Chapter 2
The Deviation of China's Social Insurance Fund Mode and Its Corrections

The function of the social insurance system as a key part of the modern social security system is reflected in the operation of social insurance funds. The mode of social insurance funds forms the foundation for the social insurance system. To address the pressure of an aging population and to meet the demands of the rapid development of the capital market (especially in international capital flows), along with international momentum for reforming the social security system, intense debates have been triggered on the traditional pay-as-you-go social insurance mode.

2.1 Debates on the Social Insurance Fund Modes

Of the three main worldwide funding modes for social insurance funds (mainly old-age pensions), namely the pay-as-you-go system, the fund accumulation system and the hybrid system or the partial fund accumulation system (see Table 2.1 for their basic characteristics), those which have drawn most attention and provoked controversy are the pay-as-you-go system and the fund accumulation system. Since the successful transition from the pay-as-you-go system to the fund accumulation system in Chile in the 1980s, as well as the rise of the ROI rate of the fund accumulation mode, people have come to prefer the fund accumulation system. It is believed that it is an important pillar for developing the capital market and an effective prescription for overcoming the problems concomitant with an aging population, while helping to increase savings, enhance the fund use rate and promote economic growth.

The main argument is as follows:

(1) the pay-as-you-go system cannot address the heavy burden of an aging population. An aging population, which demands the continuous increase of the social insurance tax rate, may aggravate unemployment and early retirement

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Y. Wang, *Social Security in China: On the Possibility of Equitable Distribution*,
Research Series on the Chinese Dream and China's Development Path,
DOI 10.1007/978-981-10-5643-7_2

Table 2.1 Comparison of the basic modes of social insurance funds

Fund mode	Fund source and management	Advantages	Disadvantages
Pay-as-you-go	Public, tax, and ratification of expenditures according to revenue	Strong re-distribution function (inter-generational diversion and horizontal transfer), and simple management	With great demands from an aging population, the premium rate has to be adjusted frequently
Fund accumulation	Compulsory, private management, and ratification of expenditures according to revenue	Incentive payment and compulsory savings, promoting capital market and economic growth	The fund is susceptible to the impact of the macro-economy and inflation. It has a poor redistribution function. The investment management is complicated
Hybrid mode	Compulsory source, partial ratification of expenditures according to revenue and partial ratification of revenue according to expenditure	Considering both the re-distribution function and the accumulation function	Management is extremely complicated, and function orientation tends to change

and lead to a reduction in permanent savings and investment. The growth of implicit public pension debts is difficult to sustain.

(2) Fund accumulation may promote economic growth. Old-age pensions are an important force in the capital market. In 1996, gross global assets amounted to about USD 42 trillion, of which about 20% (USD 10-12 trillion) were the pension assets of developed countries (Dawei et al. 2000).
(3) The success of the Chilean model. Chile successfully made the transition from the pay-as-you-go system to the fund accumulation system in the early 1980s. In a period of over 10 years, the country not only made up deficits, but also accumulated a fund of over USD 20 billion. As a result, the difficulty in paying pensions was resolved and fiscal and enterprise burdens were alleviated. The personal contribution rate was also lowered and the pension replacement rate was increased, thus providing a large amount of funds for economic construction.
(4) The accumulation mode is conducive to improving the saving rate and stimulating economic growth. Economic growth is a function of savings. Chile and Switzerland, through compulsory savings plans, increased their respective national savings rate. The savings rate in Switzerland increased from a GDP of 6–8.5%, and Chile's also increased to some extent. Some studies hold that a

pension reform could increase the original aggregate savings rate by about 10–30% (James 1998).

(5) The high ROI of investment funds. Generally speaking, in countries with more open fund management, the ROI of investment funds is higher in the capital market, such as in France, Australia, the United Kingdom, the United States, Ireland and Canada, with notably more outstanding performance in English-speaking countries (see Table 2.2).
(6) Since the 1970s, there has been a wave of reforms of the social security system worldwide, with the purpose of seeking a new relationship between national actions and private actions and strengthening individuals' responsibility for themselves and others.

While analyzing the role of the fund accumulation system, we should note that people have varied opinions regarding the fund accumulation mode. In fact, the fund accumulation system is overrated, thus giving rise to the fallacy of "anything from the fund accumulation system must be good."

