Social security reform: Does partial privatization make sense for China?

John B. Williamson*, Catherine Deitelbaum

Department of Sociology, Boston College, Chestnut Hill, MA 02467, USA

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Abstract

By the year 2025, one quarter of the world’s population over age 60 will be living in China, a nation in the process of partially privatizing its social security system. This article presents a brief history of social security policy in China, describes the current scheme, presents an analysis of the pros and cons of this scheme, and asks why China is currently on the road to adopting policy changes that are so strongly influenced by the neoliberal social security model being advanced by the World Bank. Social security policy in China is being driven largely by demographic considerations, but it is also being influenced by factors linked to globalization. The plan to partially privatize the nation’s social security system will put at risk many vulnerable categories of the population, particularly women, low-wage workers, those in the informal sector, and recent immigrants from rural areas. © 2004 Elsevier Inc. All rights reserved.

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1. Introduction

Currently, China is facing a number of significant demographic, political and economic challenges. Like many nations, China is coping with the problem of population aging. In China’s case, however, the shift in age structure has been and will continue to be dramatic: 9% of its population was over 60
(currently the mandatory age of retirement for male employees in China) in 2000 and this number is projected to increase to 22% by 2030 (Wang, Xu, Wang, & Zhai, 2001). According to current projections, by 2025, one quarter of the world’s elderly population (age 60+) will be living in China (Kinsella & Velkoff, 2001; U.S. Census Bureau, 2002). As a result of population aging, the dependency ratio (defined as the number of retirees per 100 workers) is also rising. The dependency ratio was 0.03 in 1970, 0.29 in 2001 and is projected to increase to 0.55 by 2030, at which time there will be less than two workers per retiree (Keran & Cheng, 2002). The challenges of population aging and rising dependency ratios are in part the result of increased life expectancy, but the major factor has been the rapid decline in fertility, due, in large part, to China’s strict one-child policy instituted in the mid 1970s. In the future, many Chinese couples will face the task of caring for four elderly parents as well as some grandparents. These changes in family structure and the increase in rural–urban migration due to uneven rates of economic growth are two of the factors contributing to a breakdown of the traditional family support system, which remains the major source of old-age support (McCarthy & Zheng, 1996).

In the twenty-five years since the onset of China’s transition from a command to a market economy (including its recent acceptance to the World Trade Organization), China has undergone dramatic economic changes. State-owned enterprises (SOEs), due to their previous positions as industrial monopolies and because of their relatively generous benefits to workers, are under increasing pressure as the transition to a market economy progresses. Many are struggling with only moderate success to increase their productivity and competitiveness. Private companies, on the other hand, which have less generous employee benefits and are less vulnerable to political pressures than state-owned enterprises, have found it easier to adapt to the rapid economic growth of recent decades. Economic growth and job creation have become top priorities for the central government (“China’s Unemployment Rate”, 2003); in addition, while official reports of urban unemployment are just 4%, this estimate increases to over 9% when including laid-off workers who receive a minimal stipend from the government (Shilling, 2003).

At the intersection of these demographic and economic changes lies the issue of Chinese pension reform. Chinese policymakers are searching for a way to address the larger problems of population aging and economic restructuring, while at the same time, providing a pension system which is sustainable, more centralized, portable, and will substantially increase the rate of participation by both employers and employees. Chinese policymakers have the difficult task of balancing the reform of an unsustainable enterprise based pay-as-you-go defined benefit (PAYGO DB) pension program while maintaining political stability and assuring that the economy does not falter. China’s shift to a multi-pillar pension scheme in the late 1990s represents a serious effort to bring about much needed pension reform, but the new scheme has been plagued by problems.

In this article, we will ask whether the move to partial privatization makes sense for China at this point in time. As part of our evaluation, we assess the pros and cons of the move to partial privatization, which is at the core of the recent Chinese pension policy reform effort. By first tracing the evolution of China’s pension program, we can better understand the policy legacy of recent reform efforts. We then outline China’s current pension policy and highlight how it deviates from prior policy. Of particular note is the shift of much of the responsibility for funding these pensions from employers (the SOEs) to the individual workers. Following that we will analyze the potential benefits and limitations of these reforms; where appropriate, we draw on evidence from other nations.

We conclude by asking why China is currently on the road to adopting a multi-pillar social security scheme based on the neoliberal model being advanced by analysts at several international financial institutions, most notably the World Bank and the International Monetary Fund (IMF). Our answer is that
Chinese social security policy is being influenced by the imperatives of globalization, particularly economic globalization; but that influence is being mediated by a number of historical, political, structural, and cultural factors linked to current demographic trends, social security policy legacy, and China’s history as a state-socialist nation.

