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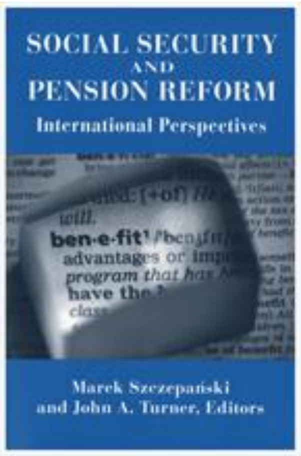
Tianhong Chen
Wuhan University

John A. Turner
Pension Policy Center



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Marek Szczepański
John A. Turner
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Social Security Reform in China

Tianhong Chen
Wuhan University

John A. Turner
Pension Policy Center

China has one-fifth of the world's population aged 60 and older (United Nations 2007). Thus, social security old-age benefits programs in China play an important role in the worldwide context of providing benefits for older persons.[1] Also adding to the importance of understanding China's retirement income system, China is undergoing a period of important changes in its provision of old-age benefits. At the start of 2009, less than 30 percent of its adult population was covered by a social security old-age benefits program, but in 2012 that had increased to 55 percent (*Economist* 2012). Chinese government data for the end of 2011 indicated that 241.1 million people were contributing to the new rural social security pension system, with 85.3 million people receiving benefits (Ministry of Human Resources and Social Security 2012). Another important development due to the one-child policy, and reflecting changes in the age distribution of workers compared to retired persons in China, is that in 2012 for the first time the Chinese labor force decreased, with decreases expected to continue for a number of years (Thai News Service 2013).

As in many countries around the world, until recently rural workers in China generally did not participate in a social security program providing old-age benefits. Traditionally, older persons worked as long as they were able. After that, they lived with their children or received financial support from their children, with the support in China traditionally coming primarily from their sons.

In countries such as China, however, where birth rates have fallen rapidly and where many adult children in rural areas are moving to urban areas to work, the traditional support system for older persons is weakening. As evidence of this, one study finds that families in rural China with fewer children and with fewer sons tend to save more for their retirement (Ebenstein and Leung 2010). These changes increase the need for extending social security coverage to workers in rural areas.

Because most workers in middle- and lower-income countries generally do not participate in social security, extending social security or pension coverage to rural and informal sector workers is arguably the most important problem facing social security programs around the world (Gillion et al. 2000). Worldwide, only 26 percent of the working population is effectively covered by social security old-age benefits programs (ILO 2010). Extending coverage to rural areas and the informal sector is difficult, however, because generally these workers have low and variable cash incomes. For these reasons, they cannot make regular contributions and are limited in the amount they can contribute. At the same time, the transaction costs for contributors, and the transaction and administrative costs for the government, may be sufficiently high to make small contributions economically infeasible.

SOCIAL SECURITY OLD-AGE BENEFITS PROGRAMS IN CHINA

In China, all persons are registered as either urban or rural residents. This classification system (called the *hukuo* system), which is unique to China, is important in the provision of social security old-age benefits. When rural residents move to cities, they retain their registration as rural residents, which affects their access to social security programs in urban areas.

China has three major social security old-age benefits programs, covering three different groups of people: urban areas have two old-age benefits programs, and there is a separate program for rural workers. The central government is considering rules permitting transfer of contributions for workers between the three programs, so that workers who have contributed to more than one program can combine their contributions into one program and receive benefits solely from that program

(*China Daily* 2012). The current pension arrangements make it difficult for workers to move to different areas in China.

Urban Employees' Pension Program

The Urban Employees' Pension Program, established in 1997, is for employed workers in urban areas. It is a two-pillar mandatory program and the only one of the three major programs that is mandatory.

Coverage. In 2010, 36 percent of China's total workforce (urban and rural), or about 264 million workers, was participating in a social security pension plan. One of the reasons for the low coverage rate may be that workers in urban areas cannot afford the required contribution. Complicated procedures for enrolling and lack of trust in the systems may be other explanations (Zheng 2012). Another factor contributing to low coverage rates in urban areas is that rural workers are typically excluded (Oksanen 2012).

Contribution rate. The contribution rate for the Urban Employees' Pension Program is 28 percent, of which the employee contributes 8 percent to an individual account and the employer contributes 20 percent to the social account for the basic pension or social pension, which is a traditional pay-as-you-go defined benefit program.