The reasons are as follows:

(1) Fund accumulation does not necessarily increase the national savings rate. Cases proving that the accumulation system can enhance the savings rate are found only in Switzerland and Chile, of which the ratio of savings to GDP in Chile dropped from 21% in 1980 to 20% in 1989. As compulsory savings only account for a part of gross national savings, the increase of the compulsory savings rate is not tantamount to the increase of the gross savings rate.
(2) The role of the capital market is overrated. The role of the capital market is growing, but at the expense of huge risks. The Asian Financial Crisis that broke out in 1997 was an obvious case which highlights this point. Stiglitz observes that developing countries should not simply imitate the capital market in developed countries but should face reality, that is, it is very likely, if not inevitable, that their domestic capital market may operate rather poorly (Stiglitz 1989).
(3) The management cost of the fund accumulation mode, especially for private pension funds, is quite high, even significantly higher than the public system. The management cost and commission charges of commercial old-age insurance in the United States account for 35% of insurance premiums, the profit loss caused by the management cost of private funds in the United Kingdom amounts to 5.2% each year, and the management cost of private old-age pensions in Chile accounts for 1.5% of the salary base (see Table 2.3). The International Labor Organization has, after conducting a survey, concluded that it is certainly wrong to consider that the expenditure of administering the public sector is higher than that of the private sector.
(4) Insurance fund modes require a large amount of government subsidies, as is the case with Chile and other countries.
(5) Over-emphasis on fund accumulation, though improving fund efficiency to some extent (but not fully, as no adequate evidence is available so far), also

Table 2.2 Investment portfolio and ROI of old-age insurance funds and gross assets in diverse countries (regions)

Country	Item							
	Bond (%)	Stock (%)	Cash (%)	Real estate (%)	Average ROI (%) (1983–1993)	Gross assets by the end of 1993 (USD 1 billion)		
	Domestic	International	Domestic	International				
Australia	35.87	4.00	36.37	12.05	3.83	7.88	12.1	122.2
Belgium	38.31	11.94	13.93	17.41	7.46	10.95	9.0	5.6
Canada	47.93	0.46	26.85	8.61	8.46	7.49	8.3	162.3
Denmark	67.93	0	18.67	0	6.05	6.35	8.2	14.4
France	62.00	5.00	20.00	0	2.00	11.00	13.0	199.7
Germany	65.05	1.59	9.97	0.91	8.38	12.00	6.5	254.2
Hong Kong	2.10	11.03	34.03	49.05	3.99	0	8.1	6.8
Ireland	33.67	7.14	21.43	27.55	3.06	7.15	11.8	13.8
Japan	53.58	9.00	24.18	5.01	5.01	3.22	6.2	1752.7
The Netherlands	60.60	5.81	7.69	11.31	3.40	11.19	7.5	216.2
New Zealand	25.87	11.19	27.97	23.08	2.80	9.09	10.8	7.9
Norway	74.52	4.70	5.91	1.09	8.70	5.08	8.0	30.6
Singapore	97.35	0	0	0	2.65	0	1.8	32.9
Spain	95.00	0	3.02	0	0	1.98	8.8	13.4
Sweden	92.43	0	4.66	0	0.97	1.94	7.2	61.8
Switzerland	59.00	4.00	9.00	2.00	10.00	16.00	3.5	195.3
The United Kingdom	8.96	3.05	56.01	23.01	3.06	5.91	11.5	726.4
The United States	33.05	0.72	48.52	3.61	11.76	2.34	9.5	2908.0

Source World Bank (1998, p. 79), Lianyou (2000, p. 82)

Table 2.3 A Survey of the International Labor Organization (ILO) on expenditure of social security management

Pay-as-you-go pattern		Fund accumulation pattern		Private pension management cost	
Country	Management cost (%)	Country	Management cost (%)	Country	Management cost (%)
France	1.7	Singapore	0.8	The United	35
Germany	1.5	Malaysia	4.5	States	5.2
The United States	0.8	India	5.4	The United Kingdom Chile	1.5

Source Ministry of Finance (1998, p. 248)

weakens the re-distribution function of the social security system, because only individuals possessing more accumulated funds acquire more gains. This also involves the basic problem of value judgment; that is, how to handle the re-distribution function of social security and how to balance the fairness and efficiency of the social security system.