2. Pension Reform in China from 1949 to 2000

Pension programs in China have a complex history, characterized initially by centrally pooled funding and low dependency ratios and now by a fragmented state-owned enterprise-based pension system, escalating dependency ratios, high contribution rates, and an unequal distribution of pensioners across regions. From its inception in 1951, shortly after the founding of the People’s Republic of China (PRC), old-age insurance benefits were originally the responsibility of employers; however, two years after the pension program was initiated, funding responsibilities were shifted to a more centralized authority, financed by a 3% contribution of the total wage bill (Davis, 1988; Sin, 2000; Takayama, 2002). Seventy percent of the 3% contribution, administered at the local level by trade unions, went to pay retirees, while the remaining 30% went into a national-level pool to serve as a reserve fund (Sin, 2000).

In 1969, and in the midst of the Cultural Revolution, the Military Control Commission dismantled the trade unions, as well as the Ministry of Labor. As a result, state-owned enterprises (SOEs) were required to take over the funding of the pay-as-you-go (PAYGO) defined benefit (DB) pension scheme (Davis, 1988; Sin, 2000). Funds from the accumulated reserve pool were spent on other government needs, thus ending any prefunding (Sin, 2000). While the pension burden on SOEs was relatively low in the early 1970s, the decentralization of the pension program marked the beginning of the fragmentation that would plague Chinese pension plans until later attempts to unite it in the late 1980s and early 1990s with municipal and provincial pooling.

Urban China in the 1970s was plagued by stagnant economic growth, but retirees continued to collect relatively generous benefits, at 75–100% wage replacement levels post-retirement, while young workers increasingly faced the prospect of unemployment (“State Pension Reform”, 1997; Davis, 1988). The political and social upheaval associated with the Cultural Revolution during this period further contributed to the bleak job outlook. During the late 1960s and the 1970s many young people were sent to work in rural areas, to temporary jobs, or to state jobs that did not guarantee lifetime employment or a pension. Most were unable to obtain steady work with the traditional job benefits (Davis, 1988).

In the late 1970s after the Cultural Revolution, Mao’s successor, Deng Xiaoping, began a series of economic reforms designed to promote economic growth and the modernization of the Chinese economy (Bottelier, 1999). These measures, however, in addition to spurring economic growth, caused major changes in the number of pensioners and also in the public’s attitudes about retirement. Retirement came to be viewed as a civic right, rather than as conspicuous leisure. While the reforms were intended to help ease Chinese unemployment, the dramatic reduction in retirement eligibility criteria from 20 years to 10 years of employment, an increase in pension benefits, and the high unemployment rates among youth, combined to produce a 400% growth in the number of pensioners from 1978 to 1985, and a worker–pensioner ratio that dropped from 3 to 1 in 1978 to just 7.1 to 1 by 1986 (Sin, 2000; West, 1997). It was also during this period (the mid 1970s) that China’s one-child policy was instituted. These two events of the late 1970’s–increasing dependency ratios as a result of early retirement incentives and the
implementation of fertility reduction measures which set the stage for an increase in population aging — led to the pension financing problem that became so salient by the 1990s.

The reforms of the Chinese economy became a serious issue for state-owned enterprises, which were becoming simultaneously burdened with an aging labor force, obsolete technology, Soviet style management practices, and pressure to downsize in order to keep up with the modernization of the economy. Increasingly, the government was called upon to honor pension obligations that many SOEs could not meet. Because many employees were reluctant to leave the security of lifelong employment and generous pension benefits, many SOEs were unable to successfully restructure and adjust to the shift from a command to a more market oriented economy. In contrast, many of the new private sector enterprises, which had less heavy pension burdens and in some cases were not covered by the formal pension system, were much better equipped to adjust to changing economic structures and incentives (Takayama, 2002). In addition, private sector enterprises, many of which were economically dynamic, and state-owned enterprises, many of which were much less productive, were often concentrated within different industries and different regions; as a result, the pension burden tended to be concentrated within particular regions and industries (James, 2002).

Begun as an experiment in some areas in 1982 and implemented nationwide in 1986, municipal pooling of pension funding was intended to help alleviate the increasing burden on SOEs and to decrease the need for government subsidies to SOEs to cover pensions. However, the municipal level pooling soon proved to be largely ineffective. Analogous to the pension problems experienced by the SOE based system, the new municipal pooling system again was faced with marked disparity between regions and the pension burden remained concentrated by both region and industry. The contribution rate also varied significantly by region, with high rates in ‘old’ industry regions and lower rates in regions where there were a greater number of private enterprises which had their own occupational pension schemes (James, 2002). While pensions were supposed to be municipally pooled, in practice only the net funds remaining after the enterprise funded its own retirees were transferred. The enterprises therefore retained control over allocation and administration of most of their funds, thus complicating security and creating moral hazard issues (James, 2002; Wang et al., 2001). In addition, there was widespread evasion within the pooling system as young and growing companies underreported wages and workers often joined the informal labor force in order to avoid contributions (Keran & Cheng, 2002). As a result, the municipal pooling of pension funds was slow to develop and the government lacked the capacity to enforce it.