By 2006, individual accounts programs were established in 10 provinces, but the extension to other provinces stagnated (Zheng 2012). However, government policy of the Ministry of Labor and Social Security at the end of 2005 mandated the extension of the program, with the 8 percent contribution rate, to all provinces, which now has occurred.

The government has not segregated the money in the individual accounts from other social security funds, and has spent much of that money, now in essence converting those accounts to notional accounts to which interest is credited to notional account balances (*Economist* 2012).

Benefits. The Urban Employees' Pension Program provides two benefits: one comes from the individual account, which depends on the contribution level of the individual and the rate of return received on the contribution; and the second comes from the social account, which is a pay-as-you-go defined benefit. All participants must contribute to this program for at least 15 years and arrive at the retirement age before they can apply for the old-age benefit from this program. The average benefit level of this program is 1,721 yuan per month by the end of the year 2012, which is adjusted according to the inflation rate.

Regional variation. The contribution rates of 8 percent plus 20 percent are set by the central government as guidelines, but the exact contribution rate for the social pension can be decided by local government, and can be higher or lower. The contribution rate of Guangzhou City is 12 percent for the social account. Guangzhou has a considerably lower contribution rate for the social account because many younger migrants live in the city, so population aging is not a serious problem. The contribution rate for the social account is 20 percent in Beijing and 22 percent in Shanghai. Shanghai faces serious population aging. The 8 percent contribution rate that workers make for the individual account does not vary across provinces because the account is linked to the individual participant and is not affected by the age structure in the province.

China has 33 provincial-level governments. Beijing, Shanghai, Chongqing, and Tianjin are four municipalities that are treated as provinces. Besides, two Special Administrative Regions—Hong Kong and Macao—are treated as provincial governments. Also, the contribution responsibility is divided among provincial, municipal, and county governments, and the exact proportion shared by different levels of local governments varies in different provinces.

The management of social security funds is fragmented, even within provinces. Only four provinces, two of which are Beijing and Shanghai, have pooled the social security funds. There are more than 2,000 social security funds managed by different government entities (Zheng 2012). The fragmentation of the system has historic origins. In 1949, soon after the founding of the People's Republic of China, a national pension system was established, but trade unions at the local level were given responsibility for administering it. In 1969, during the Cultural Revolution, trade unions were abolished, and state-owned enterprises were given responsibility for managing the pension system (Oksanen 2012).

Urban Residents' Pension Program

Coverage. The Urban Residents' Pension Program, started in 2011, is a voluntary program for urban residents who do not have jobs, are self-employed, work for small businesses, or are migrants from rural areas. It is similar to the National Rural Pension Plan, described later.

Contribution rate. Participants can choose the level of contributions they wish to make within a set range. The central government suggests a contribution range of 100–1,000 yuan per year, which is divided into 10 levels, in 100 yuan increments. But as the Urban Residents' Pension Program is managed by the county or municipal government, the range of contribution levels differs among areas.

Local governments subsidize the contributions of those urban residents who participate in the program through a matching contribution, which varies across provinces. The lowest matching contribution, set by the central government, is 30 yuan per participant per year. Thus, on the minimum contribution of 100 yuan a year, this provides a 30 percent match rate, which, of course, is lower for higher contributions. Local governments, however, can raise the match rate according to the financial ability of the government.

Benefits. The Urban Residents' Pension Program provides two benefits. One comes from the individual account, which depends on the contribution level of the individual, the government matching contribution, and the rate of return received on those contributions. The second benefit is entirely financed by the local governments and is not based on the contributions of participants, other than that they must contribute a minimum of 15 years in order to qualify for it. That benefit is 55 yuan per month, but local governments in high-income provinces can raise this benefit level according to the financial ability of the government.

The governments pay the cost of the noncontributory basic benefit. In the wealthier and eastern provinces of China, the central government subsidizes 50 percent, and the local governments pay the remaining 50 percent of the noncontributory benefit. In the poor middle and western provinces, the central government pays 100 percent of the benefit, and the local governments do not pay for the noncontributory benefit.