The debate over the pay-as-you-go mode and the fund accumulation mode is still continuing to provoke controversy in theoretical circles, with no substantial conclusion. Different opinions may be formed from viewing the issue from different perspectives. Gruat, an ILO scholar, believes that despite the claim of a crisis in the World Bank's "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth", the solution to the crisis proposed in this report not only fails to provide a better guarantee for old-age pension benefits, but also presents larger potential risks than the correctly designed and managed fixed benefit system (Gruat 1998). The World Bank report also acknowledges that without a developed capital market and being unable to establish an effective regulatory authority, it is impracticable for many countries to adopt the solution of fixed pay. In practice, most countries around the world, including developed countries and covering OECD countries, have practiced or still practice the pay-as-you-go mode, with the basis for old-age insurance still being public old-age insurance run by the government. Currently, only 18 countries with great differences in levels of economic development, low socialization and a small scale of economic aggregate, such as Fiji and Ghana adopt the fund accumulation system (Jiangang 1999). However, in light of the disadvantages of the pay-as-you-go mode and the advantages of the fund accumulation system, and inspired by the successful transition of countries such as Chile to implement the fund accumulation system, the World Bank proposed the multi-pillar mode including the fund accumulation system in the early 1990s, which has exerted a degree of influence upon the reform of the social insurance system of many countries (including China).

2.2 Institutional Deviation of the Hybrid Mode of the Social Insurance Fund in China

(i) Institutional design of "completing the whole task in one stroke"

In the course of establishing a socialist market economy, China should reform its traditional social security system. Unlike the transformation of the social insurance system in countries like Chile, the reform of the social insurance system in China is confronted with two basic tasks: First, in coordination with the socialist market economic system, to establish a socialized social security system and complete the institutional transformation from enterprise (unit) insurance to social insurance. That is an important characteristic quite different from the reforms of the social security system having occurred in any other country. Such a transformation is not within the scope of controversy over the pay-as-you-go or the fund accumulation modes. If the pay-as-you-go practice was adopted in the past, this transformation is to meet the demands of increasingly expanding pay-as-you-go practice. The second task is to establish a multi-pillar system including the fund accumulation system so as to follow the trend of economic development and the reform of social security reforms worldwide. The hybrid system (partial fund accumulation system) combining social pooling and personal accounts has been gradually put into practice since the 1990s in China, in the hope that the above two tasks can be accomplished at the same time, that is, the problem of dual system transformation.

After the exploration through pilot reform and theoretical generation conducted since the mid-1980s, the "Decision" of the Third Plenary Session of the Fourteenth Central Committee of the CPC adopted in 1993 put forward that a hybrid system combining social pooling and personal accounts be implemented for the basic old-age insurance and medical care systems for urban employees in China. According to this approach, China has conducted experimental reforms of the hybrid system by different means in different cities and developed several dozen types of reform. In 1997 and 1998, the State Council, through a comparative summary of the reform types in different places, issued the "Decision on Establishing a Uniform Enterprise Employees' Old-Age Insurance System" and the "Decision on Establishing an Urban Employees' Basic Medical Insurance System", which constituted the basic framework of the two major social insurance systems in Chinese urban areas, old-age insurance and medical insurance.

The combination of social pooling and personal accounts is a type of hybrid mode combining pay-as-you-go and fund accumulation, containing characteristics of both modes. The purpose of combining the pay-as-you-go system and the fund accumulation system in the urban social insurance system is, on the one hand, to meet the demands of completing the transformation of the social insurance system so that the current fund can provide basic insurance to retired people without accumulation, and on the other hand, to enable in-service employees to accumulate a certain amount of social insurance funds, especially old-age pensions, during the 20–30 years when economic growth and the demographic structure were optimal in

- Old-age pension payment
  - Old-age pension for “old people”——Calculated and issued according to the original method——Social pooling fund
  - Old-age pension for “in-service persons”
    - Basic old-age pension——Social pooling fund
    - Transitional old-age pension——Social pooling fund
    - Personal account old-age pension——Personal account fund П120
  - Old-age pension for “new persons”
    - Basic old-age pension——Social pooling fund
    - Personal account old-age pension——Personal account fund П120

Fig. 2.1 Diagram of the payment approaches of social old-age pensions in chin

China, so as to alleviate enterprises’ fiscal burden and develop the capital market. This institutional design of “completing the whole task in one stroke” has become recognized by most experts, scholars and decision-makers. Compared with the simple pay-as-you-go system or the fund accumulation system, the hybrid system has its own operation mechanism. First, the hybrid system has to guarantee of the payment of retired people (“elderly people”); second, it should provide basic old-age pensions and personal accumulation for in-service personnel (“in-service persons”); third, it should provide basic insurance and complete personal account accumulation for “new persons” (see Fig. 2.1).