While urban pension reform was initiated in the 1980s, in the 1990s the reforms gained widespread political support, as pensions became increasingly unsustainable and the long-term consequences of the one-child policy and population aging became apparent. Attempts were made in 1991 and 1995 to encourage a multi-pillar pension scheme, and in 1997 Chinese policymakers formally promulgated a three-pillar plan in State Council Document No. 26 (Leckie, 2000; Ma & Zhai, 2001). The first two were mandatory pillars and the third a voluntary occupational scheme.

While the World Bank had recommended a 9% contribution rate and an expansion of the pension scheme beyond SOEs to Town and Village Enterprises (TVEs) in order to fund the two tier pension program, Chinese policymakers decided on a more conservative pension scheme. The contribution rate for the two pillars (which varied by municipality) was set at no more than 20% of the wage bill for employers with an additional 4% contribution by workers. The first pillar was a pay-as-you-go defined benefit (PAYGO DB) scheme based on social pooling and was originally intended to be completely funded by 13% of the 20% total contribution from the enterprises. The remaining enterprise contribution (7%) was to go into the second pillar comprised of employees’ individual accounts. The workers’
contribution (4%, increasing to 8% by 2002) was to go directly into employees’ individual accounts and was aimed at enhancing transparency of worker contributions. In 2000, in State Council Document No. 42, the 1997 two-pillar model was revised to formally separate the funding of the two pillars and alleviate corruption problems that seemed to be the result of the mixed funding of the two pillars (Wang, 2001).

The 2000 reform specifies that the full 20% employer contribution is to go to the PAYGO DB municipal pooled first pillar, while employees are supposed to contribute 8% directly to mandatory individual accounts. The wage replacement rate is projected to be about 58% for employees with 15 or more years of employment, significantly lower than the previous PAYGO DB system’s average of 80%, which may make it politically vulnerable (Sin, 2000). However, the previous PAYGO DB system was unsustainable, with a projected 40% of GDP expenditure by 2033 (Li, 1999).

3. Implementation issues and problems in China’s current pension reform

While the specifics of China’s current pension plan were outlined in State Council Document No. 42 in 2000, implementation has been slow. An experimental reform begun in the province of Liaoning in 2000 (chosen due to its high dependency ratio of one pensioner for every three workers) following the guidelines in Document No. 42 has produced mixed results (Holland, 2002). In Liaoning much of the administrative responsibility for the pension system has been shifted from the enterprise to the municipality. This shift has increased the degree of unification in the system. Individual accounts have been established as well, with the full 8% worker contribution, for the most part, being deposited into employee accounts (Williamson & Shen, in press). However, contribution rates have a wide range of 27–36% across municipalities, collections are only about 73% of the total expected contributions, and there remains the ever-present issue of financing current retirees (James, 2002). Employers’ contributions of 20% of payroll, intended for the first pay-as-you go defined benefit (PAYGO DB) pillar, have not been enough to cover current retirees’ benefits (James, 2002; Wang et al., 2001). As a result of the gap in funding for current pensioners created by the 8% employee contribution designated for the individual accounts, there has been a need for additional financing. In Liaoning, the central government has taken responsibility for one third of the remaining amount owed to pensioners, with the provincial government and municipal pool each also contributing one third. While this practice has covered current retirees in Liaoning province, the central government cannot afford to contribute one third of funding to cover municipal shortfalls nationwide. In addition, while worker accounts in Liaoning are receiving the 8% employee contribution, in most other provinces and municipalities, this 8% contribution is going to fund current retirees (Zhu, 2002).

Much of this funding shortage stems from uncertainty about how to fund the transition from the previous PAYGO DB system to the new multi-pillar account as well as how to calculate pension benefits for those individuals who have already been covered for many years under the prior PAYGO DB scheme. This uncertainty has led to low compliance, with just five of twenty-seven provinces reporting

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1 Unification has persistently plagued the Chinese pension system, since it disbanded its centralized collection agency in 1969 in favor of a strictly state-owned enterprise system. Reform efforts since 1986 have focused on re-establishing a unified system: first on the municipal level, i.e. state-owned enterprises contribute to a municipal pool, and then on the provincial level, i.e. municipalities contribute to a provincial pension pool.
successful pooling, as well as to widespread evasion. Current retirees are receiving less by way of pension benefits than had been promised under the prior scheme, leading to a lack of credibility for the new pension plan among the general population (Keran & Cheng, 2002; Ma & Zhai, 2001). In an attempt to cover some of the increasing pension debt in mid-2001, the government decided to sell some of its shares in state-owned enterprises (SOEs). The goal was to generate much-needed revenue; however, this produced serious volatility in capital markets and was halted one year later (Williamson & Zheng, 2003).

