individual accounts real

China has chosen an architecture for its old-age insurance system in which individual accounts play key roles. In fact, the rural old-age insurance scheme consists solely of individual accounts, while in the urban scheme individual accounts are an essential part of a two-pillar model.

The reason for having individual accounts is to build up a fund out of which an annuity can be paid when a contributor reaches retirement age. Although individual accounts can in principle be either nominal (empty) or real (funded), it seems clear that China's intention in making individual accounts a central part of its old-age insurance system was advance funding – in other words, that the accounts would be real. However, this is not what has generally happened. Because of the large unfunded liabilities of the pre-1996 pension system and a contribution rate since 1996 that has not been sufficiently high to raise the revenues needed to pay pensions as they become due, much of the revenues that should have been set aside in individual accounts have had to be diverted to the payment of pensions. The result is that the individual accounts have, *de facto*, become almost entirely nominal.

This situation should not be allowed to continue because, in the face of an ageing society, it will make it even harder in the future to ensure the financial sustainability of the old-age insurance system.

Recommendation 9: *Measures need to be taken as soon as possible to ensure that the contributions intended for individual accounts are, in fact, put aside for that purpose and that the individual accounts are made real. Options for achieving this goal should be included in the parametric changes referred to in recommendation 8.*

In practical terms, it may be necessary to treat the nominal portion of individual accounts (i.e. the amounts accrued before the measures referred to in recommendation 9 are implemented) as a further part of the unfunded liability of the old-age insurance scheme as a whole and, therefore, to be financed on a pay-as-you-go basis from pooling.

2.8 Diversifying the investment of pension funds

The shift from nominal to real individual accounts in the urban old-age insurance scheme proposed in recommendation 9, along with the expansion of coverage under that scheme as well as the rural old-age insurance scheme through the measures proposed in sections 3 and 4 of this paper, will substantially increase the amount of the reserve funds of the pension system.

At the present time, with the exception of the National Social Security Fund, the reserve funds of the old-age insurance system can only be invested in government bonds and bank deposits. These investment vehicles pay relatively low rates of return which are substantially below the growth in average wages.[12] Moreover, in the case of government bonds, they essentially only recycle contributions back to the central government, which will ultimately have to turn to future workers and employers for the revenues required when the bonds have to be redeemed to pay pensions.

The investment of the reserve funds of the pension system should be diversified in order to achieve a higher overall rate of return than is possible by investing only in government bonds and bank deposits. However, such diversification must be done in a way that does not involve an unreasonable degree of risk (i.e. negligible or negative rates of return, or outright loss of the funds).

[12] According to information obtained by the ILO Study Team during its mission to China, current government bonds pay interest of 3 percent (down from 4.4 percent in 2004). Bank deposits pay interest of 2.5 percent. Average urban wages, in comparison, have increased in recent years at an average annual rate of over 11 percent, while price inflation is currently 1.8 percent.

"Lessons learned" from the investment of social security funds, both positive and negative, can be found in the experience of other countries. This experience has shown that successful investment – especially investment involving diversification into higher-return and higher-risk asset classes such as equities – is highly dependent on establishing appropriate governance structures and adopting sound investment guidelines.[13]

Properly done, diversification could play a major part in ensuring the financial sustainability of China's pension system as well as further strengthen China's economic development and contribute to building the regulatory and supervisory mechanisms needed in a robust modern economy.

Recommendation 10: *Options for diversifying the investment of the reserve funds of the old-age insurance system should be undertaken. The study should include examination of means for protecting against undue risk of loss in investments and ensuring appropriate governance of the investment process.*

There is a long-term aspect of diversification that warrants comment. It arises in conjunction with the objective of making individual accounts real, as proposed in recommendation 9, and the much larger objective of extending the coverage of the old-age insurance system to China's entire workforce, which is the focus of this paper.

Assuming that individual accounts will continue to play key roles in the old-age insurance system when that system covers all of China's workforce, there would be about 500 million individual accounts in total. In a mature state, each individual account would have funds equalling, on average, about CNY 20,000 (in constant 2003 yuans). Taken together, the individual accounts would constitute a sum totalling some CNY 10,000 billion. Such a sum would almost equal China's GDP.[14]

The investment of such an enormous amount could cause substantial distortions to China's financial markets, even if China's GDP at that time is significantly larger in real terms than at present (which it certainly will be). Therefore, careful thought will need to be given as to how and where those investments are made. Otherwise, it could become fairly difficult to achieve a real rate of return comparable to what could reasonably be expected today or in the medium term through the investment of a much smaller diversified portfolio.

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[13] Model guidelines were recently developed by the International Social Security Association (ISSA) and presented at the ISSA's General Assembly in Beijing in September 2004. The ISSA's *Guidelines for the investment of social security funds* are available on the ISSA website (www.issa.int).

[14] According to data from the *Statistical Yearbook of China 2004*, China's GDP in 2003 was CNY 11,725 billion.

At the present time, this consideration is hypothetical. It will be many years in the future before a tangible situation might arise that will require a response. However, the possibility should be kept in mind because, if (when) the situation does arise, it will need a long-term solution that has been put in place far in advance of its arising.

3. Extending the coverage of urban workers

China has experienced rapid urbanization in recent years, and this trend is forecast to continue into the foreseeable future. In 1993, about 27 percent of all employed persons in China worked in urban areas. By 2003, this had increased to almost 35 percent. During the decade, urban employment, in absolute numbers, had grown from 183 million at the end of 1993 to 256 million at the end of 2003.[15]

For purposes of old-age insurance in China, the term "urban worker" is generally used to describe all those persons whose registered place of residence is in an urban area. This reflects, to a considerable degree, a distinction between urban residents/workers and rural resident/workers with long historical roots.

In the past, the population of China could be divided into relatively distinct categories of urban and rural. In recent years, however, these categories have become increasingly blurred, as large numbers of rural workers have come into cities to find employment while retaining ties to their rural places of origin. As a result, the categories "urban worker" and "rural worker" are, today, often not mutually exclusive. Nonetheless, the urban/rural distinction is still relevant for analytical purposes.

There are four broad categories of urban workers:

- *Enterprise employees* – persons who work under a formal labour contract and who have a stable employment relationship with a state-owned enterprise (SOE), collectively-owned enterprise, public institution (other than those financed entirely from government budgets), joint venture or privately-owned enterprise.

- *Flexible employees* – those who have an unstable employment relationship with an enterprise, without long-term job security, and often without a formal labour contract. Many flexible employees were formerly employed by SOEs that went bankrupt or that downsized their workforces. Many other flexible employees are migrant workers (residents of rural areas who come to cities to find work, either year-

[15] National Bureau of Statistics and MOLSS. *China Labour Statistical Yearbook 2004*. Beijing, 2005. Table 1-5.

round or seasonally). Since the extension of old-age insurance coverage to migrant workers is examined in section 4.3 of this paper, the discussion of flexible employees in this section is concerned only with those who are urban residents.

- *Employees of small establishments* – persons who work for individual commercial or industrial entities (often referred to in China as "individual households") having less than seven employees.[16] Most such small establishments are in the service or related sectors – for example, neighbourhood restaurants, shops and grocery stores.

- *Self-employed persons* – those who work entirely for their own account.[17]

Slightly less than half of all urban employees (45.4 percent) are contributors to the old-age insurance scheme. This demonstrates the magnitude of the coverage gap that remains to be filled.

3.1 Urban enterprise employees

There are approximately 135 million urban enterprise employees in China. In principle, they are already virtually all covered by the old-age insurance system for urban workers. In practice, however, some of them are not covered. The lack of coverage is particularly a problem with privately-owned enterprises and some joint ventures.

It is difficult to quantify exactly the number of urban enterprise employees who are not covered. However, from the available statistics on contributors to the urban old-age insurance system, the ILO Study Team estimates that, nationwide, they constitute approximately 20 million workers.

The gaps in the coverage of urban enterprise employees are primarily due to the fact that some enterprises fail to report part of their workforce in order to avoid paying the 20 percent contribution due from employers.[18] In some instances this is done in collusion with the employees concerned, who, for a

[16] Seven is the measure used in Fujian province to distinguish small establishments (which have less than seven employees) from enterprises (which have seven or more employees). It is not clear if seven is used for the purpose of making this distinction throughout China, or if different numbers are used in other provinces.

[17] Caution is required in interpreting the meaning of the term "self-employed persons" in a Chinese context. In China, the category of "self-employed persons" often (but not always) includes the owner and employees of small establishments and, sometimes even, flexible employees and migrant workers. Except for the owners of small establishments, this differs significantly from the meaning given to the term "self-employed persons" in most industrialized countries.

[18] The contribution rate varies from province to province and, within some provinces, from city to city (or county to county). In Fujian province, for example, the contribution rate is 18 percent for employers, 8 percent for employees, and 25 percent for self-employed persons. However, to simplify discussion, this paper uses (unless specifically indicated otherwise) the contribution rates set out in the national legal framework: 20 percent for employers and 8 percent for employees.

variety of reasons, including myopia and perhaps lack of confidence in the pension system, prefer to keep the eight percent employee contribution for immediate consumption rather than having it set aside towards an eventual old-age pension when they reach retirement age.

The solution for increasing the coverage of urban enterprise employees is clear: strengthen compliance and verification. This has already been discussed in section 2.3 and recommendation 5.

The increases in coverage that can be achieved by targeted efforts at improving compliance are illustrated by the experience of the Tax Office of Fujian province, which assumed responsibility for the collection of old-age insurance contributions in that province in 2001. In 2000, the year before the Tax Office assumed this responsibility, 21,561 enterprises in Fujian were covered by old-age insurance, and there were 1,292,400 participating employees. By the end of 2004, the number of covered enterprises had increased by almost 3.5 times, to 73,875, and the number of participating employees had risen by more than 40 percent, to 1,827,400.

Recommendation 11: *In the implementation of recommendation 5, the first priority should be to target registered enterprises in order to ensure full coverage of all the employees of those enterprises.*

3.2 Flexible employees, employees of small establishments, and self-employed persons

There are an estimated 40 million flexible employees and employees of small establishments in China. The number of self-employed persons is estimated at 10 million.

Whether flexible employees, employees of small establishments and self-employed persons are covered by the urban old-age insurance system varies from province to province. However, even in provinces in which such workers are legally covered in principle, the actual coverage is low. This is primarily due to three factors: First, the workers themselves generally have low salaries, so they usually need all or most of their income for current consumption and are disinclined to contribute any part of it towards a future old-age pension. Second, in the case of flexible employees and employees of small establishments, their employers often do not want to pay the high employers’ contributions for old-age insurance. Third, the collection of contributions and compliance, which can already be a challenge for the regular employees of formal enterprises, is an even more daunting challenge when dealing with small establishments, persons in irregular employment such as flexible employees, and self-employed persons.

In spite of these challenges, efforts nonetheless need to be pursued to extend coverage, especially to flexible employees and employees of small establishments.