The new system increases requirements on value preservation and the appreciation of accumulated funds. To realize the balance of payments is the fundamental principle for the operation of social insurance funds. The partial fund accumulation system requires that social insurance funds realize two “balances of payment”; one balance is to ensure payment to retired people from pooling funds, and the other balance is to realize the long-term dynamic balance of the accumulated fund. This system has to integrate horizontal balance and vertical balance to realize the periodical balance of payment. In the early period, the financing rate is higher than the payment rate so as to realize partial fund accumulation, that is, a reserve fund, in the case that in the advent of the peak period of aging, the peak fund payment demand can be met at a relatively low financing rate, so as to prevent any financial crisis in social insurance funds (see Fig. 2.2).

(ii) Institutional deviation of the hybrid mode of social insurance funds in China

China’s social insurance fund hybrid system, to some extent, meets the fund system ideal and the multi-pillar system advocated by the World Bank; however, in practice, these systems are not the same, resulting in a large disparity between the operation mechanism and the operation effect.

First, too much importance is accorded to the role of the fund system. China fails to define the primary and secondary relationship between social pooling and personal accounts in the institutional framework, which means that China is not clear

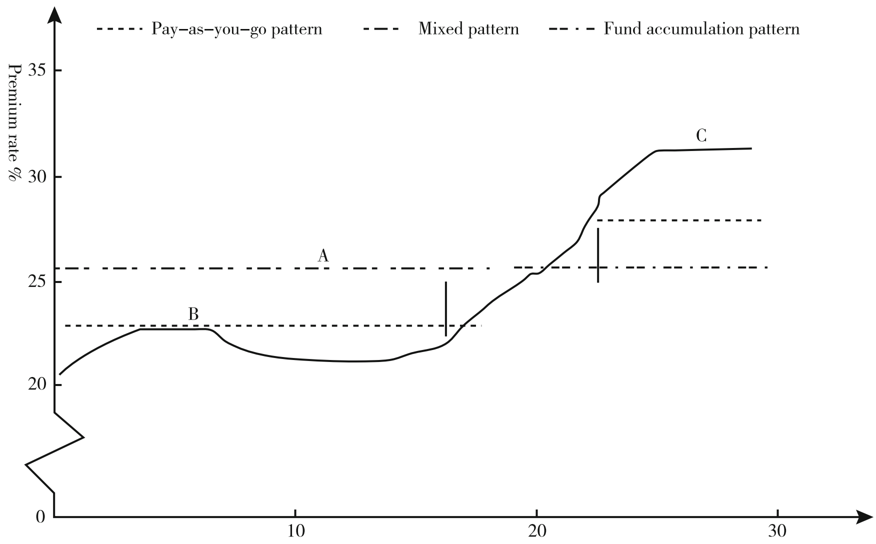

Fig. 2.2 Diagram of variation of premium rates of three financing modes. *Source* Man (1997, p. 169)

with regards to whether the new social insurance system to be established is to be dominated by social pooling (pay-as-you-go) or will be inclined towards developing personal accounts (fund accumulation). In the fund ratio cut of social pooling and personal accounts, no primary and secondary relationship between the two aspects of China's new social insurance system can be discerned. However, as the ratio of personal accounts in China's hybrid mode is larger (see Table 2.4), it can be concluded that the design of China's social insurance fund modes much prefer the fund system commended by the World Bank. However, to complete the "dual system transformation" in the social insurance system, China does not have the practical conditions for realizing the fund system in the short term. Such institutional vagueness is not conducive to the normal operation and sustainable development of the new system.

Second, the design of China's social insurance system has not attached adequate importance to the issue of transitional cost, which affects the effect of personal accounts (the accumulated part of the fund) and is an objective cause for the presence of empty individual accounts. For example, in the design of the old-age insurance system plan, historical debts are under-estimated, and the approach of empty personal accounts going before gradual replenishment is adopted, which leads to empty personal accounts. As future funds are now prepaid, if no solution is worked out, either the institutional design of the mode integrating social pooling and personal accounts will be affected, or a financial crisis will arise. At present, adjustments should be made regarding the old-age insurance system, or the system will be become difficult to sustain.