Not only are many individual accounts empty due to diverted funds, but in most municipalities, most of the workers are not contributing the full 8% called for under current statutes. In the meantime, employers are expected to fill the gap created when workers contribute less than 8%. This places a significant financial strain on already struggling enterprises, and the government is increasingly being asked to intervene. The National Social Security Fund was formulated in 2000 in response to the continued need for central government subsidies of municipal pensions. With revenues from the government, the fund’s governing body, the National Council for the Social Security Fund, provides emergency subsidies to municipal pension pools and delegates the investment of the fund’s assets (Bottelier, 2002).

The persistent fragmentation of the social security system and its inequities across regions has also led to a lack of portability of pensions, which is necessary to encourage labor mobility and economic growth between municipalities and SOEs and non-SOEs (Takayama, 2002). Moreover, there are significant disincentives for new non-state enterprises with respect to participation in the public pension scheme due to high payroll taxes and little reprisal for companies who underreport wages or delay paying pension benefits (Takayama, 2002). Thus, in 2000, while there were 213 million employed urban workers, only 105 million, or less than 50%, were covered by the formal social security system (State Statistical Bureau, 2001) resulting in a dependency ratio of about one pensioner for every three workers.

Not only the implementation, but also the structure of the new scheme has proven problematic. The post-retirement annuity for individual accounts is based on a 120-month payment schedule (i.e. an implicit 10-year life expectancy after retirement). Currently, the average retirement age is 56 for men and 50 for women, but the life expectancy at retirement for the majority of these workers, particularly the women, is already substantially over 10 years and rapidly increasing (James, 2002). Thus, the government is committed to honoring generous pension guarantees after the annuity funds run out, and, with the 120 month rule, the reform does not make life expectancy adjustments to deal with the challenges of population aging and rising dependency ratios (Cheng, 2002; Zhao & Xu, 2002). There are also continued administrative issues, as both pension fund surveillance and management are largely the responsibility of the enterprises (James, 2002).

The new funded component of the reform has major investment limitations. There are no formalized account managers for the individual accounts; rather, they are managed by banks, which are required to keep 20% of investments in bank deposits and the remaining 80% in government bonds (Cheng, 2002). These strict regulations have led to evasion and alternate investments in potentially higher return, but also higher risk, local projects (Leckie, 2000). The domestic market is also underdeveloped and until recently international investment was not permitted. However, it is likely that China’s recent acceptance into the World Trade Organization (WTO) will eventually lead to outside investment and to significant growth in China’s capital markets.

The current pension reform, while a step in the right direction, is still plagued by excessive fragmentation and an uneven access to benefits. Only a handful of municipalities have successfully
pooled their pension systems, including cities such as Shanghai, Beijing, Tianjin, and Chonquing (Bottelier, 2002). Provincial pooling remains problematic in many areas due to uneven economic development within the provinces. In addition the pooled structure of the pensions creates disincentives for young and economically dynamic private companies. Similarly, many regions have a high concentration of declining SOEs, so the pooling of funds does not solve the overall shortage of pension assets. Rather, the government often has to “bail out” the pension deficits of the SOEs by diverting much needed funds for capital investment into pension financing for these ailing enterprises (Huang, 2001) and, in some cases, municipal governments have used local tax revenues to pay pension claims (Wang et al., 2001). Lastly, within a province, there is often a hierarchy of municipalities, making pension asset sharing between the municipalities difficult and quite political (Bottelier, 2002).

4. The potential benefits and liabilities of partial privatization

While China has taken many steps in recent years to fix its ailing pension system, one of the most important came in 1997 with the introduction of a multi-pillar system that included a funded defined contribution (FDC) component. However, the adoption of a pension system that includes an FDC component may be premature. The evidence to date suggests that many enterprises (and municipalities) are finding it very difficult to deal with the transition costs and fund the individual accounts at the same time. Not only have most individual accounts been left empty because the revenues were needed to fund pensions for current retirees, but also central, provincial, and local governments have had to further subsidize these pensions. Even with the diversion of these funds, many retirees in China have had to go without promised pension benefits. Under the new FDC scheme there has been no effort to address how to compensate workers for the funds that have been diverted from these accounts to pay current pensioners. The pension system has also been plagued by excessive fragmentation and corruption, leaving it with little public credibility.