Some have suggested that a separate old-age insurance scheme should be created for flexible employees and employees of small establishments. The ILO Study Team does not agree with such a proposal. China already has three different old-age insurance schemes – one for urban employees, another for rural employees, and a third for civil servants. Moreover, the urban old-age insurance scheme varies, in some degree, from province to province. In the long term, the objective should be to harmonize the different provincial schemes for urban workers into a single unified program, and, in the even longer term, to eventually merge the urban, rural and civil-servant schemes into a single program. The creation of a separate scheme for flexible employees and employees of small establishments would only add more complexity to an already complex arrangement and further hinder labour mobility. It should be avoided.[19]

Flexible employees, employees of small establishments and self-employed persons who are registered residents of urban areas are urban workers. As such, they should be covered on a mandatory basis under the urban old-age insurance scheme. However, the high contribution rate for the urban scheme – 28 percent of wages, of which 8 percent is paid by the employee and 20 percent by the employer (with self-employed persons usually paying contributions at a somewhat lower total rate, for example 25 percent) – discourages enterprises from declaring their flexible workers, small establishments from declaring their employees, and self-employed persons from registering themselves.

The high level of contributions required from employers is primarily due to the large unfunded liability from the pre-1996 old-age pension scheme. This unfunded liability arises mostly from pensionable service performed prior to 1996 for SOEs and collectively-owned enterprises. The ILO Study Team does not believe that it is reasonable to expect employers of flexible employees, small establishments and self-employed persons to have to bear the same burden for this unfunded liability as that which enterprises must pay for their former and current regular employees. Instead, the Study Team believes that only part of the employer's contribution of 20 percent should be borne by the employer for these categories of workers, and the remainder should be borne by the central and provincial governments through a subsidy.

[19] In the course of meetings during its mission to China, the ILO Study Team was told of other proposals to create separate old-age insurance schemes for categories of workers such as migrant workers and employees of township and village enterprises. The Study Team's response to these proposals is the same as its response to the proposal for a separate scheme for flexible employees and employees of small establishments: They should all be avoided. Instead, means should be found for accommodating the particular circumstances of the groups of workers concerned within the existing urban and rural schemes.

As well, in light of the generally low wages paid to flexible employees and employees of small establishments, the ILO Study Team believes that the eight percent contribution rate applicable to regular enterprise employees should be lowered for flexible employees and employees of small establishments. The foregone portion of the employee's contribution should be paid instead by governments in the form of a subsidy. This would parallel a key aspect of the pilot projects in Liaoning, Jilin, and Heilongjiang provinces, under which a government subsidy (3.75 percent of contributory wages) is paid by the central government for all participating employees.[20] Self-employed persons should contribute at a rate equal to that of flexible employees and their employers and receive the same total government subsidy.

As an illustration of how this approach could be applied in practice, the employer's contribution could be set at 10 percent for flexible employees and employees of small establishments, and the employee's contribution could be set at five percent. The remaining 13 percent would come from government subsidies. Self-employed persons, in this example, would contribute at the rate of 15 percent, with the same 13 percent government subsidy to bring the total contribution to 28 percent. The schedule of contributions and subsidies under this example would, then, be as follows:

For flexible employees and employees of small establishments:

Employee contribution	5%
Employer contribution	10%
Government subsidy	13%

For self employed persons:

Self-employed contribution	15%
Government subsidy	13%

The ILO Study Team stresses that the preceding is intended only as an illustration of the proposed approach, and not a specific recommendation regarding the respective contribution rates of employers, employees and self-employed persons and the level of government subsidies. Determination of specific contribution rates and levels of subsidies would require a detailed analysis that is not possible in the time allotted to the Study Team for the current project.

Recommendation 12: *The contribution rate for flexible employees, employees of* small establishments *and their employers, as well as that for self-employed persons, should be lower than the contribution rate for*

[20] In effect, the contribution which an employee would otherwise have to pay is lowered by 3.75 percent of his/her contributory wages as a result of the central government's subsidy.

enterprises and enterprise employees. The difference should be made up by a government subsidy.

The government subsidy should be financed jointly by the central and the provincial governments. The relative shares of the central government and provincial government should vary from province to province according to a formula that takes into account the average GDP in the province, the fiscal capacity of the provincial government, and the province's demographic (contributor-to-pensioner) ratio.

The ILO Study Team notes three considerations which, in its opinion, should be kept in mind in regard to recommendation 12:

(1) The proposed lower contribution rate applicable to flexible employees and employees of small establishments could have undesirable side-effects if it were to be misused – for example, if employers (perhaps in collusion with their employees) were to try to declare regular employees as flexible employees in order to lower the contributions due and to benefit from the government subsidies. Clear guidelines, therefore, would be needed to identify the employees for whom the lower contribution rate would apply. Moreover, monitoring mechanisms would be required to ensure that the guidelines are being properly applied. These monitoring mechanisms would be an integral part of the strengthened means for ensuring compliance and verification discussed in recommendations 5 and 11.

One means for limiting possible abuse would be to base eligibility for the subsidy on an employee's annual wages rather than on the category in which the employee falls (i.e. whether he/she is a regular enterprise employee, a flexible employee, or an employee of a small establishment). This would ensure that the subsidy is targeted to employees with low wages. It would also ensure equal treatment for regular enterprise employees with low wages.

From a policy perspective, a targeted subsidy based on an employee's wages would be preferable for reasons of efficiency and equity to a subsidy based on the category in which the employee falls. However, from an operational perspective, such a targeted approach could be difficult to apply at the present time because of limited administrative capacity. It should, therefore, be considered as a possible medium-term option (3-5 years in the future) as part of the measures to strengthen administrative capacity referred to in recommendation 3.

(2) Self-employed persons who currently participate in the urban pension scheme already are generally treated preferentially in regard to the replacement rate derived from their contributions. Although their contribution rate is higher than that paid by enterprise employees (since self-employed persons must pay most or all of the employer's contribution along with the employee's contribution), their contribution base (earnings subject to

contributions) is usually a deemed amount equal, for example, to the local minimum wage, 60 percent of the local minimum wage, or 60 percent of the local average wage. Thus, the actual amount of their contribution (the contribution rate multiplied by the contribution base) may, in fact, be lower than the average amount of the contribution paid by an enterprise employee. However, the base amount (pooling part) of a pension is determined by the local average wage in the year prior to retirement, not on an individual contributor's contribution base. Taken together with the fact that the replacement rate (measured in relation to the contribution base) from the individual-account amount of the pension is the same for everyone, this means that a self-employed person derives a higher *total* replacement rate (again measured in relation to the contribution base) than a typical enterprise employee. The same would apply to flexible employees and employees of small establishments if the subsidized contribution rates proposed in recommendation 12 are implemented.

In the opinion of the ILO Study Team, this existing preferential treatment of self-employed persons, and the preferential treatment that flexible employees and employees of small establishments would receive from the implementation of recommendation 12, is justified because of the generally low wages most of these workers receive. They need to be subsidized, as an incentive for them to participate in the old-age insurance system.

(3) It is generally preferable, from a public financing perspective, for government subsidies to be directed to benefits rather than contributions because subsidies to benefits do not have to be made until later, when the benefits themselves are paid, while subsidies to contributions have to be made at the same time as the contributions are paid. However, if individual accounts are to be made real (see recommendation 9), there may be no alternative, in this instance, to subsidizing contributions.

On the other hand, an argument could be made for an exception to recommendation 9 in the specific case of the subsidized portion of the contributions to the individual accounts of flexible employees, employees of small establishments and self-employed persons. For these categories of workers, and *only* for the subsidized portion of the contributions to their individual accounts, a "notional" contribution could be credited to the accounts. When the workers concerned reach retirement age and become entitled to a pension, the annuity (individual-account amount of the pension) would be calculated on the basis of the real funds in their accounts (the actual contributions and the investment earnings on those contributions) as well as the "notional" funds (the "notional" contributions along with the deemed investment earnings from those notional contributions). The part of the annuity based on the notional contributions and the related deemed investment earnings would be paid by governments.

4. Extending the coverage of rural workers

Almost two-thirds of the Chinese workforce – 488 million workers – are in rural employment. In absolute terms, the number of persons in rural employment remained almost unchanged during the decade from 1993 to 2003. However, as a percentage of China's total workforce, rural employment declined from about 73 percent at the end of 1993 to less than 66 percent at the end of 2003.[21]

The decline in rural employment as a proportion of the total workforce will continue in coming years, as urbanization in China proceeds. However, the number of persons in rural employment will nonetheless remain very large by any measure.

At the present time, according to data from the MOLSS, only a small fraction of the total rural workforce – about 10 percent – is covered by the old-age insurance scheme for rural workers. The coverage gap, therefore, is extremely large. This underscores the urgent need for measures to ensure that more of the rural elderly will have some form of income security in their old age.

Although rural workers are often collectively described as "farmers", this has more to do with the fact that they are registered residents of rural areas rather than the actual work they perform. Many rural Chinese, in fact, work in cities or in non-agricultural activities in townships and villages.

For purposes of analysis, rural workers can be grouped into four categories:

- *"Real" farmers* – those who are actually engaged in agricultural activities, including raising crops, breeding animals, fishing and forestry.

- *Employees of townships and village enterprises (TVEs)* – persons who work in enterprises which are owned by townships and village and are located in rural areas.[22] TVEs are now often referred to in China as "non-public enterprises". However, the designation TVE is still used in many statistical reports so, to avoid confusion, it is also used in this paper.

- *Migrant workers* – residents of rural areas who have gone into urban areas to find work but whose registered place of residence remains in a rural area. These persons are sometimes referred to as "migrant farmers". In statistical reports such as the *China Labour Statistical Yearbook*, migrant workers are included in the category of "urban employment" since they work in urban areas.

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[21] *China Labour Statistical Yearbook 2004*. Table 1-5.

[22] Some TVEs are located in urban areas. Since, for all intents and purposes, such TVEs are indistinguishable from other urban enterprises, they should be subject to the same requirements regarding old-age insurance coverage as other urban enterprises.

- *"Land-lost farmers"* – persons who had been engaged in agricultural activities in the past, usually in areas adjacent to or near cities, but whose land has been expropriated for economic development, such as the construction of factories, office buildings, housing, retail facilities or public infrastructure (e.g. highways, airports, hydroelectric projects).

The four categories of rural workers are not mutually exclusive. In many instances, for example, a migrant worker may spend part of the year working in a city, and part of the year in his/her village engaged in farming (especially at the time of seeding and harvesting). This needs to be kept in mind in analyzing ways to extend the coverage of rural workers.

4.1 "Real" farmers

At the end of 2003, there were almost 313 million persons in China employed in raising crops, breeding animals, forestry and fishing. Some of these were probably employees in the usual sense of the term, while others were family members contributing to work on the farm. However, they have all been combined into a single group which, for lack of a better term, is referred to in this paper as "real" farmers.

The number of real farmers has declined from a high in 1991, when they reached almost 342 million. However, they still constitute almost two-thirds (64 percent) of all rural workers, and more than two-fifths (42 percent) of the total Chinese workforce.[23]

The rural old-age insurance system has primarily been designed to respond to the circumstances of real farmers. It consists solely of voluntary individual accounts, to which a farmer has complete discretion whether to contribute at all and, if he/she does contribute, to determine the amount of the contribution.