National Rural Pension Plan

Out of a population aged 60 and older of 150 million in China, 100 million live in rural areas (*China News* 2009). Thus, 14 percent of the world's population aged 60 and older is covered by China's National Rural Pension Plan.

Coverage

In 2008, only 12 percent of China's rural population was participating in a social security pension system (Oksanen 2012). The voluntary social security pension for rural residents that preceded the new National Rural Pension Plan had contribution and benefit levels that were low, and the program was not subsidized by the government.

Because most rural workers in China were not participating in a social security old-age benefits program, beginning in late 2009, China established the National Rural Pension Plan. It started by extending the program to more than 300 counties on a pilot basis and reached 23 percent of counties by the end of 2010 (Mu 2010). By the end of 2011 it was extended to 60 percent of counties, and it is expected to be in all counties by the end of 2012 (Yang 2012). The launch of the new program was preceded by a period during which different pension arrangements were tried on a pilot basis in different parts of the country to see which arrangement would work best (Cai et al. 2012).

All rural residents aged 16 and older who are not students and who are not enrolled in another pension plan can voluntarily participate in the rural plan. They can participate whether they work in a rural or urban area, whether they are employed or self-employed, and whether they work for pay or do not work for pay. The program is not earnings-related in that anyone meeting the age requirements can contribute to it regardless of earnings, and the amount of the individual's contributions is not related to his or her earnings.

Rural migrants to the city can participate in the Urban Employees' Pension Program if their employers contribute for them. If their employers do not contribute for them, they can choose to participate in the rural pension plan. Because of the high contribution rates, most employers are unwilling to make pension contributions for rural workers who migrate to urban areas. About one-third of the residents in urban areas are migrants from rural workers who do not have full rights to participate in the urban pension systems (Oksanen 2012).

Contributions

The central government has established minimum standards for contributions. The lowest minimum contribution is 100 yuan a year and the lowest maximum contribution is 500 yuan a year (about U.S.$80), with only 5 percent of participants contributing that amount (Dorfman et al. 2013).

While most small counties use the government minimum standards, variation above those standards is permitted and occurs in some places that have a higher standard of living. Wuhan and Shanghai are examples of regional variation in contribution levels. In Wuhan, the minimum contribution is 200 yuan a year and the maximum contribution is 1,200 yuan a year, while in Shanghai the minimum is 500 yuan a year and the maximum is 1,300 yuan a year. In both Wuhan and Shanghai, contributions are permissible between the minimum and maximum in 200 yuan increments. In some prosperous provinces, contributions of up to 2,500 yuan are allowed (Cai et al. 2012). These levels of contributions will be adjusted upward over time to reflect increases in income.

An important feature of this program is that the contribution rate is much lower than in the program for urban workers, where the rate is 28 percent of pay. The contributions to this program are made by individuals and government, with no contribution by employers.

Matching contributions

China provides a matching contribution to encourage rural residents to participate in the National Rural Pension Plan. Because rural residents do not pay income taxes, the lack of a tax incentive for rural residents to participate may explain in part the matching contribution. The subsidy, which is provided by the local government, is 30 yuan a year, where the minimum contribution by the participant is 100 yuan a year (about U.S.$16).

The matching contribution varies in different areas. For example, in Xian City, the matching amount varies from 30 yuan for a contribution of 100 or 200 yuan, to 40 yuan for a contribution of 300 yuan, to 45 yuan for a contribution of 400 yuan, and to 50 yuan for a contribution of 500 yuan. Thus, for contributions above 300 yuan there is an additional government match of 5 yuan for every additional 100 yuan contributed by the participant. In Guangzhou City, which is one of the most developed cities in China, the annual contribution levels (and its matching contribution) are divided into 120 (180) yuan; 360 (420) yuan; 600 (600) yuan, 840 (720) yuan; 1,080 (840) yuan; 1,320 (900) yuan; and 1,560 (960) yuan. The matching contribution is higher than the worker's contribution at the two lowest contribution levels. The subsidy level in Guangzhou is higher than in other cities.

Some commentators have argued that the matching contribution is low (Cai et al. 2012), but experience seems to indicate that it and the other incentives to participate may be adequate. Nearly half of participants make the minimum contribution (Dorfman et al. 2013), which generally provides the highest match rate. The government matching contribution is paid into the person's individual account.