One of the most significant challenges for Chinese policymakers in designing an effective pension scheme is responding to population aging. China’s new FDC component is designed to deal with population aging by providing a closer link between contributions and benefits (Holzmann & Palacios, 2001) and reducing the projected pension debt in the long run by shifting some of the responsibility for pension benefits away from the employer and government to the individual. In the short term, however, there are serious concerns about how to finance the transition to an FDC pillar. Without adequate planning, diverted funds to FDC individual accounts may create major fiscal difficulties for the government’s obligations to current retirees, difficulties China is currently facing. Examples from other nations prove more dramatic: Argentina’s economic collapse in the late 1990s has been blamed in part on the large deficit created as a result of redirected pension contributions (Baker & Kar, 2002). Even Chile, with its FDC model that has been deemed very successful by many commentators, ran up an annual deficit equal to 8% of the GDP in the beginning stages of the transition to a privatized pension scheme and still has an annual deficit of about 5% of the GDP with no major decline projected for the near future (Baker & Kar, 2002; Kay, 1999).

In addition to demographic concerns, the Chinese government is under enormous pressure to deal with the issue of unemployment and, as a result, the government has been making employment growth a top economic priority (“China’s Unemployment Rate”, 2003). Because of its contributions to national savings, the FDC model is attractive as one way to promote economic growth and increase job
opportunities. In Australia, their Superannuation Guarantee, which is an FDC pillar, is projected to eventually increase national savings by 25% (Bateman & Piggot, 2001). Similarly, in Chile, national savings have increased an average of 10% per year since the move to privatized social security (Williamson & Pampel, 1998). Such dramatic increases have helped develop Chilean financial markets and have promoted a more favorable outlook for long-term economic growth (Holzmann & Palacios, 2001). However, initial increases in national savings may in large measure be offset by transition costs. For example, while Chile has experienced an increase in the national savings rate, fiscal costs (including payments to current retirees) for the first fifteen years of the new system have resulted in an overall net decline in national savings of close to 3% of GDP (Mesa-Lago, 2001). For China to have an effective transition to a multi-pillar system with an FDC component, there must be careful attention to financing the transition as a way to foster the desired long-term economic benefits, namely, increased national savings and economic growth, that many analysts associate with an FDC pillar.

In addition to concerns about funding retirees during the transition period, China needs to assess the capacity of its financial infrastructure to support privatized individual accounts. When Chile underwent its pension reform in the early 80s, it was in the midst of a major simultaneous restructuring of its financial sector (Acuña & Iglesias, 2001). China, with an immature domestic stock market and lacking adequate regulatory bodies as well as asset managers (Leckie, 2000), must be careful not to put the cart before the horse. A market which is not equipped to handle a large influx of investment capital could be quite volatile as demand exceeds supply.

In part due to its immature markets, contributions to individual accounts in China are currently publicly managed. The assets are invested in a combination of savings deposits (in government banks) and government bonds. However, most advocates of the FDC model argue that for this model to yield high returns there must be private managers and competition among these managers. Further, even in countries in which there is competition among fund administrators, there is a need to protect against the concentration of funds within one or two principal administrators.

If China is to have fair markets, there must be additional development of its financial system, including steps to deepen the stock market and to establish effective regulatory bodies (Leckie, 2000). Currently, China plans to restrict even the future investment of pension assets largely to bank deposits and government bonds. Such restrictions will not produce the conditions under which an FDC based pillar is likely to generate high returns (Saunders & Shang, 2001).

Privately managed funded defined contribution (FDC) models are attractive to many reformers due to the expectation of high returns on individual contributions. These privately managed accounts increase transparency by linking individual contributions and the returns on the accumulations in these accounts over the years to eventual pension benefits, making contributions seem more like an investment or savings than a tax. In contrast, contributions to pay-as-you-go defined benefit (PAYGO DB) schemes are typically viewed as a tax because of the weaker link to eventual pension benefits and the contributions made. Depending upon the success of investments decisions, the level of return for an FDC scheme is potentially greater than that for a PAYGO DB scheme (Kay, 1999). It is necessary, however, to factor in the substantially higher administrative costs associated with FDC schemes.