In the opinion of the ILO Study Team, the rural scheme's design is well suited to the economic situation of the great majority of Chinese farmers, whose cash income is low and often unpredictable because of external factors which are entirely beyond their control, such as weather or the market prices for the crops they produce. The scheme, however, has three principal weaknesses: the lack of incentives for farmers to make contributions, the relatively low rate of return on the funds in the individual accounts of those farmers who decide to make contributions, and the fact that the farmers themselves have to bear the entire risk related to the key variables that will determine the amount, and therefore the adequacy, of their pensions.

In regard to incentives, the Study Team notes that some villages with the financial capacity subsidize the contributions of their residents as a way of encouraging those residents to contribute to their individual accounts.

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[23] *China Labour Statistical Yearbook 2004*. Table 1-20.

However, the number of such villages is relatively small. Moreover, they are mostly villages with average incomes substantially above the median for rural China, and the residents of those villages already usually have more capacity to save for their old age than the great majority of Chinese farmers. Villages in central and western China, where the rate of rural poverty is generally the highest, are the least likely to be able to subsidize the contributions of their residents.

An alternative to subsidies from villages would be subsidies from the central and/or provincial governments. Given the total number of farmers in China, such subsidies – if they were to be considered at all – would have to be targeted to villages with low average incomes to be most efficient and to limit aggregate costs. For these same reasons, the subsidies would also have to be modest in amount (e.g. a subsidy of, say, CNY 10 for every CNY 100 contributed by the farmer him/herself). A question that arises is whether the annuity that would become payable from such subsidized contributions when a farmer reaches retirement age[24] would be sufficiently higher than the minimum livelihood guarantee (see recommendation 14) to act as an incentive for making contributions to an individual account in the first place.

Recommendation 13: *The MOLSS should examine options for subsidies from the central and/or provincial governments targeted to farmers in low-income villages as a means of providing incentives for those farmers to make contributions to individual accounts in the rural old-age insurance scheme.*

The second weakness of the existing rural old-age insurance scheme is the relatively low rate of return on the funds in the individual accounts which constitute the scheme. The rate of return is the direct consequence of the limitations on the ways in which the funds can be invested (i.e. the requirement that they be invested either in government bonds or in bank deposits). Because of the low rate of return combined with the lack of incentives to contribute to an individual account, it is debatable whether it is economically rational for a farmer to forgo current consumption by making a contribution to an old-age account, or whether it makes more sense for a farmer to spend what little disposable money he/she has on immediate needs.

Section 2.8 and recommendation 10 have already discussed the need to diversify the investment of old-age insurance funds in order to increase the overall rate of return without undue risk of loss. While this is an important issue for the urban old-age insurance scheme in which individual accounts

[24] For consistency of terminology, “retirement age” is used in this paper in regard to both the rural and the urban schemes when referring to the age at which a pension becomes payable (e.g. in the case of the rural scheme, age 60 for both men and women). However, the Study Team realizes that most “real” farmers do not, in fact, retire entirely from farming at this age and are likely to continue their farming activity (perhaps at a reduced intensity) well beyond it.

constitute one of the pillars, it is, in a sense, even more important for the rural scheme, in which individual accounts constitute the entire scheme.

The ILO Study Team, therefore, can only reiterate recommendation 10 and its call for a study of options for diversifying the investment of old-age insurance funds in order to increase the rate of return.

Finally, there is the issue of risk and, in particular, the fact that the risk is borne entirely by the farmers if they decide to contribute to an individual account in the existing rural old-age insurance scheme.

The risk takes several forms, two of which are of particular significance: [25] the uncertainty regarding the rate of return on the investment of the funds in a farmer's individual account prior to the time he/she reaches retirement age, and the uncertainty regarding the price of an annuity when a farmer reaches retirement age and uses the balance in his/her account to purchase an annuity. Either of these can negatively affect the amount, and therefore the adequacy, of the farmer's pension. Both are completely outside the farmer's control and, in a market economy, are at most only partially under the government's control.

The two risks just described are not unique to the rural old-age insurance scheme. They also exist in the urban scheme. However in the urban scheme these risks are mitigated by the presence of the base amount (pooling part) of a pension, which ensures a minimum benefit linked to local average wages in the year prior to retirement. There is no comparable part to a pension in the existing rural scheme.

In the opinion of the ILO Study Team, it is essential that a minimum guarantee – an income floor, financed out of government revenues, below which no aged farmer would be allowed to fall – be added to the rural old-age insurance scheme as soon as government finances permit. This is the only way to mitigate the risk of inadequate benefits in their old-age which farmers in China today must bear entirely by themselves.

The best means in theory for providing a minimum guarantee would be by complementing the existing rural old-age insurance scheme by a rural demogrant (a flat-rate benefit, paid in the same amount to all elderly rural residents) financed from the general revenues of the central and provincial

[25] A third risk that could warrant specific mention is the possibility of the mismanagement of the funds in the individual accounts and the resulting loss of part or all of those funds. Instances of the mismanagement of rural pension funds by some local authorities (e.g. investing funds in high-risk projects with insufficient prior analysis) are often cited as a principal reason that prompted the central government as well as many provincial governments to decide to suspend efforts at expanding the rural old-age insurance scheme until further studies could be carried out. From discussions at meetings with officials during its mission to China, the ILO Study Team is convinced that the Chinese authorities are fully cognizant of this risk and are determined to put measures in place that will minimize the possibility of its occurrence in the future.

governments. The rural demogrant, whose amount would be somewhat higher than the minimum subsistence level, would provide an income floor for all elderly rural residents. It would, therefore, respond to the dual objectives of poverty avoidance and poverty alleviation.[26] For farmers with incomes above poverty levels during their working lives, the individual accounts of the existing rural scheme would then focus on the objective of maintaining pre-retirement living standards. In this way, farmers would be allowed, according to their means and preferences, to save enough for their old age so that the annuity from their individual account, when combined with the demogrant, would provide an income sufficient to maintain approximately the same standard of living after retirement as they had before retirement.

A variant of a rural demogrant could be a basic rural pension, whose full amount would be the same as the demogrant, but entitlement to which would require having made contributions to an individual account in the rural old-age insurance scheme for a prescribed minimum period. For example, contributions to an individual account in at least 25 years could be required for entitlement to the full basic rural pension, with a proportionately reduced basic pension being paid to someone who has contributed for less than 25 years. To qualify, a contribution to an individual account in a given year would have to equal or exceed a prescribed amount that would be based on the average local rural income in that year. Subsidies (if any) from the central and/or provincial governments, as discussed in recommendation 13, would be taken into account in determining if the minimum annual contribution has been made.

A rural demogrant or basic pension, such as just described, would play a role in the rural old-age insurance scheme comparable to the one played in the urban scheme by the base amount (pooling part) of a pension (the part that is usually equal to 20 percent of the local average wage in the year prior to retirement). In the urban scheme, the base amount is financed on a pay-as-you-go basis from the pooled contributions of employers, supplemented as required by government subsidies. Since farmers do not usually have employers, it seems only reasonable that a rural demogrant or basic pension would be financed entirely from government sources.

Although a rural demogrant or a basic pension has much to commend it, even a very modest benefit could likely not be realistically contemplated in the foreseeable future because of the very large number of farmers in China, the limited financial resources of the provinces in central and western China in which rural workers are concentrated, and the competing demands on the resources of the central government. For example, a rural demogrant or basic

[26] The term “poverty avoidance” generally refers to the objective of keeping persons who were not poor during their working lives from becoming poor in their old age. The term “poverty alleviation”, on the other hand, refers to the objective of providing persons who are life-long poor a sufficient income in their old age to lift them out of dire poverty. Both objectives are clearly relevant to rural China today.

pension of CNY 100 a month to all farmers aged 60 and over would cost an estimated CNY 100 billion a year.

The alternative to a demogrant or a basic pension is a means-tested benefit sharply targeted to the poorest of rural residents. Such a benefit – the minimum livelihood guarantee – already exists in urban areas and is gradually being extended to rural areas. The ILO Study Team was told by officials of the central government's Ministry of Finance that the extension of the minimum livelihood guarantee across all rural areas of China, along with the improvement of coverage for medical insurance, are the central government's two highest priorities for rural social development in the short and medium term. The Study Team agrees entirely with these priorities.

Recommendation 14: *The extension of the means-tested minimum livelihood guarantee to all rural areas of China should remain a high priority and be accomplished as quickly as the financial circumstances of the central and provincial governments permit. While it will not, by itself, extend the coverage of the rural old-age insurance scheme to the majority of farmers who are not now covered, it will nonetheless address the problem of extreme poverty among the rural elderly, and advance the objective of social justice.*

4.2 Employees of TVEs

The number of rural workers employed by TVEs at the end of 2003 is estimated at 130 million. There are a wide range of TVEs. Some TVEs are virtually indistinguishable from urban enterprises, the only difference being that they are located in townships and villages in rural areas. In fact, some TVEs operate in urban areas and, except for the fact that they are owned by townships or villages, are effectively urban enterprises. Other TVEs, in contrast, are small economic entities with unstable workforces that have similarities to urban small establishments.

As a general rule, TVEs – no matter whether they operate in a rural or an urban area – along with their employees should be subject to the urban old-age insurance scheme. This is, in fact, already the policy recommended by the central government, although it has reportedly not been implemented consistently by all provincial governments throughout China.

However, before making a categorical recommendation regarding the coverage of TVEs and their employees, there is need to take account of the fact that TVEs with marginal profitability and unstable workforces may not be able to afford the 20 percent employer's contribution of the urban scheme. Requiring such TVEs to make that contribution could put an unreasonable financial burden on them and result in some (perhaps many) going out of business. This would be to no one's advantage and would, in fact, be counterproductive to the objective of extending the coverage of the old-age insurance system.

Two options are possible for addressing this issue. One would be to exempt such TVEs from mandatory coverage under the urban scheme and continue to allow their employees to make voluntary contributions under the rural scheme. The other would be to require those TVEs and their employees to be subject to the urban scheme, but under the lower subsidized contribution rates described in recommendation 12 for urban small establishments and flexible employees.

From the perspective of extending coverage, the ILO Study Team strongly prefers the second option, provided that the TVEs in question have the financial capacity to pay the employer’s contribution even at the reduced subsidized rate. This could only be determined through an analysis of the financial records of a sample of TVEs.

Whichever option is applied to TVEs with marginal profitability, guidelines would need to be developed by the central government for identifying the TVEs in question. The guidelines would have to allow a degree of flexibility, to be exercised by provincial authorities, for responding to local circumstances. The central and provincial governments would need to monitor the application of the guidelines carefully to avoid abuse as well as to ensure a reasonably consistent practice within each province and, to the extent possible in as large and varied a country as China, between provinces.