Administrative rules for making contributions

Chinese residents who choose to participate in the rural pension plan have different contribution options, depending on where they live. In some areas, they must make the entire contribution for the year as a single payment in January. In Beijing, however, they can make the contribution between January 1 and December 20. They register to participate with the village government, which is at the lowest level of the hierarchy of government. They must contribute in cash. To be specific, they take cash to the government department in their village to make their annual contribution.

At the end of the contribution period, the village government aggregates all the contributions and sends them to the township government, which then sends the contributions of all the villages to the county government. The rural pension fund is generally managed by the county government, but in some cities, depending on local regulation, the municipal government manages the fund, which is deposited into banks. The central government intends for the funds to eventually be managed by the provincial governments (Cai et al. 2012).

Local governments pay the administrative expenses for the plan, which is a form of subsidy for the program. Those expenses thus are not taken out of the contributions, which would reduce the amount of benefits.

Benefits

While the National Rural Pension Plan is structured as one plan, it provides benefits to two different groups under different but related arrangements. The first is a contributory plan, to which participants must contribute in order to receive benefits when they reach age 60. The second is a noncontributory plan for people who are 60 and older. The relationship between the two parts of the rural plan is explained below.

Participants must contribute for 15 years in order to be eligible to receive benefits. For participants older than age 45 at the start of the system, to qualify for benefits they will need to contribute every year up to age 60 and then make a lump sum payment to cover the shortfall in years of contributions (Cai et al. 2012). It appears, however, that few workers are making lump sum contributions. Workers who are 60 and older can qualify to apply for the noncontributory benefit, which is currently 55 yuan per month in most of the counties in China.

The benefits for participants who have contributed a minimum of 15 years or who have contributed a lump sum equivalent to 15 years of payments have two components. The basic benefit currently is 55 yuan a month. This amount equals one-tenth of the average monthly wage in rural areas in 2011 (Wang and Qing 2012).

That benefit is payable at age 60 to both men and women in most of China. However, the benefit eligibility age varies to some extent, with, for example, women being able to receive the benefit at age 55 in Beijing. The benefit is not means tested, and workers are not required to stop working to receive it. By contrast, for the urban pension men can receive the benefit at age 60, while women can receive it at age 50, or if they are classified as cadres, meaning that they have a management position in their company, the age for benefit receipt is 55. These ages for benefit receipt also are mandatory retirement ages for most urban workers. A small percentage of urban workers, such as some university professors, are exempt from these requirements. In addition, workers in hazardous or dangerous occupations can qualify up to five years earlier than these ages. That exception for hazardous or dangerous occupations is not part of the rural pension system. One study finds an average retirement age in urban areas of 53 (Sin 2005). The benefit eligibility age in the rural pension system, and presumably actual retirement ages, are thus considerably higher than in the urban pension system.

Unlike most social security programs around the world, in China the social security benefit financing differs by region and also involves financing in part by local governments. The basic benefit is financed by the central government in the central and western parts of the country, but in the more prosperous eastern provinces it is financed half by the central government and half by the local governments (Lei, Zhang, and Zhao 2011). Localities can increase the benefit amount above 55 yuan a month if they have the financial resources to do so. The average benefit received by beneficiaries is 74 yuan a month (Yang 2012), which is not financed by the contributions of participants. This benefit represents the first time that the Chinese government has made a major financial commitment to a rural pension system (Shen and Williamson 2010).

In addition, a defined contribution benefit is provided based on the accumulation in the participant's individual account from the participant's contributions, government matching contributions, and accrued investment returns. That benefit is paid monthly and equals the individual account at age 60 divided by 139, which is the same factor used for calculating monthly pensions from the individual accounts in the urban plans. The divisor depends on the age at which the person collects benefits, with it being higher at lower ages. It is 195 for a woman retiring at age 50 and 170 for a woman retiring at age 55 in the urban pension system. Generally, men cannot collect retirement benefits at those ages. Individuals do not need to stop working to receive this benefit from the rural pension plan.

The benefit payment is not limited to the amount in the individual account, but it is guaranteed by the government for life and thus is paid as an annuity. If a person dies before receiving the full amount in his or her personal account, the spouse receives the remaining amount, and if the spouse is not surviving then the children. Otherwise, the system does not provide a benefit to a surviving spouse.