Table 2.4 Ratio cut of social pooling funds and personal accounts in China's basic old-age insurance and medical insurance

Type of insurance	Social pooling fund		Personal account fund	
	Source of funds	Percentage of the total amount of funds (%)	Source of fund	Percentage of the total amount of funds (%)
Basic old-age insurance	Payment by units (20–16% of the total salary)	13 percentage points of the payment by enterprise, that is, 54.2% of the total amount of insurance funds	The part transferred to personal accounts from enterprise payment (a drop from 7 percentage points to 3 percentage points), personal payment (4–8% of the personal salary base)	11 percentage points, that is, 45.8% of the total amount of insurance funds
Basic medical insurance	Unit payment (16% of total salary)	70% of the enterprise payment (4.2 percentage points), that is, 52.5% of the total amount of insurance funds	The part transferred to personal accounts from enterprise payment (30%), personal payment (2% of the personal salary base)	3.8 percentage points, that is, 47.5% of the total amount of insurance funds

Source Calculated and arranged according to the "Decision on Establishing a Uniform Enterprise Employees' Old-Age Insurance System" (1997) and the "Decision on Establishing an Urban Employees' Basic Medical Insurance System" (1998) of the State Council

Third, China's comprehension of the multi-pillar mode contains deviations. Of the three-pillar system advocated by the World Bank, the first pillar is the pay-as-you-go and public-operated system that ratifies expenditure according to revenue, mainly for providing a social security net for elderly people with a low-income, the second pillar is the compulsory fully-accumulated system that ratifies expenditure according to revenue, with private and competitive fund management, and the third pillar is voluntary savings and annuity providing supplementary retirement income. Though the sources of the second pillar (compulsory personal accounts) are compulsory, its nature is similar to personal savings, its property rights are personal, while its operation and management are conducted by private and competitive fund companies. However, China has not defined the relationship between the two funds or the property right ownership of personal accounts, but practices centralized and interconnected management, thus leaving an institutional loophole for the appropriation of personal accounts by the social pooling fund. Given the difficulty of the social pooling fund to meet the demands of increasing payments, the "gratuitous" appropriation of personal accounts by social pooling accounts has resulted. Not only is it difficult for personal accounts to be fully funded, which become certificated "empty accounts", but fund investment is also unable to be conducted, value cannot be preserved or appreciated, and the accumulation effect of the partial fund accumulation system is lost, all a far cry from the initial objectives of institutional design.

Fourth, the management system for personal accounts (fund accumulation) aspect of China's social insurance fund mode is hindered and not conducive to appreciation on investments. Constrained by many factors such as fund payment pressure and capital market imperfections, the investment channels for the social insurance funds that have been accumulated in China are not smooth, with chaotic management, being barely able to realize value preservation and appreciation. In sum, the hybrid mode of combining social pooling and personal accounts in China, though similar to the fund accumulation system and the multi-pillar system advocated by the World Bank, differs widely from them in terms of operation mechanism and practical conditions. China has confused its system with that advocated by the World Bank, creating many problems in practice.

2.3 Difficulties in the Practice of the Hybrid Mode of Social Pooling and Personal Accounts

The hybrid mode of China's social insurance system attempts to integrate the "fund system" and the "multi-pillar" system. However, the framework of China's new old-age insurance and medical insurance system, which is equipped with the shell of the "fund system" to some extent, does not have the conditions and management mechanism for implementing the fund system; despite its formation as a "multi-pillar" system, it deviates from the "multi-pillar" operational mechanism, thus giving rise to difficulties in fund operation.

(i) The social pooling fund is becoming over-burdened, while old-age insurance personal accounts operate as empty accounts

The expenditure of old-age pensions amounts to the largest amount of expenditure within social security, as all members of society will become old one day, thus requiring an increase in expenditure on old age pensions to meet the pressures of an aging population. At present, though old-age social insurance in China only covers persons employed in urban units, the coverage is considerably widespread (the total number of retired persons in 1999 was 37.3 million, and the total insurance benefits amounted to RMB 336.1 billion). The payment of the old-age insurance fund has turned from "pay-as-you-go" to the hybrid system and historical debts have led to great obstacles when attempting to transform the old-age pension system. Due to the transformation of the old-age security system, a considerable amount of historical debts have had to be paid from the old-age insurance social pooling fund. The expanding expenditure has exerted great pressure on the social insurance pooling fund. Since the implementation of the new old-age insurance system, the social pooling fund has become overburdened, and there is no option but to appropriate funds into individual accounts. As a result, the personal accounts of