Recommendation 15: *As a general rule, TVEs and their employees should be subject, on a mandatory basis, to the urban old-age insurance scheme. However, recognition needs to be given to the circumstances of TVEs with marginal profitability. A study should be conducted of the feasibility of allowing such TVEs and their employees to contribute to the urban scheme at the reduced subsidized rates described in recommendation 12 for urban small establishments and flexible employees. If this option is adopted, or if, as an alternative, TVEs with marginal profitability are exempted from coverage under the urban scheme, guidelines should be developed setting out criteria to determine which TVEs would qualify for the option or the exemption. Application of the guidelines should be closely monitored to avoid abuse as well as to ensure consistency in practice.*

4.3 Migrant workers

The number of migrant workers in China is estimated at about 100 million. By some forecasts, their numbers may grow to as many as 300 million in the next 25 years.

Migrant workers have played a critical role in China's rapid economic growth in the past two decades, providing much of the labour in sectors such as construction and the service industries. The ILO Study Team was told at meetings with officials during its mission to China that the State Council has identified the extension of the coverage of migrant workers to be a high priority, and has asked the MOLSS to examine options for accomplishing this.

Some migrant workers move from rural to urban areas within the same province. Most, however, come from the poorer provinces of central and western China and go to the cities of the richer provinces in the east – the so-called "G-7" – to work. Whatever the source and the destination of the migrant workers, some factors are the same: generally low wages (on average, CNY 5,000 a year) and unstable short-term employment (on average, nine months per job).

In principle, migrant workers are subject, like other urban workers, to the urban old-age insurance scheme. However, the extent to which such coverage is actually realized varies from province to province and, within some provinces, from city to city. In some provinces and/or cities, the coverage of migrant workers is high, with most such workers and their employers contributing to the scheme. In others, the rate is low.

Whatever the coverage rate as measured by the payment of the required old-age insurance contributions, the *actual* or *effective* coverage rate is generally low throughout China because many (some informed sources suggest *most*) migrant workers for whom contributions have been paid request a refund of the contributions that have been credited to their individual accounts when they change jobs. Such refunds, which apply only to the employee's contribution and a small part of the employer's contribution but *not* to the entire employer's contribution,[27] are allowed under the current legal provisions governing the old-age insurance scheme if an employee has not contributed for the 15 years needed to qualify for a pension. Refunds are particularly prevalent just before the Lunar New Year, when most migrant workers return to their village or town of origin to celebrate the holidays with family and friends.

The starting points for extending old-age insurance coverage to migrant workers must be, first, clear statements in the national law and provincial regulations that such workers are subject to the urban old-age insurance scheme on a mandatory basis and, second, active measures to ensure compliance with these legal provisions. The means for accomplishing these objectives have been discussed in recommendations 1, 2 and 5.

[27] Generally speaking, of the total employer/employee contribution of 28 percent, the eight percent contributed by the worker along with three percent contributed by the employer – a total of 11 percent – are credited to the worker's individual account. The remainder of the contribution – the other 17 percent contributed by the employer – goes into the pooling fund.

However, these measures, important though they are, will not be sufficient on their own. Other major barriers to the effective coverage of migrant workers are the fact that pooling has not yet been achieved at the provincial level in many provinces of China and that portability of accrued (and accruing) pension rights for workers who move between provinces is practically non-existent, in particular as applies to the base amount (pooling part) of a pension.

As already noted, a migrant worker's average length of employment with a single enterprise is nine months. Even if a migrant worker were to remain exclusively in one city for all or most of his/her working life, he/she would need to have a considerable number of such jobs before ever reaching the 15 years of contributions required for a pension. And a great many migrant workers do not remain in one city. They must go from one city to another, or even one province to another, in search of available work.

In a province in which pooling has not been achieved at the provincial level, the periods of work in two cities of the same province are not added together in determining whether a worker has made sufficient contributions to qualify for a pension. This makes it entirely understandable why migrant workers who move between cities in such provinces request, at the end of each job, a refund of the contributions credited to their individual accounts. The same applies to migrant workers who move between provinces, given the absence of inter-provincial portability arrangements.

Migrant workers who request a refund of contributions may feel that they have made a cash gain by getting back their eight-percent contribution plus a portion of their employer's contribution (3 out of a total of 20 percent). However, the real "winners" in the process are the local old-age insurance funds. Those funds retain the greater part of the employers' contribution (17 percent), all of which can be applied to the shortfall in pension revenues if the local fund is in deficit or go into its reserves if it is in surplus. Moreover, at the same time, the local schemes are absolved of the future pension liabilities that would otherwise arise from the contributions.

Pooling at the provincial level throughout China and arrangements between provinces to ensure portability of accrued (and accruing) pension rights are two further essential measures required to extend effective old-age insurance coverage to migrant workers. In the absence of these measures, most migrant workers, who are generally low paid but who nonetheless play a crucial role in China's economic growth, will continue not to have pensions in their old age. Moreover, these workers will, indirectly, be subsidizing the pensions of better-off enterprise employees because of the contributions that their employers pay on their behalf and which are effectively mostly lost, as far as the migrant workers are concerned, when they receive a refund of contributions. This underscores the importance of recommendations 6 and 7 regarding provincial pooling and the portability of pension rights.

There is an additional consideration that was discussed in section 2.6 and which is of particular relevance to migrant workers. It has to do with determining entitlement to the base amount (pooling part) of a pension (the part that is usually 20 percent of the local average wage in the year prior to retirement).

Under the present legal provisions governing the urban old-age insurance scheme, the base amount is “all-or-nothing”. A person who has made contributions to the scheme for at least 15 years is entitled to the full base amount each month after reaching retirement age for the rest of his/her life, along with an annuity from the balance in his/her individual account. A person who has not contributed for 15 years is only entitled to a refund of the balance in his/her individual account and no on-going pension at all.

For migrant workers, with their unstable employment and frequent changes of jobs, 15 years of contributions can be a very long time. Along with the factors just discussed as well as the temptation of additional cash for immediate consumption, myopia, and perhaps lack of confidence in the pension system, it is likely another key factor that causes migrant workers to obtain a refund of contributions whenever they can.

It is reasonable to require 15 years of contributions before someone can be entitled to the *full* base amount of an on-going pension. However, as discussed in section 2.6, consideration should be given to a *proportionately reduced* base amount as part of an on-going pension for someone who has contributed for at least a minimum period (e.g., five years) but for less than 15 years. Under such an approach, a worker who has contributed, for example, for only five years would receive a base amount calculated as (5 / 15) x 20 percent, or 6.67 percent of the local average wage in the year prior to retirement. A worker who has contributed for 10 years would receive a base amount of 13.33 percent [13.33 = (10 / 15) x 20]. The reduced base amount would be added to an annuity from the balance in the worker’s individual account to produce an on-going monthly pension payable for the rest of the worker’s life, starting when he/she reaches retirement age.

Taken together with an information campaign aimed at making migrant workers more aware of the need to provide for their old-age and how the old-age insurance system can help them to achieve this goal, such a proportionately reduced base amount could make it more attractive for migrant workers to keep their contributions in the system rather than obtaining a refund of contributions. However, the temptation of the immediate money from a refund of contributions would remain, and many would likely still succumb.

The only guaranteed means for keeping this from occurring would be a prohibition against *any* refund of contributions before reaching retirement age. Such a restriction already exists in the rural scheme (at least in the rural scheme in some provinces), [28] where no withdrawal of contributions is allowed before reaching the age of eligibility for a pension (age 60). Consideration should be given to introducing a similar restriction into the urban scheme (as well as extending it to the rural scheme of all provinces, if this is not already the case).

Under such an arrangement, workers would effectively have their contributions, along with a part of their employers' contributions, "locked in" to their individual accounts until they reach retirement age. If, at that point, a worker has not made contributions for a sufficient period for even a pro-rated base amount (pooling part) of a pension, he/she would receive a lump-sum payment equal to the balance credited to his/her individual account (contributions plus accrued investment earnings).

As noted previously, some migrant workers spend part of the year working in urban areas and part in their rural areas of origin. Other migrant workers go to cities for a few years in search of work and economic opportunities, but with the intention of eventually returning to their place of origin. For both of these types of migrant workers, the rural old-age insurance scheme may be better suited, overall, to their needs than the urban scheme.

Consideration could be given to providing migrant workers who remain registered residents of a rural area with an option: At the end of a job in an urban area, they could choose between having the balance in their individual account remain in the urban scheme or be transferred to an individual account in the rural scheme. The latter, of course, would always be subject to the condition that the funds remain locked in to the account in the rural scheme until the worker reaches the age of entitlement to a pension. Such an option would allow those who are only temporarily working in an urban area to accrue their old-age insurance protection in the rural scheme, while those who have, for all intents and purposes, become urban workers would accrue that protection in the urban scheme.

If such a transfer option were available, a migrant worker who exercises the option would, clearly, forego the possibility of obtaining the base amount (pooling part) of an urban pension (or, at least, having those contributions taken into accounting in determining his/her eventual entitlement to a base amount). In recognition of this, an additional sum could be transferred from the urban old-age insurance fund to the worker's rural individual account. The additional amount could, for example, be calculated on the basis of the money value of the portion of the base amount that is foregone.[29]

[28] At its meetings with social security officials in Fujian province, the ILO Study Team was told that such a restriction applies in that province. It is not clear if this is generally the case throughout China, or if some provinces allow a withdrawal of funds from an individual account in the rural scheme before the contributor reaches the age of entitlement to a pension.

[29] A minimum period of contribution to the urban scheme – for example, at least six months or a year – would have to be required before an additional amount would be paid. The additional amount could be calculated on the basis of the length of a migrant worker's period of contribution and the portion of the base amount deemed to have accrued from those

Recommendation 16: *The extension of the coverage of migrant workers should be achieved by: (a) enactment of a clear national law and provincial regulations explicitly stating that migrant workers are subject to urban old-age insurance coverage on a mandatory basis (recommendations 1 and 2); (b) strengthening compliance mechanisms to ensure that these provisions of the law and regulations are enforced (recommendation 5); (c) achieving pooling at the provincial level to protect the accrued (and accruing) pension rights of migrant workers who change jobs within a province (recommendation 6); and (d) putting in place mechanisms allowing portability of accrued (and accruing) pension rights for migrant workers who change jobs between provinces (recommendation 7).*

Consideration should be given to lowering the contributory requirement for a pension under the urban old-age insurance scheme to five years, and allowing workers who have contributed to the scheme for at least that long, but not for the 15 years currently required for an on-going pension, to receive a proportionately reduced base amount as part of an on-going pension that would also include an annuity from the balance in their individual accounts.

If the contributory requirement were lowered, the refund of contributions should be prohibited before a worker reaches retirement age. However, migrant workers, at the end of a job in an urban area, should be given the option of transferring the funds in their urban individual account into a rural individual account. If a worker exercises this option, an additional sum should be transferred from the urban old-age insurance scheme to the worker's rural individual account in recognition of the worker's foregone base amount of a pension from the urban scheme.

4.4 Land-lost farmers

Land-lost farmers are a growing group among China's rural population who have been particularly affected by the country's rapid urbanization in recent years. It is estimated there are 40 to 50 million land-lost farmers in China.