Noncontributory benefit

Persons aged 60 and older who have not qualified for another pension can receive the basic benefit of 55 yuan a month if all their children are contributing to the rural pension, regardless of whether the children are working. The benefits will be adjusted for inflation, but the exact adjustment mechanism has not yet been determined (Cai et al. 2012).

This requirement on the adult children is called "family binding." The incentive may work particularly well in China, which has a strong tradition of adult children taking care of their older parents. If the older persons do not have children, they automatically qualify. The central government requires that all the recipients' children contribute, but the enforcement is done at the local level. At the local level, however, the incentive to receive the central government subsidy for benefits for people aged 60 and older works against the strict enforcement of this requirement, so that some local governments may qualify all persons aged 60 and older.

Regional variations

China has a number of levels in the hierarchy of government. From lowest to highest, they are village, township, county or district, municipal, provincial, and central. The National Rural Pension Plan is sponsored by the central government and run by the county or municipal government, with oversight from the Ministry of Human Resources and Social Security.

The central government provides guidelines for the pension systems in China, but for the rural pension system, the details, including contribution rates, are determined at the level of the county or district government. It is called the county government in rural areas and the district government in urban areas. In some areas, the county or district government has established the system exactly according to the central government guidelines, while in other areas the systems vary. Thus, the systems may vary within provinces.

Combined Urban and Rural Programs

Some cities, such as Wuhan, did not establish the Urban Residents' Pension Program. Instead in 2011, Wuhan established a unified Pension Plan for Rural and Urban Residents. The plan covers those who live in urban areas and do not have jobs and all those in the rural areas. Neither group can get contributions from employers, but they do receive the government matching contribution. This is a reform trend for counties and cities to establish a unified pension program for both urban and rural residents who do not have formal jobs in China.

Government Employees' Pensions

Government employees and employees in government-owned enterprises in China are covered by a separate pension system, paid for out of general revenues. That system costs 0.7 percent of GDP per year. About 8 percent of covered participants are in that system. In addition to these programs, hundreds of thousands of plans have been established by local municipalities to meet the needs of migrant workers from rural areas or of particular industrial zones (Zheng 2012).

Hong Kong's Mandatory Provident Fund

Hong Kong has a separate old-age benefits system. All workers are required to join the Mandatory Provident Fund, which is a system of defined contribution plans. Employees earning between HK$6,500 (U.S.$839) and HK$25,000 (U.S.$3,226) monthly (in 2012) pay 5 percent of their earnings, with employers also paying 5 percent (U.S. Social Security Administration 2012).[2] The contributions go to a financial service provider chosen by the employer. As of November 2012, employees can choose the service provider for their contributions. Workers receive benefits as a lump sum. Because of savings accumulated through this program, Hong Kong has a high ratio of pension assets to GDP of 32.5 percent, which compares to a simple average for OECD countries of 33.9 percent (OECD 2012).

FINANCING ISSUES

Individual Account Benefits

Concerning the financing of the individual account benefit, the divisor of 139 for benefits received at age 60 is the key parameter in determining the generosity of the individual account benefit. Thus, in assessing the financing of those benefits, it is important to determine whether that divisor provides benefits that are adequately financed, or alternatively, whether the benefits are overly generous. When financial planners in the United States advise individual account holders about the sustainable amount that a retiree can withdraw from an account without overly risking that they will run out of money, they often advise that a retiree can withdraw 4 percent of the initial account balance, adjusted for inflation, each year (McKenzie and Turner 2012). The 4 percent amount is designed to provide an inflation-indexed withdrawal. That advice depends on the life expectancy of the individual and the expected rate of return received on the account. It would be a higher percentage for a shorter life expectancy and a higher expected rate of return. If the amount were used instead to purchase an annuity, which is a better comparison, it would be equivalent to a withdrawal of 5.7 percent, based on male annuity rates, no inflation adjustment of benefits, and the low interest rates available in 2013. The withdrawal rate would be lower than 5.7 percent for a benefit that was adjusted for inflation.