Table 2.5 Income and expenditure of China's old-age insurance fund in 1989–1999

Year	Fund income (billion yuan)	Fund expenditure (billion yuan)	Total surplus (billion yuan)
1989	14.67469	11.88292	6.79899
1990	17.88178	14.93363	9.78760
1991	21.57084	17.30714	14.40688
1992	36.5766	32.19145	22.00683
1993	50.35402	47.06303	25.85889
1994	70.74245	66.10902	30.47662
1995	95.00507	84.76087	42.98338
1996	117.17639	103.18689	57.85604
1997	133.791	125.133	68.285
1998	145.9	151.16	61.16
1999	196.5	192.5	73.4

Source The Ministry of Labor (1997, p. 17); the Ministry of Labor and Social Security, and the National Bureau of Statistics (1997, 1998 and 1999)

accumulation accounts cannot be ensured to have adequate funds and can only operate as empty accounts. It was estimated that "empty accounts" in personal accounts have amounted to about 200 billion since 1997. In 1998, the total expenditure of national old-age insurance funds was greater than the total income (see Table 2.5). In this way, not only will personal accounts encounter a tremendous financial crisis, but the social insurance hybrid mode will also face huge institutional risks.

(ii) The nominal social insurance premium is too high, affecting the revenue of social insurance funds

To ensure that the huge fund payment is met, the urban social insurance premium in China has been set very high. With the acceleration of an ageing population, room for further increase of insurance premiums is becoming increasingly narrow. In 1999, urban old-age insurance in China only covered 46.9% of the total number of working people in cities and towns and 55.9% of the number of people who should have been covered by such insurance. Affected by factors such as economic downturns, difficulties encountered by enterprises and insufficient payments, the payment rate of units and individuals that have participated in social insurance has not been satisfactory. For example, the payment rate calculated by Guangdong Province according to the number of insurance participants dropped from 96.9% in 1993 to 91% in 1999. The arrears of social insurance premiums have become more common and the problem is even more serious in economically undeveloped areas. The payment rate in many places is only 70%; arrearages in national basic old-age insurance exceed RMB 36 billion. By regulation, social insurance charges should be deducted from employees' actual salary. But the salary base for premium payments differs widely from the employees' actual salary. In 1999, the average monthly salary base for enterprise old-age insurance in Guangdong Province was

RMB 847, but it was discovered through a survey that the base for old-age insurance premium payments by enterprises only accounted for about 70% of an employees' actual total salary. The World Bank discovered through a survey in 1995 that the actual old-age insurance payment rate of urban employees in China was only about 13% of the total amount of their salary. In that year, the nominal payment rate was above 23.5% (higher than the average rate of about 20% in the world), but the actual payment rate was only 55.3% of the nominal payment rate (World Bank 1998).

The presence of the above problems affected the source of social insurance funding and the stability of income. The average salary of urban in-service employees in 1999 was RMB 8346. Calculated with a coverage of 1.17 billion people and the social insurance premium rate as stipulated by the state (on average about 38–41% of the total salary, with 25–28% for old-age insurance, 8% for medical insurance, 3% for unemployment, and 1% for work-related injury and maternity insurance each), the revenue of urban social insurance in China is enormous, amounting to RMB 539-581.3 billion. If the rate of people participating in the insurance scheme, the fund payment rate and the actual payment rate all surpass 90%, the annual income of the social insurance fund should amount to RMB 377.3–406.9 billion. However, the national income of the social insurance fund only amounted to RMB 220.8 billion in 1999, accounting for only 54%-59% of the due payment, or only 38–41% of the total nominal payment. Due to the excessive discrepancy between the actual amount of collection and actual expenditure in the social insurance fund, China has to stipulate a very high social insurance collection rate, which suppresses an enterprises' initiative for premium payment.

(iii) The social insurance fund is very difficult to manage, with the huge pressure of value preservation and appreciation

The hybrid mode places a set of very high requirements upon fund managers, because it requires the actuarial valuation of the balance of payments of "two funds", the calculation of fund balance at different stages and the management of a large amount of accumulated funds with great risks and high requirements regarding safety. Affected by factors such as institutional design, management systems, management experience and a lack of professionals, the management and value maintenance and appreciation of accumulated funds in the social insurance of China are confronted with increasingly serious problems: On the one hand, the problem of disorderly management and capital loss is so severe that over RMB 10 billion yuan of social insurance funds was illegally appropriated, occupied or embezzled in the mid-1990s (Lianyou 2000). But on the other hand, in righting the wrong, proper limits have been exceeded, without preserving adequate fund investment channels; the fund appreciation rate falls short of inflation or interest rates (see Table 2.6), hardly able to realize the purpose of value maintenance and appreciation.