Officials with whom the ILO Study Team met both in Beijing and in Fujian province spoke of the urgency of dealing with the multitude of issues affecting

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contributions. For example, if 15 years is required for a full base amount equal to 20 percent of the local average wage, one year of contribution could be deemed to have accrued 1.33 percent [(1 / 15) x 20] of the local average wage. Since such an additional amount would be paid even to migrant workers who, in total, will not have completed the minimum period of contributions to the urban scheme for entitlement to an ongoing pension (in the proposals in this paper, five years), fairness would suggest that all other contributors to the urban scheme who have made contributions for the minimum period required for the additional amount, but not for the period required for entitlement to an ongoing pension, should receive the same additional amount when, on reaching retirement age, they qualify for a lump-sum refund of the balance in their individual accounts.

land-lost farmers, in particular their general lack of coverage under the old-age insurance system.

The Study Team was told that, under existing legal provisions, a farmer whose land is expropriated is entitled to compensation from government which can be as high as 30 times the average annual income the farmer derived from the land in the three years before the expropriation. The actual amount of compensation varies from county to county. It appears that it is usually considerably less than the maximum amount just described.

Generally speaking, land-lost farmers are expected to use their compensation to generate income that will make up for the income which they no longer can derive from farming. Many land-lost farmers use their compensation to set up a small business (for example, a restaurant or store), although with mixed success since most do not have the experience or training to run even a small commercial establishment. Some villages provide land-lost farmers with a plot of land on which they can build a house, financed from the compensation, which will generate income from renting rooms. It seems likely that some (perhaps many) land-lost farmers become migrant workers and go to cities to look for employment.

In some places, land-lost farmers are required to put part of their compensation into an individual account in the rural old-age insurance scheme. The individual's contribution may be subsidized (matched) by contributions from the central and provincial governments as well as from their villages. A 30-40-30 matching formula (30 percent from governments, 40 percent from the village, and 30 percent from the farmer him/herself, with absolute limits on the amount of the government and village subsidies) was mentioned by one of the officials with whom the Study Team met, although it is not clear if this is an isolated example or a growing practice. The Study Team was told that it may soon become national policy that all land-lost farmers must put part of their compensation into an individual old-age account, although a final decision in this regard has not yet been taken.

The ILO Study Team understands the need to address the particular problems faced by land-lost farmers. However, in the opinion of the Study Team, the core of the issue is related to fairly compensating such farmers for the loss of income resulting from the expropriation of the land they used to farm as well as to assisting them to find new means of earning a living.

For older land-lost farmers, whose chances of successfully starting in a new line of work are limited, persuading them to contribute to the old-age insurance system may, in fact, be the best, or even the only, alternative. On the other hand, for younger land-lost farmers it may be more effective to give them access to training so they can develop new skills from which, combined with the funds derived from their compensation, they can earn a living in the future. Requiring such younger land-lost farmers to contribute part of their compensation to an old-age account could hinder their chances for a new beginning.

For these reasons, the ILO Study Team does not endorse a proposal for *requiring* land-lost farmers to contribute part of their compensation to an individual account in the rural old-age insurance scheme. However, the Study Team does support an approach in which subsidies are made available to land-lost farmers who choose, voluntarily, to make such a contribution. The subsidies could increase with age in order to give particular encouragement to older land-lost farmers to contribute.

Recommendation 17: *Part of the compensation for land-lost farmers could take the form of government subsidies, augmented as feasible by additional village subsidies, for those farmers who choose to put a portion of their compensation into an individual account in the rural old-age insurance scheme.*

5. Conclusion

This paper has set out a wide range of recommendations for the extension of the coverage of China's old-age insurance system to the workers who are not now covered by that system. Although the ILO Study Team believes that each of the recommendations in the paper warrants consideration, it also realizes that the recommendations cannot all be implemented at the same time. The scope is too great. It will be necessary to establish priorities, identifying those measures that demand immediate attention and those that can be postponed for a later stage.

Establishing priorities will be especially important in regard to the various government subsidies proposed in this paper. Consideration of the fiscal capacities of governments at all levels to sustain the old-age insurance system is essential. Pension systems are inevitably costly if they are effective, and government resources are limited. It is critical, therefore, that resources be allocated strategically in line with clear priorities, and that the costs be forecast into the future to take account of changing demographic and economic circumstances.

As was stated in the introduction to this paper, China has already made notable progress in building its old-age insurance system. From its meetings with officials of both the central government and the government of Fujian province, the ILO Study Team is convinced that China will continue to make notable progress in extending the coverage of that system. The Study Team hopes that this paper will be of some assistance in this important endeavour.

Epilogue

As the ILO study of means to extend the coverage of China's old-age insurance system was concluding, the MOLSS announced measures that had been decided by the State Council to strengthen old-age insurance for urban workers. These measures, contained in the State Council's *Decision on the Improvement of the Basic Old-age Insurance System for Enterprise Employees*, were as follows:[30]

- *Ensure the timely payment of all future benefits, deal promptly with any remaining arrears, and avoid new arrears.* In announcing the State Council's decision, the MOLSS noted that pension arrears, which stood at CNY 600 million a month in 1998, had declined to CNY 132 million in 2003. The MOLSS further noted that there were no new pension arrears in 2004 and 2005, and that 16 provinces have no pension arrears.

- *Develop unified policies for covering employees of small establishments, flexible employees and self-employed persons, and extend the coverage of persons in these groups.* A standard contribution rate of 20 percent should apply to these three categories of workers, as well as a standard contribution base (earnings subject to contributions) equal to the local average wage of on-the-job employees. In other words, all workers in the three categories will contribute as if their wages were equal to the local average of on-the-job employees, irrespective of their actual wage level.

- *Make individual accounts real, and develop transition plans for moving from an entirely pay-as-you-go system to a partially funded one.* Making individual accounts real has been a central part of the pilot projects in Liaoning, Jilin, and Heilongjiang provinces. Based on what has been learned in the pilots, measures will be taken to implement the goal of real individual accounts throughout China. As part of these measures, only an employee's own contribution of eight percent of wages will be credited in the future to his/her individual account rather than the eleven percent that has been credited to date. Moreover, as an incentive for employees to contribute to the old-age insurance system, the central government may subsidize (pay) 3.75 percent of the employee's contribution of eight percent, and local governments (provincial and municipal) may subsidize a further 1.25 percent, leaving only three percent of wages to be paid by the employee him/herself. The subsidy from the central government, however, would not apply to employees working in the so-called G-7 richest provinces of China.

[30] The information was primarily drawn from a document entitled *Situation on Improvement of the Basic Old-age Insurance System for Enterprise Employees* issued by the MOLSS on 15 December 2005 and accessible on-line at www.china.org.cn/e-news/news051215.htm.

- *Modify the method for calculating benefits, with particular attention to encouraging incentives to contribute.* The new calculation method affects both the initial (starting) base amount and individual-account amount of a pension, as follows:

  - The initial base amount of a worker's pension, which had previously been a flat-rate equal to 20 percent of the average local wage in the year prior to retirement, will now be determined by three factors: the average local wage in the year prior to retirement, the employee's average indexed personal monthly contributory wages over his/her career, and the length of the employee's period of contributions. Although no details are available regarding the second factor, it will presumably reflect the relationship between a worker's actual earnings over his/her career and local contributory wages in general over the same period. A worker who, for example, had wages in each year of his/her working life equal to the local average contributory wage of all covered workers taken together would likely have an index factor of one. On the other hand, a worker who had wages each year equal to 120 percent of the average of all workers would likely have an index factor of 1.2. To calculate the initial base amount of a worker's pension, the average local wages in the year prior to retirement will first be multiplied by the worker's index factor. After having accrued 15 or more years of contributions, the base amount of the worker's pension will equal one percent of this product for each year of contribution to the old-age insurance system. There will be no ceiling on the number of years of contribution that will be taken into account in the calculation.

  - The initial individual-account amount of a worker's pension, which was previously calculated by dividing the balance in his/her individual account at the time of retirement by 120, will be determined in a manner similar to that used for a conventional life annuity, based on the worker's further life expectancy at his/her time of retirement and projected rates of return on the balance in his/her account.

- *Establish a regular method of adjusting (indexing) benefits in payment.* This part of the State Council's decision seems intended to formalize the method already used for adjusting pensions in payment. The State Council will decide when adjustments should be made, as well as the amount of the adjustments. There will not be a fixed (e.g. annual) schedule of adjustments; rather, they will occur "at appropriate intervals", as determined by the State Council. The amount of the adjustments will be "at a certain ratio of annual average wage growth of the on-the-job enterprise employees."

- *Actively promote occupational pensions.*

- *Strengthen measures to ensure the payment of contributions, as well as improve the supervision and management of social security funds.*

- *Increase the level of pooling.*

- *Improve the delivery of services to pensioners.*

- *Strengthen the capacity of the agencies that administer the old-age insurance system, including standardized, computerized and specialized management, to insure the full implementation of policies*.

The State Council has requested provinces to develop plans for the implementation of the measures described above. Implementation will take place over the period covered by the 11th National Five-Year Plan (2006 to 2010), of which these measures are an integral part. The provincial plans should include concrete steps for extending coverage by at least 10 million workers nationwide in each of the five years.

In regard to the new method of calculating benefits, these will apply in their entirety to "new persons" – those who started work after the current urban old-age insurance system began operation (generally speaking, since 1 January 1996). Transitional arrangements, to be developed by provincial authorities, will apply to "middle persons" who had already started working before the new system began operating and who, as a result, have been covered by both the old and the new systems. The State Council decision specifies that no middle persons should have their pensions reduced as a result of the new calculation methods.

The measures for strengthening the urban old-age insurance system are, generally speaking, consistent with the conclusions and recommendations of the ILO Study Team. They address many of the issues which the Study Team identified as priorities requiring urgent attention.

The Study Team urges caution in implementing the measures regarding employees of small establishments and flexible employees. While little comprehensive data is available, it appears that the average wages of these workers is substantially below that of urban workers in general. Many of these workers could have great difficulty paying contributions at a rate of 20 percent of a deemed salary (the local average) which is considerably higher than their actual salary. This could result in large-scale evasion of contributions. A system of subsidies, financed by the central and provincial governments, will almost certainly be required.

Appendix

China's old-age insurance system

In accordance with China's constitutional and legal arrangements, the old-age insurance system is regulated by a general legal framework established by the central government authorities in Beijing and subordinate legal instruments for the implementation of that framework determined by provincial government authorities. In practical terms, old-age insurance in China consists of three separate systems: one for workers in urban areas, a second for workers in rural areas, and a third for civil servants.[31] The rules applicable to the three systems are very different. This appendix describes the old-age insurance system for urban workers and that for rural workers. It does not deal with the old-age insurance system for civil servants.

Section A looks at the national framework for old-age insurance for workers in urban areas. Section B discusses the national framework for workers in rural areas.

A. Old-age insurance for workers in urban areas

The oldest and most developed part of China's old-age insurance system is for workers in urban areas. The system covers, in principle, almost all persons working in urban areas. In practice, coverage to date has centered primarily on workers in the formal sector (enterprise employees). The State Council has identified the extension of coverage to workers in the urban informal sector as a high priority.