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2 This argument focuses on the issue of distributional transparency; but there is another form of transparency that is just as important, transparency with respect to replacement rates. The PAYGO DB model is generally more transparent in this respect than the FDC model because the size of the eventual pension is not influenced by unexpected swings in financial markets.
In Chile, for example, administrative costs came to almost 20% of yearly contributions during the first 15 years or so. While the average return for the pension assets was close to 11% between 1982 and 1998, returns to the worker less commissions and other administrative costs were closer to 5% during this same period (Kay, 2000). Also, in the very small accounts that are common for low-wage workers and those with irregular work histories, periodic flat rate fees tend to erode the balance and offset even relatively high returns for the pension fund assets in the aggregate. Policy makers in China have good reason to be concerned about the potentially high administrative costs of individual accounts, particularly those accounts held by low-wage and irregular workers.

In addition to the issue of administrative costs, other major areas of concern for those with an interest in the consequences of FDC schemes for low-income workers are: market volatility, incentives to evade contributions, and the lack of redistribution. The financial crisis in much of Asia between 1997 and 1999 and the downturn in many of the world’s equity markets between the first quarter of 2000 and the first quarter of 2003 highlight the risks associated with pension benefits that are vulnerable to capital markets. Particularly vulnerable are workers close to retirement who do not have the benefit of long term trends in equity markets. While the FDC system and its projected high rate of return may benefit average-wage and high-wage workers, volatility in mandatory pension schemes, particularly for low-income workers and women, who would have smaller accounts, could result in a minimal account balance if the market experienced a significant and lasting downturn (Williamson & Pampel, 1998).

The risk associated with individual accounts has also led to evasion in several countries, with low-income workers choosing to forgo contributions due to the desire to maximize take-home pay to meet pressing current needs, to shorter projected life expectancies, or to the desire to invest in tangible assets such as property (James, 1999). Not only has worker evasion been pervasive, but also compliance (measured as the number of participating companies who are active contributors) is lower than expected in many countries which have already adopted FDC schemes (Mesa-Lago, 2001). Employees with irregular work histories are more likely to have problems with employers not turning in contributions or not recording them. In Australia, there has also been the problem of a substantial number, nearly 2.5 million of a total 20.5 million, of ‘lost’ accounts: accounts that, once opened, have gone without contributions (Bateman & Piggot, 2001). This problem is particularly common for seasonal workers and those in the informal economy.

Often there is little or no redistribution associated with FDC schemes. Pension benefits based on capital returns often disproportionately benefit more affluent workers, leading to greater income inequality among the aged with adverse consequences for intragenerational inequity. In addition, while there is the potential for greater benefits due to capital market investment, there is also the chance that more individuals are either not insured or only partially covered (James, 1999).

As in China, many nations address the risks associated with FDC accounts through a mandatory flat rate PAYGO DB pillar, often targeted at low-wage workers. While such a pillar is meant to offset the risk of individual accounts, a minimum pension can unintentionally lead many low-wage employees to remain at work only for the required contribution period of the minimum (basic) pension, usually in the range of 15–25 working years. Workers then often transition to the informal labor market sometimes continuing to save for retirement by investing in properties, farming equipment, or children’s educations (Packard, 2002).

The minimum pension is often very modest. Because of the high degree of income inequality in many developing nations, a living wage for poorer workers would be quite inadequate for more affluent workers, and for this reason it is unlikely to be politically supported by those workers (James, 1999).
China’s past history of state provision of goods and services for all may eventually make an adequate minimum pension feasible, but today the first pillar does not provide much more than a very basic subsistence pension.

Some of the goals of an FDC model, namely that of increased benefits due to significant capital returns, are often at odds with funding for other social needs. Revenues diverted from an existing PAYGO DB scheme into individual accounts produce deficits that often must be made up using general government revenues. This can lead to budget cuts or inattention to other public services, such as education and healthcare (Borowczyk, 2001). This issue of transition funding, that is, paying the pensions of those already retired, during the transition years, remains one of the most difficult problems associated with a pension reform that calls for the introduction of an FDC pillar. Analysts caution that countries choosing privatization can suffer a substantial loss in revenue, making the decision to privatize risky for nations with recurring budget problems and high levels of national debt (Baker & Kar, 2002).

5. Why is China on the road to a partially privatized social security system?

A number of factors linked to globalization are relevant to the analysis of why social security policy is developing as it is in China, but globalization does not by itself tell the whole story. The effects of globalization are clearly being mediated by a number of historical, structural, cultural, and ideological factors (Walker & Deacon, 2003). Some factors at first appear to be internal political concerns quite independent of external events and pressures, but then upon closer inspection end up being linked to globalization.

For a number of reasons Chinese policy makers put a high premium on both short-term and long-term economic growth. The introduction of a multi-pillar social security scheme that includes one or more funded pillars is viewed as one way to help increase the nation’s savings rate which in turn should contribute to an increase in capital available to invest in projects that will contribute to economic growth. While there are some very reputable economists who question this conclusion (Stiglitz, 2002), most do support it.