Table 2.6 Price index, bank interest rate and treasury bill interest rate of 1985–1999

Year	Rise of commodity retailing price (%)	Bank interest rate (%)		Treasury bill interest rate (%)	
		Current	One-year	Annual interest rate	Term (year)
1985	8.8		4.32	9	5
1986	6.0		5.04	10	6
1987	7.3		5.04	10	6
1988	18.5		8.64	10	3
1989	17.8	2.88	11.34	14	3
1990	2.1	2.88	10.08	14	3
1991	2.9	1.8	7.56	10	3
1992	5.4	1.8	7.56	10.5	5
1993	13.0	3.16	10.98	13.96	3
1994	21.7	3.15	10.98	15.86	5
1995	14.8	3.15	10.98	–	–
1996	6.1	1.98	7.47	–	–
1997	0.8	1.71	5.67	9.18	3
1998	−2.6	1.44	4.77	–	–
1999	−30	0.99	2.25	2.89	3

Source Arranged according to "China Statistical Yearbook (2000)" of the State Statistics Bureau

2.4 The Approaches and Measures for Deepening the Reform of the Social Insurance Fund System in China

(i) Stick to the principal status of social pooling and reduce the ratio of personal accounts

The problems arising from the operation of China's social insurance fund are related to the fact that we overburden the institutional design of the "fund system" and the "multi-pillar system". Therefore, to improve the social insurance system with Chinese characteristics, we should accord with the national conditions of China, having a backward capital market, a low level of economic development, and old-age pensions which can only meet the most basic necessities for the survival of retired persons, sticking to the principal status of the public insurance fund system, and weakening the over-dependence on personal accounts and lowering the excessively high expectation of value. The scale of the personal account fund should be determined according to the objective reality, which may start from "small accounts", and based on the principle that personal accounts should be funded by personal payments. If an enterprise also pays, it should be at its own discretion (such as enterprise supplementary insurance) instead of being compulsory. In this way, the independence of personal accounts and the supporting reform of the management system can be guaranteed.

(ii) Stick to the multi-pillar design and improve the fund management system

Though the "multi-pillar" system of the World Bank is more suitable for developed countries with a developed capital market and a healthy management system, the design concept of the "multi-pillar" old-age pension system deserves recognition, because it mobilizes the initiative of various parties to participate in endowment insurance and serves as an active measure addressing the ageing crisis. The traditional urban pension system in China relies too heavily on the guarantee from enterprises, institutions and governments. With the development of the market economy, increasing diversification of property rights, increasing improvement of the capital market, and increasing betterment of the legal system, it is necessary and feasible to establish a pension system with a multi-pillar mode.

Besides the basic old-age insurance and basic medical insurance run by the government, China may also carry forward its cultural tradition of frugality and saving, develop various forms of supplementary insurance, and bring into play the initiative in family security, community help and social charity. It is necessary to point out that to develop a compulsory personal account accumulation system (the second pillar), China must follow the requirements of the market economy and international customary practices to establish a management system in which the social pooling fund is independent from personal accounts. Differing from the social pooling fund, personal accounts cannot be mixed up, as their ownership and right to yields belong to individuals. To implement the fund accumulation mode for personal accounts, scattered and competitive social insurance fund investment companies or foundations should be established. The personal account fund should be handed over to independent and competitive market entities (which may be private), that is, fund management companies, for operation. The government may monitor fund operation through laws, regulations and government control so as to ensure the security of accumulated funds.

(iii) Open up sources of non-conventional insurance funds to address the cost of an institutional transition

An important root cause for the institutional crisis in China's new social insurance system is that the government has failed to establish adequate and sound channels for addressing historical debts through the reform of the social insurance system. Two problems were resolved in the transformation of the old-age pension system in Chile: first, the old-age pension debts under the old system were resolved through the fiscal ("endorsed bond") channel, which created an ideal environment for reform; second, planned investment was conducted for the accumulated fund in personal accounts to realize the value preservation and appreciation of the social insurance fund. The method of West Germany providing East Germany with social insurance financial support after the re-unification of Germany can also be taken for reference. In light of inadequate normal (institutional) sources for the social insurance fund now, non-institutional sources should be opened up through multiple channels so as to resolve historical and implicit debts. We think that fund sources may be expanded in the following ways: first, adjust the fiscal expenditure structure and continue to pay the retirement pension for retirees from state-owned units before 2000; second, sell off some state-owned assets, including some state-owned shares or some state-owned land and public housing etc.; third, issue social security national debts, lottery and introduce special taxes (such as inheritance tax).