A.1 Legal framework

There are no formal laws of the National People's Congress (NPC) that deal specifically with the old-age insurance system. Instead, various instruments (decisions, circulars, proposals and regulations) promulgated by the State Council and by other competent authorities of the central government form the legal framework for the system at the national level. Implementation of the instruments is the responsibility of authorities at the provincial level.

[31] Generally speaking, the term "civil servants" refers to employees of government ministries and public agencies and institutions that are financed entirely from the state budget, whether at the central, provincial or local (city, county, district) level. Employees in urban areas of government agencies and public institutions which are financed (either wholly or partially) from sources other than the state budget are usually covered by the old-age insurance system for urban workers.

The most important instruments (along with the dates of their promulgation) are the following[32]:

- *Decision on the Reform of the Old-age Insurance System for Enterprise Employees* (26 June 1991);
- *Decision on Several Issues regarding the Establishment of the System of the Socialist Market Economy* (14th Central Committee of the Communist Party of China, 1993);
- *Circular on Furthering the Reform of the Old-age Insurance System for Enterprise Employees* (1 March 1995), often referred to as "Document No. 6" of the State Council;
- *Proposals on Establishing Occupational Pension Schemes* (29 December 1995);
- *Decision on Establishing a Unified Basic Old-age Insurance System for Enterprise Employees* (16 July 1997);
- *Circular on Raising Social-Pooling of Basic Pensions to the Provincial Level and Handing over the Industrial-Pooling of Basic Pensions to Local Departments* (1998);
- *Provisional Regulations on the Collection of Social Insurance Contributions* (22 January 1999);
- *Pilot Program on Improving the Social Security System in Urban China* (2000);
- *Circular on Improving the Basic Pension Insurance Scheme for Enterprise Employees in Urban Areas* (MOLSS, 2001);
- *Decision on the Improvement of the Basic Old-age Insurance System for Enterprise Employees* (3 December 2005).

A.2 Origins and evolution

1951	• Start of the system of old-age insurance for employees of SOEs and some collectively-owned enterprises. Consistent with China's planned economy of that period, the financing and administration (including payment) of the pensions were entirely the responsibility of the enterprise for which a pensioner previously worked.
1955	• Start of the old-age insurance system for civil servants (employees of government ministries and agencies and of other

[32] Unless otherwise indicated, the instruments were issued by the State Council.

	public institutions).
1978	• Decision taken to move in stages from a planned economy to a socialist market economy. • Creation of distinct old-age insurance schemes for enterprise employees and civil servants.
1979 to 1995	• Start of pooling (for a definition of this term, see section A.4 below) for SOEs and most collectively-owned enterprises in urban areas. By the end of 1995, some degree of pooling for SOEs had been achieved at the provincial level in 13 of the most economically advanced provinces, and in the rest of China at the county or city level. For collectively-owner enterprises, pooling was achieved in more than 2,000 counties.
1986	• Introduction of a labour-contract system to regulate relations between enterprises and their employees. • Consequential to this, gradual introduction of mandatory contributions by enterprise employees covered by the old-age insurance system. Prior to this time, pensions were financed entirely by contributions paid by enterprises and from government subsidies. The initial contribution rate for employees was set at three percent of wages.
1986 to 1993	• Establishment of pooling at the industry/sector-wide level throughout China for the following 11 industries and sectors of the economy: railways, water conservancy, electric power, post and telecommunications, coal mining, the China Construction Engineering Corporation, transportation, banking, civil aviation, petroleum and natural gas, and the Nonferrous Metals Corporation. This marked the effective start of the move away from the arrangement whereby pensions were paid by the enterprise for which a pensioner previously worked to a new arrangement whereby pensions are paid on a pooled basis to which various enterprises contribute. • Consequential to this, for the 11 industries and sectors of the economy just listed, transfer of the management of the related old-age insurance funds and administration of the related portion of the old-age insurance system to industry/sector-wide agencies.
1993 to 1996	• Decisions taken to study and experiment with a multi-pillar pension system consisting of a base amount and an individual-account amount (for a definition of these terms, see section A.12 below), supplemented (as needed and feasible) by occupational pension plans (see section A.16 below). The base amount would be financed through pooling at the county/district, city or provincial level as well as through government subsidies. The individual-account

	amount and supplementary occupational pensions would be financed by contributions to individual accounts. A provisional target was set to have such a multi-pillar pension system fully operational, and covering all enterprise employees and self-employed persons in urban areas by 2000.
1997	• Decision taken to establish an old-age insurance system for enterprise employees in urban areas throughout China consisting of a base amount and an individual-account amount.
1998	• Decision taken to cease pooling at the industry/sector-wide level and to move it in stages to the widest possible geographic area (e.g. county/district, city, province), with an ultimate goal of achieving pooling at the provincial level throughout China. • Consequential to this, decision taken to transfer the management of old-age insurance funds and the administration of the old-age insurance system to county/district, city, or provincial agencies (depending on the level to which pooling was moved).
1999	• Coverage of the old-age insurance system for employees in urban areas extended to include foreign-invested enterprises and joint ventures, private companies, and other types of enterprises. • Provinces allowed to include self-employed persons in the old-age insurance system for employees in urban areas "in accordance with the specific conditions in their localities."
2000	• Establishment of the National Social Security Fund in order to create a reserve to finance part of the unfunded liabilities of the old-age insurance system as a whole as well as for the expansion of the old-age insurance system and other social security programs.
2001	• Initiation of a pilot project in Liaoning province intended, among other things, to experiment with ways to preserve and increase the value of the funds in individual accounts, better link the base amount of a pension with the number of years of contributions, and set a uniform wage upon which to calculate contributions of flexible employees.
2002	• Provinces encouraged to include flexible employees, employees of small establishments and self-employed persons in the old-age insurance system for employees in urban areas.
2003	• Initiation of an information-based system (the "golden social security project") aimed at raising the overall level of management of the social security system and, in particular, responding to the needs of a progressively mobile work force in which growing numbers of workers move from one enterprise to another.

2004	• Extension of the Liaoning pilot project to Jilin and Heilongjiang provinces, including the application of "lessons learned" and "best practices" from Liaoning.
2005	• Decision taken to apply the lessons learned from the Liaoning, Jilin and Heilongjiang pilot projects across China, including extending the coverage of the old-age insurance system by at least 10 million workers a year in each year of the period 2006 to 2010.

A.3 Persons covered

Permanent enterprise employees – persons working for SOEs, collectively-owned enterprises, foreign-invested enterprises and joint ventures, private companies, and other types of enterprises in urban areas – are, in principle, covered on a mandatory basis by the old-age insurance system. However, new employees are often not covered during their "probationary period", which can vary in length from three months to a year according to provincial regulations.

Until the most recent decision of the State Council promulgated in December 2005, provinces have only been encouraged to extend the coverage of the old-age insurance system to employees of small establishments, flexible employees and self-employed persons as economic conditions permit. Under the most recent decision, coverage of these categories of workers is to become mandatory. Provinces have been requested to develop plans for implementing this decision.

Table 1 at the end of this appendix shows key statistics regarding the employment and the coverage of urban and rural workers at the end of 2003 (all numbers in millions). Data are taken from the *Labour Statistical Yearbook 2004*, and the internet-version of the *China Statistical Yearbook 2004.*

A.4 Financial system

The financial system for old-age insurance for workers in urban areas is a combination of pay-as-you-go, advance funding and government subsidies.

The base amount and transitional amount of a pension (see section A.12 below) are financed on a contributory pay-as-you-go basis from the pooling fund (described below) as well as through subsidies from the central and provincial governments.

The individual-account amount of a pension is, in principle, financed from the accumulated contributions, plus investment earnings, in a worker's individual retirement account. However, the individual accounts are, in fact, largely nominal because the funds credited to these accounts have often had to be diverted to the pooling fund in order to pay pensions to persons who are already retired.

In descriptions of the Chinese pension system, the term “pooling” is used to refer to the accumulation of contributions at the industry/sector, county/district, city or provincial level in order to create a fund out of which the base and transitional amounts of pensions are paid to qualified persons residing in the corresponding geographical area (or, in the case of industry/sector pooling, working in the applicable industries or sectors).

The objective of the central government is to achieve pooling at the provincial level throughout China, along with a single (unified) province-wide contribution rate, definition of the contribution base (earnings subject to contributions) and basic pension structure (rules for determining entitlement and calculating the amount of a benefit). By June 2003, such comprehensive pooling had been achieved in Beijing, Fujian, Shaanxi, Shanghai and Tianjin. In Hebei, Jilin, Guangxi, Yunnan, Gansu, Qinghai, Ningxia, Xinjiang and Tibet some (but not all) elements of comprehensive pooling had been put in place.

While government subsidies primarily take the form of direct grants to the pension scheme, there are also indirect subsidies arising from tax exemptions for contributions to the pension scheme.[33] Enterprises are allowed to claim their contributions as an operating costs. Therefore the contributions are deductible when determining an enterprise’s income for tax purposes. Similarly, employees are allowed to deduct their contributions when calculating their taxable income for purposes of income tax.

A.5 Contribution rate

Under the legal framework established by the central government, the contributions for old-age insurance required from enterprises should not exceed 20 percent of an enterprise’s total wage bill. The contribution rate applicable to enterprises in any given province is determined by the provincial authorities. It can vary from one county/city to another within a province. In order to raise the funds required to pay current pensions, the contribution rate for enterprises is more than 20 percent in many provinces.

Enterprise employees usually contribute at a rate of eight percent.

Employees of small establishments, flexible employees and self-employed persons have usually contributed at a rate of either 18 or 20 percent (at the choice of each province). The December 2005 decision of the State Council sets a uniform contribution rate of 20 percent for these categories of workers.

[33] In the international literature, these are often referred to as “tax expenditures”.

A.6 Earnings subject to contributions

Enterprise employees should pay contributions on their total earnings, including bonuses, subject to the minimum and maximum described below.

The minimum amount of earnings subject to contributions (the contribution base) is 60 percent of the average local wage. An enterprise employee earning less than the minimum nonetheless pays contributions on the minimum contributions base. The maximum amount of contributions is three times the local average wage. A persons earning more than the maximum only pays contributions on the portion of earnings up to the maximum.

Enterprises, generally speaking, should pay contributions on the basis of their entire payroll, without regard to the maximum contributory earnings on which the contributions of employees are calculated. In some provinces, however, enterprises are not required to pay contributions on the portion of individual salaries, if any, greater than three times the local average wage.

Employees of small establishments, flexible employees and self-employed persons have been allowed to determine their own contribution base, within the range bounded by the minimum and maximum applicable to enterprise employees. In practical terms, when such persons pay contributions, it has usually been on the minimum contribution base (i.e. 60 percent of the local average wage). The December 2005 decision of the State Council sets a uniform contribution base for these categories of workers equal to the local average wage.

A.7 Retroactive payment of contributions

It is not clear to what extent the national legal framework deals with the retroactive payment of contributions.

A.8 Individual accounts

Of the total contribution of about 28 percent of wages paid by or on behalf of a worker, 11 percent has, until recently, been credited to the worker's individual account. The December 2005 decision of the State Council specifies that, in future, only the employee's contribution of eight percent will be credited to his/her individual account.