The divisor of 139 for monthly benefits is equivalent to withdrawing 8.6 percent of the initial account balance each year. Thus, it appears that the benefit divisor of 139 should be increased if the goal is to have a system that is financed primarily by the contributions of participants. That change would result in lower benefits, but it would be more consistent with a sustainable, self-funding pension system. By one analysis, county governments will be liable for 40 percent of the payments from the individual account pensions (Herd, Wu, and Koen 2010).

The Overall Expense of Pensions

In 2011, 61 percent of the revenues for the rural pension system overall came from government subsidies (Wang and Qing 2012). The individual pays for none of the basic benefit for parents and for none of his or her own basic benefit. The cost to the central government of providing the noncontributory benefit to all the 100 million rural persons currently aged 60 and older would be about 2 percent of the government budget (Shen and Williamson 2010). The government also subsidizes a substantial portion of the individual account benefit. This cost is borne by local governments. Overall, the individuals will only pay at most 18 percent of the cost of their pensions, with the government paying the rest (Herd, Wu, and Koen 2010).

The government is thus incurring what appear to be substantial unfunded liabilities for the social security pension systems (Reuters 2012). Most countries have pay-as-you-go social security systems with unfunded liabilities, thus unfunded liabilities are a common feature. China, however, differs from many countries in that it has a very high savings rate. Thus, there may be more justification for unfunded liabilities in China than in other countries. In addition, the central government has large nonpension reserves that could be used in the future to help pay for these liabilities (*Economist* 2012).

In comparison to programs in other countries, the total cost of the rural pension program in China is relatively low at 0.22 percent of GDP. This compares, for example, to 0.38 percent of GDP for a means-tested program in Chile (Herd, Wu, and Koen 2010). Thus, the program combines a relative low cost, due to low benefits, and a high degree of government subsidy, due to the relatively small amount contributed by participants.

Investment Policy Issues

In China, the rate of return on provincial urban pension funds has averaged 2 percent over the last 10 years, which is less than the rate of inflation over that period. However, in 2012 the national government announced a pilot program that would permit the 13 provinces that manage pension funds for individual accounts to invest in domestic equities. The council that manages the National Social Security Fund, which is China's public pension reserve fund, will act as the trustee and principal investor of each of these funds. The amount invested this way could be as much as 360 billion yuan (U.S.$57 billion), roughly 20 percent of the funds' combined total assets under management (U.S. Social Security Administration 2012).

The National Social Security Fund (NSFF) was established in 2000 to support China's future social security expenditures. The NSSF receives money from government allocations from a government lottery and from the sale of state-owned enterprises. It is a strategic reserve fund designed to help pay for future social security expenditures during future periods of rapid aging.

Since 2006, the NSSF has managed the investments of the individual account funds of nine provinces, municipalities, and autonomous regions. As of December 31, 2011, the NSSF had net assets of 838.6 billion yuan. Included in that, the value of the individual account funds managed by the NSSF is 65.8 billion yuan. Domestic fixed income investments accounted for 51 percent of the investments (National Council for Social Security Fund 2012). That percentage is relatively high for a fund of this type.

CONCLUSION

While social security old-age benefit programs around the world generally are uniform national programs, at least for the group of workers they cover, the three main programs in China have regional variations that make the program more complex, but that also relate to the regional differences in standard of living in the country. The financing of the programs varies across regions, with the central government providing all of the financing for the basic benefit in the central and western parts of the country, but half of the financing, with the local government providing the other half, in the more prosperous eastern provinces. The level of contributions by participants and the level of benefits they receive also vary across regions.

China has a program for rural workers that has features that may provide lessons for other countries wishing to extend pension coverage to the rural and informal sectors. It is a voluntary program, but by providing substantial government subsidies, it encourages coverage of workers who do not pay income taxes and thus have no tax incentive to participate. As a further incentive, old-age benefits are provided to the parents of participants who contribute when all the adult children in a family are participating in the program. Only a single contribution per year is required, and participants can choose from a range of contribution levels.

Notes

We have received helpful comments from Heikki Oksanen and David Rajnes. In this chapter, we follow the western convention of listing Chinese family names as the second name, with the given name the first name. The official name of China is the People's Republic of China.

1. The official name of Chinese currency is renminbi (RMB). The basic unit of the currency is yuan, which are the units used in this chapter. Hong Kong uses a different currency.
2. The dollar limits are adjusted upward over time.

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