Recent reforms can be viewed as an effort to bring a pension scheme that had been in partial default into fiscal balance. We say partial default because many workers have not been receiving the pension benefits they were due (Bradsher, 2004). If this effort is successful, the new scheme is expected to contribute to both economic growth and to political stability. International investment capital is attracted to nations with political stability and strong prospects for continued political stability (Fligstein, 2001). The political instability and economic collapse in Russia following the break up of the Soviet Union has not gone unnoticed by social and economic policy makers in China or by foreign investors considering joint business ventures in China.

The partial privatization of the Chinese social security scheme could end up contributing to political stability for two quite different reasons. One is that it would be expected to contribute to economic growth, which in turn would tend to reduce the unemployment rate. Because high unemployment is a potential source of protest and unrest, partial privatization could contribute to political stability (Yardley, 2003). A second reason is that partial privatization would gradually shift the responsibility for the size of the eventual pension benefit from the state-owned enterprise to the employee, making the individual feel more responsible for the size of the eventual pension benefit. To the extent that the level of these benefits and the payment (or lack of payment) is viewed as the responsibility of the employer and the local or
central government, there is the potential for unrest. But to the extent that popular thinking shifts and people start holding themselves responsible, China’s workforce may be less likely to participate in protests or in other ways take action that might contribute to political instability.

International investment capital is also attracted to developing nations in which property rights are well institutionalized (North, 1990). While property rights are not as yet as well developed in China as in western nations, the Chinese government is well aware of the need to more fully institutionalize property rights. One reflection of this awareness is the amendment to the Chinese constitution made in early 2004 reconfirming the nation’s commitment to individual property rights. The partial privatization of social security can be viewed as yet another aspect of the effort to further institutionalize individual property rights.

To the extent to which we focus on: (1) concerns about property rights, (2) China’s desire to be viewed as having a favorable business climate and as being an attractive destination for foreign direct investment capital, and (3) on China’s efforts to make its products competitive in international markets, we are dealing with the consequences of economic globalization. But the globalization process also includes other forms of social or cultural globalization that may help account for current trends in Chinese social security policy.

In the past sociologists have had much to say about cultural diffusion, the process by which innovation and popular culture spread from one country to another. More recently neo-institutionalists have described the ways in which countries imitate institutional structures and social policy ideas from other states they consider successful (Carruthers & Babb, 2000). One particularly clear example of this is Westney’s (1987) study of the ways in which 19th century Japan decided to restructure various aspects of its civil service bureaucracy based on models drawn from European countries such as Britain. It should not surprise us to find that today China is making a parallel effort to copy social security models that seem to work in other nations around the world. Chinese policy makers have been very interested in social security reform efforts in other countries, particularly those that have helped nations with a PAYGO DB scheme move to a more market oriented alternative. Much attention has been given to the relative success of partially and fully privatized social security systems that have been introduced in a number of other countries. According to many international social security experts, the funded individual account models are working relatively well in many nations in Eastern Europe and Latin America. While there are many social security analysts who question the partial or full privatization of social security schemes, the majority of those affiliated with a number of very influential intergovernmental organizations (IGOs), such as the World Bank, advocate multi-pillar models that include funded individual account pillars. The global process of imitation by which the multi-pillar World Bank model has rapidly spread around the world is consistent with what would be expected on the basis of world culture theory (Boli & Thomas, 1997).

Economic sociologists have emphasized the role of networks of experts around the world in the transmission of ideas and institutional practices associated with the globalization process (Carruthers & Babb, 2000). Again we can look to the influence of experts from the World Bank and other such financial institutions that have offered their assistance to many developing and transition nations including China, nations with social security systems experiencing or projecting severe shortfalls. In the case of China there have not only been extensive contacts between the World Bank and other such financial institutions, there have also been extensive contacts with various American think tanks, particularly those, such as the Cato Institute, espousing the partial or full privatization of the Chinese social security system (“With Pension System a Mess,” 2001). Staff members from several American
think tanks have offered seminars, set up conferences, and in other ways contributed to social security reform efforts in China. While globalization has had an impact on policy reforms in China, this impact has been mediated and modified by a number of factors linked to the nation’s history, culture, and policy legacy. Of particular note in this context has been the legacy of a highly decentralized social security system in which for many years pension provision has been the responsibility of the individual state-owned enterprise. While there has been a gradual movement toward greater centralization, in comparison to many other nations, the Chinese scheme remains highly decentralized. While China is moving in the direction of a market economy, its “hybrid” economy and social security policy continue to reflect the nation’s history of state-socialism (Nee & Matthews, 1996).