Interest is credited on the balance in the individual account. It is credited annually based on nominal interest rates on one-year term deposits declared by financial institutions. In some locations, special bonus rates may be declared from time to time.

As noted above, the individual accounts are, in theory, real (i.e. consist of actual assets). However, in practice they are largely nominal, since the funds credited to the accounts are often required to pay pensions to current pensioners due to shortfalls in the pooling fund. The December 2005 decision of the State Council seeks to end this practice and to ensure that the funds credited to individual accounts are, in fact, set aside in a reserve.

A.9 Age requirement for eligibility for an old-age pension

Subject to provisions for early old-age pensions noted below, eligibility for an old-age pension is conditional on reaching the following ages:

For male employees:	60
For female managers (cadres):	55
For other female employees:	50

Persons who have worked in forms of employment that are especially hazardous or extremely strenuous (for example, coal miners, those working in high altitudes or at extreme temperatures) can qualify for an early old-age pension five years before the ages cited above. The State Council has also, from time to time, permitted early old-age pensions for former employees of bankrupt SOEs and to some former workers in particular sectors (e.g. textiles) that have lost their jobs due to economic restructuring.

A.10 Contributory requirement for eligibility for an old-age pension

In order to be entitled to an old-age pension on reaching retirement age, a worker must have paid his/her share of contributions or been credited with contributions for at least 15 years.

A worker who has contributed for less than 15 years and who has reached retirement age is entitled to receive the balance in his/her individual account in a lump-sum.

A.11 Periods taken into account in determining eligibility

In determining if a worker has met the contributory requirement described in the previous section, the following periods are taken into account:

- Years in which a worker has paid his/her share of contributions to the old-age insurance scheme.

- Years of service prior to the establishment of the current old-age insurance scheme while working for an enterprise whose employees were subject to the old-age insurance scheme in force at that time.

A.12 Calculating the amount of an old-age pension when a benefit first comes into payment

The monthly pension consists of up to three parts: a *base amount*, an *individual-account amount*, and a *transitional amount*.

Persons who started to contribute to the old-age insurance system after individual accounts were introduced (in most provinces, 1 January 1996) are eligible, on reaching retirement age, only to the base amount and the individual-account amount. They are often referred to as “new persons”.

Persons who had already contributed to the old-age insurance system before individual accounts were introduced, and who continued to make contributions after the introduction of individual accounts, are eligible, on reaching retirement age, to all three parts of the old-age pension. They are often referred to as “middle persons”.

Persons who contributed to the old-age insurance system exclusively prior to the introduction of individual accounts – often referred to as “old persons” – are entitled to a pension calculated according to the rules in force prior to that date.

The *base amount* (sometimes referred to as the “pooling pension”) has been 20 percent of a calculation base equal to the average monthly urban wage in the area in which the contributor resides. The average used in the calculation has been that applicable to the year prior to the start of payment of the pension.

Under the December 2005 decision of the State Council, the initial base amount of a worker’s pension will, in future, be determined by three factors: the average local wage in the year prior to retirement, the employee’s average indexed personal monthly contributory wages over his/her career, and the length of the employee’s period of contributions. Although no details are available regarding the second factor, it will presumably reflect the relationship between a worker’s actual earnings over his/her career and local contributory wages in general over the same period. A worker who, for example, had wages in each year of his/her working life equal to the local average contributory wage of all covered workers taken together would likely have an index factor of one. On the other hand, a worker who had wages each year equal to 120 percent of the average of all workers would likely have an index factor of 1.2. To calculate the initial base amount of a worker’s pension, the average local wages in the year prior to retirement will first be multiplied by the worker’s index factor. The base amount of the worker’s pension will equal one percent of this product for each year of contribution to the old-age insurance system. There will be no ceiling on the number of years of contribution that will be taken into account in the calculation.

The *individual-account amount* has been 1/120th of the funds (contributions and investment earnings) accumulated in a contributor’s individual account. In effect, an assumption was made that the life expectancy of a pensioner at the time of reaching the age of eligibility for an old-age pension was 10 years. If the period during which a pensioner was in receipt of a pension surpasses 10 years, the individual-account amount would continue to be paid until the person dies, in spite of the fact that the funds in his/her individual account would be used up.[34] In such a case, the required funds would be drawn from the social-pooling fund.

Under the December 2005 decision of the State Council, the initial individual-account amount of a worker's pension will, in future, be determined in manner similar to that used for a conventional life annuity, based on the worker's further life expectancy at the time of retirement and projected rates of return on the balance in his/her account. This will significantly effect the individual-account amount of pensions.

Tables 2.1 and 2.2 at the end of this appendix show possible factors that need to be used instead of the present one of $1/120^{th}$. The factors refer to different ages and different years of the first pension payment; they take into account different rates of return and different levels of indexation that could be paid from the return in the individual accounts. Table 2.1 refers to the year 2005, Table 2.2 to the year 2025; the data are based on a further life expectancy as shown in Table 3. The data suggest that an average further life expectancy of 25 years can be assumed for retirement at age 55, but that for age 60 the average further life expectancy is between 17and 20 years in the year 2005 and between 19 and 22 years in the year 2025.

The change in the method of calculating the base amount and individual-account amount of a pension will apply only to new men/women. Provinces have been asked to establish transitional rules for middle persons. The State Council decision stipulates that "for those whose benefits [would be reduced by the decision], their pensions will not be reduced, while for those who would be entitled to more, pensions will be increased in a gradual manner."

The *transitional amount* of a pension payable to a "middle persons" (designed below as worker Z) is calculated according to the formula:[35]

$$T^Z = (A \bullet I^Z \bullet N^Z \bullet F) + K$$

[*Note:* The symbol "•" in the formula means "multiplied by".]

where

A = The average urban wage in the area in which worker Z resides in the year before worker Z's pension starts to be paid (i.e. the same calculation base as that used to determine the base amount of the pension).

[34] Since investment earnings (interest) continue to be credited to an individual account during the period in which the funds in the account are being drawn down to pay the individual-account amount of a pension, funds in the account have, in fact, been sufficient to pay the individual-account amount for a period longer than 10 years. The effective period is likely to be around 10.8 years if the funds yield a nominal interest of 1.5% and 11.7 years if the funds yield a nominal interest of 3 % (Study Team's calculations).

[35] The same, or a quite similar formula, is likely to be that used for the calculation of the initial base amount of pensions under the December 2005 decision of the State Council.

I^Z = The average index applicable to worker Z, calculated as described below.

N^Z = Worker Z's total number of years of coverage (service) prior to the year in which individual accounts were introduced in his/her province.

F = The annual accrual factor (typically ranging from 1% to 1.4%, as determined by the provincial authorities).

K = A fixed amount determined by the provincial authorities, which can range from zero to CNY 120 per month.

Worker Z's average index (I^Z) is calculated according to the formula:

$$I^Z = [\Sigma(W^Z_y / P_y)] / R^Z$$

where

W^Z_y = Worker Z's wages subject to contributions in year y, where y is taken over the period described below to determine R^Z.

P_y = The average urban wage in year y in the area in which worker Z resides.

R^Z = Worker Z's number of years of coverage (contribution) starting from the year in which individual accounts were introduced and ending in the year before worker Z retired.

In 2004, the average monthly pension for retired enterprise employees whose benefits are derived according to the calculation rules described in this section was CNY 705.

A.13 Adjusting (Indexing) benefits in payment

Benefits in payment are adjusted from time to time on an ad hoc basis, in line with increases in prices and average wages. The State Council establishes the minimum amount of the adjustments, which have usually been in the range of 40 to 60 percent of the corresponding growth in wages since the previous adjustment. Each province, however, decides on the actual adjustments that will be made to the pensions in payment in that province, subject to the State Council's minimum. Provinces with the financial capacity may decide to adjust pensions in payment by a greater amount than that recommended by the State Council.

A.14 Portability[36]

In principle, there is complete portability if a worker moves from one province of China to another. In practice, however, it is usually not possible for workers to transfer their accruing rights to a pension between provinces.

No information is available on the provisions of the national framework regarding portability if a contributor or pensioner moves permanently to Hong Kong, Macau, Taiwan or a foreign country.

A.15 Payments in the event of the death of a contributor or pensioner

In the event of the death of a contributor, his/her heirs are entitled to the payment of the balance in the contributor's individual account (contributions and credited interest) in a lump sum.

In the event of the death of a pensioner before he/she has received the pension for at least 10 years, his/her survivors are entitled to the part of the pension that results from the individual account for the remainder of the period of 10 years or to a lump-sum payment of the balance in his/her individual account.

A.16 Supplementary pensions

In addition to the *mandatory* old-age insurance for workers in urban areas described above, enterprises can establish supplementary pension plans for their employees. The decision to establish a supplementary pension plan is entirely at the discretion of an enterprise. An enterprise with a supplementary pension plan is allowed to claim the employer's share of contributions to such a plan, up to four percent of total payroll, as an operational cost. By 2002, about five percent of all enterprises had supplementary pension plans.

Enterprises with supplementary pension plans are "encouraged" to finance them through contributions from both the employer and employees, and to structure them as defined-contribution schemes based on individual accounts. At retirement, an employee covered by such a supplementary pension plan may withdraw the amount in his/her account either as a lump sum or in

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[36] The term "portability" is used in this report to refer to three types of situations: (a) whether a worker who, prior to reaching retirement age, moves to another province of China can transfer the amount in his/her individual account in the pension scheme of the province of origin to the scheme of the province of destination, and also whether he/she can have periods of contributions in both provinces taken in account, and added together, when eventually determining his/her eligibility for an old age pension on reaching retirement age; (b) whether a worker who, prior to reaching retirement age, permanently takes up residence in Hong Kong, Macau, Taiwan or a foreign country can receive the accumulated funds in his/her individual account in a lump-sum on departure; and (c) whether a pensioner who leaves his/her usual province of residence to take up residence in another province of China, or in Hong Kong, Macau, Taiwan or a foreign country, can continue to receive his/her pension in the new place of residence.

several instalments. If an employee changes employer prior to retirement, he/she should be allowed to take the accumulated funds in his/her account to the supplementary pension plan of the new employer (assuming that the new employer has a similar supplementary pension plan).

A.17 Revenues and expenditures for pensions for urban workers

In 2003, according to the Information Office of the State Council, the sources of revenues of old-age insurance for urban workers and their respective amounts were as follows:

Contributions paid by enterprises	CNY 259.5 billion
Subsidies from the central government	47.4 billion
Subsidies from other levels of government	7.0 billion
Total	CNY 313.9 billion

The national report prepared in the first phase of the ILO study on means to extend the coverage of China's old-age insurance system gives the following data on the revenues and expenditures of the old-age insurance system for urban workers from 1998 to 2003 (amount shown are in CNY billions):

	1998	*1999*	*2000*	*2001*	*2002*	*2003*
Revenues	162.3	196.5	228.7	248.9	317.2	368.0
Expenditures	151.2	192.5	211.6	232.1	284.3	312.2
Reserve	58.8	73.4	94.7	105.4	160.8	220.7

Data from the World Bank suggests that subsidies from the central and local governments have increased substantially in recent years: from CNY 31.84 billion in 2000, to CNY 35.3 billion in 2001, and to CNY 55.3 billion in 2002.