(iv) Improve revenue and expenditure control, strengthen investment operation, and realize value preservation and appreciation

Currently, there are many problems with the sources, expenditure management and investment operation of the social insurance fund in China, which should be addressed by resolute and feasible measures. In terms of fund sources, we should strengthen institutional construction to establish a stable and sustainable source foundation for the social insurance fund. (1) Continue to expand its coverage. To reform the original coverage of social insurance, employed persons with permanent urban residential registration should all be included. This is a requirement for the socialization of social insurance and also a necessity to lower the dependency ratio and expand the source foundation for the social insurance fund. (2) Lower the nominal social insurance premium rate, and increase the base salary for the payment of the social insurance fund and the successful collection rate so that the rates are maintained at least above 95%. Meanwhile, measures should be adopted to resolve the problem of a false payment base. The payment base of the social insurance fund should be changed from "total salary" to "total income"; just like the collection of individual income tax, various kinds of "normal income" that employees receive from their respective units should be included into the base for the payment of their social insurance premiums. (3) Implement the tax collection system, strengthen the collection of social insurance fund collection, and gradually convert over to social insurance tax. While fund sources are expanding, we must improve and adjust the expenditure system and structure, thus increasing revenue and reducing expenditure. (1) Effectively lower the retirement pension replacement rate so that basic old-age insurance is based on guaranteeing basic needs. The retirement pension rate should be gradually lowered from above 90% to below 60% or about 50% of the salary for payment (instead of the final salary before retirement), so that basic old-age insurance is based on basic old-age support and room for development is reserved for supplementary old-age insurance. (2) Gradually raise the retirement age, and curb early retirement to alleviate the payment pressure of the old-age insurance fund. (3) Regulate the social insurance fund expenditure adjustment mechanism, and weaken the impact of non-institutional measures on the social insurance fund. The expenditure adjustment of the social insurance fund must be conducted through scientific estimation and through institutionalized and law-based channels, so as to prevent the impact of any temporary decision on the expenditure expectation of the whole social insurance fund. (4) Adjust the expenditure structure and conduct scientific fund management. The basic principle of balance of payments should be adopted for the social insurance pooling fund. "Strike a balance between expenditure and revenues, with a slight surplus". It is not good to have no surplus, but excessive fund accumulation is not good either.

Currently, China exercises strict control over the investment of the social insurance fund, which is a passive preventive measure related to capital market imperfections, few investment channels, big risks in industrial investment, backward operation monitoring measures and the insufficient ability to prevent financial risks. However, considering the long-term sustainable development of the social insurance system and international practices, we must relax control over investment operations of the social insurance fund, and expand investment channels on the basis of rationalizing the institutional design of social insurance and the fund management mechanism, so that the accumulated fund of social insurance can enter the capital market, acquire higher return on investment and realize the value preservation and appreciation of the accumulated fund. (1) Establish a professional investment institution for the social insurance fund, and develop a fund investment monitoring framework. The social insurance investment fund mainly consisting of personal accounts and supplementary insurance must have the transition made solely by professional institutions. Such professional institutions should establish a board of directors, expert wealth management teams and develop fund custodians and an adequate monitoring and control mechanism. A proper entry and exit mechanism should be established for fund institutions to develop a competitive pattern under government oversight. (2) Stick to the principle of gradual improvement and create a good environment. (3) Expand investment areas and innovate investment tools. Currently, the government only allows insurance funds to be deposited in banks and for the purchase of treasury bonds, which cannot be adapted to the requirement of value preservation and the appreciation of social insurance. With the increasing expansion of the scale of personal accounts and supplementary insurance funds, it will be an objective need to relax investment restrictions so that such funds can enter the capital market and create room for the expansion of investment and potential areas for investment.[1]

[1]The contents of this chapter are published in the *Economic Research Journal*, 2001 (2).

http://www.springer.com/978-981-10-5642-0

Social Security in China: On the Possibility of Equitable Distribution in the Middle Kingdom
Wang, Y.
2017, XVII, 168 p. 4 illus., Hardcover
ISBN: 978-981-10-5642-0