6. Discussion and conclusions

One of the major questions we have addressed is whether or not the partial privatization of the social security system makes sense for China. Our answer has been that partial privatization, at least in the long run, might well have a number of benefits for the overall economy, but there would also be substantial offsetting costs to many individual workers along the way. In particular, partial privatization represents a shift away from the logic of social insurance with its focus on shared risk, collective provision, and protection against various sources of income insecurity in a way that typically provides substantial income redistribution favoring low-wage workers. When assessing partial privatization models, most economists tend to focus on the potential benefits to the economy and to workers in the aggregate. Sociologists, in contrast, generally give more emphasis to such issues as who is being asked to bear the greatest burden or who is being put most at risk when major changes are being made in social programs. In the case of China it is very likely that the most vulnerable (including recent immigrants from the countryside, unmarried women, low-wage workers, and those who have had irregular work histories due to mental health and other problems) are going to be put at the greatest risk and the most affluent workers are most likely to benefit. The scheme is going to be much less redistributive than the scheme it is replacing. This is a particularly serious problem for a nation with so many expected to be living at the economic margins during their retirement years.

Another question that is key to our analysis has been whether or not social security reform in China is being shaped to any significant degree by globalization. Our conclusion is that it has been shaped by a number of factors linked to economic globalization. In this context we have emphasized the need for the state-owned enterprises to be competitive in international markets, the need to convince outside investors and potential trading partners that China has a market oriented economy and is committed to protecting private property rights. China has also been influenced by other social forms of globalization, more specifically, Chinese economists have been consulting with other economists around the world, most notably those affiliated with international financial institutions such as the World Bank. The networks linking Chinese policy experts with social security experts in various IGOs and in American think tanks have been important. As suggested by a number of neo-institutionalists and world culture theorists, there has been a diffusion of ideas about social security reform including the World Bank’s multi-pillar model from policy experts around the world to those in China.

Given current demographic trends, the rapid rate of economic growth, the huge demand for investment capital, the central government’s very limited capacity to extract payroll tax revenues from
workers, and the strong support among policy elites for economic policy based on neoliberal ideology, which seems in large part to be derived from and reinforced by policy experts from organizations such as the World Bank and the International Monetary Fund, it is not at all surprising that China has decided to partially privatize its public pension system. But have they made a decision that is going to benefit China’s most vulnerable urban workers? For a number of reasons including the volatility of Chinese financial markets and the associated risk of inadequate pension benefits for low-wage workers, the current move to partially privatize the public pension system is, in our view, not a wise decision, particularly at this point in time.

As policy makers in China look to the future, a decision must be made whether to fully implement the nation’s current funded defined contribution pillar following the example of a number of other nations, including several in Latin America and Eastern Europe, or to move in one of three alternative directions.

One alternative would be to base the entire Chinese social security system on the PAYGO DB model. This could be done by phasing out the recently introduced “funded” individual accounts pillar that to date has been unfunded for most workers. It could also be done by replacing this funded pillar with a wage-related PAYGO defined benefit pillar. This alternative would run into serious opposition given the problems associated with China’s prior enterprise based PAYGO DB schemes. Chinese social security experts are in agreement that dramatic policy changes are needed, but they are not looking to defined benefit models for ideas about how to structure a wage-related pillar.

A second alternative would be to replace the current “funded” pillar with an alternative pillar based on the provident fund model, a model currently found in Singapore and in several other Asian and African nations that were once British colonies (Turner, 2002; “With Pension System a Mess,” 2001). With a provident fund scheme individual accounts are set up and funded by contributions from workers (or workers and employers). These assets are managed by the government, often being invested in government bonds. In Singapore it has been possible to provide returns that have more than kept up with inflation. However, in many nations with provident funds, long-term returns have been poor (often negative) due to serious government mismanagement of the funds. This has been particularly true in African nations (Gillion, Turner, Bailey, & Latulippe, 2000; Williamson & Pampel, 1998; World Bank, 1994).

A third alternative would be to replace the current “funded” individual accounts pillar with a pay-as-you-go (or notional) defined contribution model. This model has been described as a compromise between the pay-as-you-go defined benefit model that is common throughout the world and the funded defined contribution model (Williamson, 2004; Williamson & Zheng, 2003). The notional (unfunded) defined contribution (NDC) model would tend to make benefits follow contributions more closely than is the case with many pay-as-you-go defined contribution schemes. However, it would also protect covered workers from radical fluctuations in financial markets because retirement benefits are linked to trends in wage levels, not to trends in financial markets. Such schemes have been introduced with some success not only in affluent countries such as Sweden and Italy, but also in several transition countries including Latvia, Poland, and Mongolia.

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