A.18 Reserve funds

See section A.17 above

In 2000 the central government created the National Social Security Fund in order to create a reserve to finance part of the unfunded liability of the old-age insurance system as a whole as well as for the expansion of the old-age insurance scheme and other social security programs. The assets in the Fund –valued at CNY 190 billion at the end of November 2005 – are derived from funds acquired from reducing state shareholding, stock ownership assets, funds from the central budget, funds raised by other means approved by the State Council, and investment returns. The Fund is administered by the National Social Security Fund Executive Council. The Fund's average annual rate of return in recent years has been about 2.5 percent.

B. Old-age insurance for workers in rural areas

In spite of rapid urbanization, especially in the past quarter century, China remains a predominately rural nation, with three out of four residents in 2000 living outside of cities.

Historically in rural areas of China, the vast majority of persons have been engaged in farming. The elderly have contributed to family and communal well-being, to the extent they are able, through work on the farm and around the home. When they could no longer provide for themselves, the family has been their principal source of support. If the family was not able to provide such support on its own, clan and community have usually been expected to provide assistance.

In recent years, the traditional means of support for the rural elderly have experienced growing strain. A primary cause has been the large-scale migration of persons, especially the young, from rural to urban areas in response to the expanding economic opportunities in the cities of China combined with significant reductions in the need for labour devoted to farming resulting from unprecedented increases in agricultural productivity.

As the traditional means of support for the rural elderly have weakened, the need for a formal state-organized system for providing economic security for the rural elderly, primarily through the extension of old-age insurance, has been acknowledged. However, for those engaged in farming, the mechanisms for providing old-age insurance to workers in urban areas are largely unsuitable since they are not employed by enterprises that can bear a significant part of the cost of old-age insurance and the disposable cash incomes of most formers (once basic necessities have been provided for) are generally low. Thus, a different model tailored to the circumstances of rural farming populations has had to be sought.

The challenge of providing adequate old-age insurance for rural workers has been further complicated by the evolving nature of employment in the rural areas of China. While farming still predominates, there has been a rapid growth in non-agricultural employment. Employment by TVEs (basically, enterprises either owned or sponsored by rural government units) grew from 30 million in 1980 to 128 million in 2000. Over the same two decades, employment in privately owned enterprises located in rural areas grew from one million to 11 million, and the number of self-employed persons rose from 17 million to 29 million.

For this rapidly expanding group of rural workers, whose number can only be expected to continue to grow in both absolute and relative terms in coming years, an old-age insurance scheme geared to the circumstances of farmers may not respond adequately to their needs, which are much closer to those of urban enterprise workers.

B.1 Legal framework

The only legal instruments regarding the rural old-age insurance scheme appear to be the following:

- *Basic Proposals for Rural Old-Age Social Insurance at County Level* (1991);
- *Circular on Furthering the Rural Social Pension Scheme* (19 October 1995).

B.2 Origins and evolution

1991	• A State Council decision sets the general legal framework for old-age insurance for rural workers . The framework centered on individual accounts, funded primarily by contributions paid by the workers themselves, with some supplements provided from collective sources. • Areas "with better economic conditions" were selected by the State Council for pilot programs to develop pensions for rural workers at the county level. The pilot programs encountered difficulties in subsequent years "due to the fluctuation of interest rates for bank savings".
1998	• Administration of rural pensions was shifted from the Ministry of Civil Affairs to the Ministry of Labour and Social Security.
1999	• Reforms were undertaken to the administration of rural pensions to achieve sustainable development.

B.3 Persons covered

The old-age insurance system for workers in rural areas covers persons aged between 18 and 60 in the following categories: workers of TVEs and public institutions, employees of private enterprises, self-employed persons, and farmers. Participation is voluntary.

In 2003, according to data from the MOLSS, 54.3 million workers in rural areas participated in the old-age insurance scheme, out of a total employed rural population of 489 million persons – a participation rate of 11 percent. The scheme was developed to varying degrees in 1,870 counties. About 2 million elderly persons were receiving benefits.

B.4 Financial system

The financial system for the old-age insurance system for workers in rural areas consists of the advance funding of individual accounts through contributions paid by the workers themselves, with some supplements (subsidies) from townships and villages. Subsidies can be provided by towns, villages and enterprises according to their own economic situation.

Funds are pooled at the county level and invested in accordance with state policies – currently in bank deposits and government-issued bonds of the central government.

B.5 Contribution rate

Farmers decide on the contribution level "according to their own economic conditions".

B.6 Earnings subject to contributions

None.

B.7 Retroactive payment of contributions

Not applicable.

B.8 Individual accounts

The balance in an individual account is credited annually with interest. The interest rate is the same as for current deposits in banks.

B.9 Age requirement for eligibility for an old-age pension

Pensions from the old-age insurance system for rural workers are payable at age 60.

In addition to a pension, in some rural areas, each spouse in a couple with only one child or two girls is entitled to receive a minimum of CNY 600 a year at age 60. This additional benefit is financed jointly by the central and provincial governments.

B.10 Contributory requirement for eligibility for an old-age pension

None.

B.11 Periods taken into account in determining eligibility

Not applicable.

B.12 Calculating the amount of an old-age pension when a benefit first comes into payment

The amount of the pension is based on the amount accumulated in a worker's individual account. When a worker reaches age 60, the amount of his/her pension is calculated as 1/180th of the balance in his/her individual account. In effect, an assumption is made that the life expectancy of a worker on reaching age 60 is 15 years (180 months). If the period during which a pensioner is in receipt of a pension surpasses 15 years, the pension continues to be paid until the pensioner dies, in spite of the fact that the funds in his/her individual account are used up.

For the rural pension scheme the factors as shown in Table 2.1 and Table 2.2 at the end of this appendix would have to be applied accordingly. The figures suggest that for the age of 60 the factor 1/180 is fairly correct, when taking into account a reasonable rate of return on the invested funds. In this case even part of the indexation cost could be paid from the return on investment.

B.13 Adjusting (Indexing) benefits in payment

None.

B.14 Portability

Since contributions are paid to an individual account, it makes no difference if a worker changes employer or moves between one village and another, or to a city.

B.15 Payments in the event of the death of a contributor or pensioner

If a contributor dies before reaching the age of entitlement to a pension (60), the balance in his/her account, including interest, is paid to his/her survivors in a lump sum.

If a pensioner dies before having received a pension for less than 10 years, his/her survivors are entitled either to the pension for remainder of the period of 10 years or to a lump-sum payment of the balance in his/her individual account.

B.16 Supplementary pensions

Not applicable.

B.17 Revenues and expenditures for pensions for rural workers

No information available.

B.18 Reserve funds

At the end of 2003, a total of CNY 25.9 billion had been accumulated in the individual accounts of workers in rural areas.

Table 1:

Key statistics regarding employment by category of workers and the coverage of urban and rural workers by the old-age insurance system

1	Population year end			1292.27	
1.1	urban (including military personnel)			523.76	
1.2	rural			768.51	
1.3	above 16 years			998.89	
2	Economically active persons			760.8	
2.1	Employment total			744.3	
2.1.1	in urban areas			256.4	
2.1.1.0		thereof	Staff and Workers	109.7	
2.1.1.1		thereof:	on-post staff and workers	104.9	1)
2.1.1.2			urban "TVE's" employees	5.0	2)
2.1.1.3			other flexible employees	97.0	2)
2.1.1.4			in private enterprise and as individuals	49.2	3)
			thereof (estimated)		
2.1.1.4.1			*in private enterprises*	*30.0*	
2.1.1.4.2			*as individuals*	*19.2*	
2.1.2.	in rual areas			487.9	
2.1.2.1			in rural TVEs	130.7	
2.1.2.2			farmers and others	357.2	
3	Contributors to				
3.1	urban basic pension insurance			116.5	
3.1.1			thereof employees in enterprises	103.2	
3.2	rural pension insurance			54.3	
4	Coverage as to contributors				
4.1			urban	45.4%	
4.2			rural *less than*	11.1%	
5	**Estimation:**				
	Persons		in flexible employment	40.0	
			thereof in individual households	*10.0*	
			in self-employment	9.2	
			as migrant workers	100	

Remarks:
1) regular employees with some migrant workers
2) including migrant workers
3) not including migrant workers

Table 2.1:

Division factors for the year 2005, to be used when determining the monthly amount of a life-long old age pension.

Interest rate	5%					
Indexation	0%		3%		2%	
age	males	females	males	females	males	females
55		13.58		18.77		16.75
60	10.63	12.15	13.56	16.09	12.46	14.58
65	9.02	10.56	11.07	13.41	10.31	12.34

Hence the factor to determine the amount of a monthly pension from the accumulated amount in the individual accounts would be

55		163.0		225.2		201.0
60	127.6	145.8	162.7	193.1	149.5	175.0
65	108.2	126.7	132.8	160.9	123.7	148.1

Interest rate	3.5%					
Indexation	0%		1.5%		0.5%	
55		15.87		18.83		16.78
60	11.99	13.93	13.62	16.15	12.50	14.62
65	9.99	11.88	11.12	13.47	10.35	12.38

Hence the factor to determine the amount of a monthly pension from the accumulated amount in the individual accounts would be

55		190.44		225.96		201.4
60	143.88	167.16	163.44	193.8	150.0	175.4
65	119.88	142.56	133.44	161.64	124.2	148.6

Table 2.2:

Division factors for the year 2025, to be used when determining the monthly amount of a life-long old age pension.

Interest rate	5%					
Indexation	0%		3%		2%	
age	males	females	males	females	males	females
55		14.24		20.09		17.80
60	11.4	12.89	14.83	17.44	13.53	15.68
65	9.81	11.37	12.25	14.75	11.34	13.47
Hence the factor to determine the amount of a monthly pension from the accumulated amount in the individual accounts would be						
55		170.88		241.1		213.6
60	136.8	154.7	178.0	209.3	162.4	188.2
65	117.7	136.4	147	177.0	136.1	161.6

Interest rate	3.5%					
Indexation	0%		1.5%		0.5%	
55		16.8		20.16		17.81
60	12.97	14.93	14.89	17.5	13.57	15.72
65	10.96	12.92	12.3	14.8	11.38	13.50
Hence the factor to determine the amount of a monthly pension from the accumulated amount in the individual accounts would be						
55		201.6		241.92		213.7
60	155.64	179.2	178.7	210	162.8	188.6
65	131.5	155.0	147.6	177.6	136.6	162.0

Table 3:

Assumed further life expectancy in years by sex

	Male	Female
1. Year 2005:		
at birth	69.7	74.1
at age 55	20.48	24.54
at age 60	16.58	20.29
at age 62	15.14	18.67
at age 65	13.10	16.34
2. Year 2025:		
at birth	73.71	78.21
at age 55	22.52	26.77
at age 60	18.42	22.39
at age 62	16.89	20.70
at age 65	14.72	18.27

Source: UN World Population Prospects, Rev.2000
and own calculations