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Pooling of pensions: European experiences

Technical report

Final

Mel Cousins

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1. Introduction

1.1 The context

Major reforms over the last two decades in China and the entering of WTO have resulted in rapid economic growth, but also challenges in social consequences. Income and human development disparities have widened considerably: within urban areas, between urban and rural areas and in general between the coastal areas and the hinterland of China. The challenge for China is to pursue economic transition whilst at the same time integrating the concept of sustainability into economic growth and guarding itself against social instability. China needs to stabilise the economy, develop a sustainable financial system and address the income disparities by creating more employment opportunities and develop a sustainable social security system.

There are two Components of the EU-China Social Security Reform Co-operation Project. Component 1 of the Project is to support policy-oriented co-operation in priority reform areas. Component 1 will promote and support policy capacity-building activities and an exchange of good practices as well as build up a policy dialogue between China and the EU.

Component 2 of the Project entails the implementation of selected pilot reform initiatives at the level of participating Provinces. The Component provides technical assistance and other capacity-building services included in the pilot projects. Results of the activities under the second Component will serve as a basis for advice and an action plan on possible replication of the improvements achieved.

One of the outputs under activity 3.4 (which relates to horizontal and vertical pooling levels for pensions funds) of the second annual work plan (AWP2) of component 2 (C2) of EUCSS is a technical report on pension pooling and this report is prepared in completion of that requirement. The purpose of this report is to look at the EU experience and establish how it can inform Chinese policy development. In part 2 we discuss what is meant by the terms 'pooling' and 'horizontal' and 'vertical' pooling. In part 3, we look at the European experience. Part 4 summarises the policy messages and looks at their relevance to China.

1.2 The importance of pooling levels for pensions in China

One of the issues identified in the second annual work plan (AWP2) of component 2 (C2) of EUCSS is the question of horizontal and vertical pooling levels for pensions. At

present, pensions are not pooled at a national level in China. While pooling takes place at provincial level (to a varying degree) in some provinces, in many cases pooling is at a lower administrative level. It has been estimated that there are about 1,000 individual social funds in China. This gives rise to a number of issues which have been recognised both by government, by international agencies such as the ILO (ILO, 2006 p. 9) and IMF (Dunaway and Arora, 2007) and by academic commentators (Uchimura, 2005; Zheng, 2007; Liu et al., 2009).¹

A contribution to a recent World Bank report argues that raising ‘the level of social pooling from the current municipal level is vital for pooling risk, an essential feature of a national social security system’ (Li et al., 2007). This study points out that the higher the pooling level, the better the system will be able to cope with risk. In addition, it makes the point that ‘[s]ocial pooling at the municipal or provincial level is not conducive to labor mobility’. Furthermore, deficits have to be made up by the central authorities, limiting the ability of social security funds to cope with risk.

Issues identified in these studies and reports include disparities in entitlement to pension across regions, fund deficits in some areas which cannot be supported by positive balances in others, inefficiencies in planning and implementation caused by conflicts between different levels of governance, and limited entitlement to benefits for migrating workers.

The Chinese Ministry of Human Resources and Social Security, on 22 September 2007, declared that all provinces should implement provincial pooling within two years. However, it is not clear that this guideline will be implemented by all provinces or that where provinces do adopt provincial pooling policies that they will be fully consistent with the intentions of MHRSS.

¹ For a summary report of the state of pooling in China, see EUCSS, *Report on pooling level for pension insurance in China*. For the background to this issue see Chen (2004); Frazier (2004).

2. What is 'pooling' and why does it matter?

2.1 Pooling defined

Pooling refers to the 'level' at which risks are shared in the operation of a social pension scheme. The concept of pooling can refer to some or all the following issues:

- 1) pension policy,
- 2) contribution rate,
- 3) benefits calculation,
- 4) fund use and pooling,
- 5) fund budgeting, and
- 6) operation procedure.

The concept of 'horizontal' pooling refers to the geographical level at which pooling operates (e.g. county, province, national) while 'vertical' pooling refers to segregation of risk according to occupation (e.g. where different pooling arrangements operate for public servants as opposed to general employees).

2.2 Why does pooling level matter?

As we have seen above, there is a widespread perception that current pooling levels in China are too low. There are four main arguments as to why it is important that pooling should be carried out at a level sufficiently high to share the risks involved.

2.2.1 Variation in resources

First, there is wide variation in the availability of per capita resources between the Chinese provinces (and to an even greater extent between counties). There is a particularly wide gap in resources between urban areas and rural areas. These variations in resources are related to the broader variations in the wealth of different regions and rural-urban imbalances. These variations would suggest that pooling at at least a provincial level is necessary to implement geographic resource allocation mechanisms that improve equity by allocating resources according to need.

2.2.2 Pooling as insurance

Second, the public financing of pensions is an insurance mechanism, or a way of pooling the risk of economic cost associated with pensions across groups of people. Risks are pooled to increase the predictability of the cost and to redistribute the costs of unexpected demands. The size of the risk pool is important for several reasons. First, the larger the risk pool, the more predictable the risks and the greater the probability of correctly assessing the costs involved. In addition, a small risk pool, such as a rural county, may not be able to generate sufficient resources to cover even their predicted costs. Finally, pension insurance mechanisms improve equity by redistributing the costs of old age from the currently old (and their immediate families) to the broader working population, and small, fragmented risk pools are a barrier to redistribution. Therefore, pension financing and delivery systems that pool resources at the level of local administration weaken the insurance function of a publicly financed pension system, because they create small risk pools that do not adequately predict or redistribute the costs associated with pensions. As noted in several studies, the current systems results in deficits in some pooling areas which cannot be balanced by surpluses in other areas.

2.2.3 Facilitating effective planning and efficient management

The third reason that pension pooling at an appropriate level is important is because it allows for pension planning and fund management. If pension's budgets are fragmented, it will be difficult for policymakers accurately to assess the level of resources available and the costs involved, which is essential information to plan policy developments. In addition, multiplication of funds adds to the risks of poor fund management and/or mismanagement.

2.2.4 Labour mobility

The fourth reason that pension pooling pension funds at the provincial level would be important is because it would facilitate greater mobility of labour and allow greater co-ordination of pensions. Fragmented pooling arrangements create difficulties for migrant workers in accessing pension (and other social insurance) rights. In many cases, workers who leave their insurance pooling area are only entitled to a limited refund of contributions paid (the employee contributions and a small proportion of the employer contribution). They, thereby, lose out on future pension rights. Although there is currently a high level of labour mobility in China this is at the cost of low levels of social protection for migrant workers. Such institutional barriers to mobility may contribute to blockages in internal migration (such as, for example, the slow return of migrant



workers to coastal cities after the recent economic downturn leading to reported labour shortages in some areas).

Currently, separate pension systems exist (or are planned to be introduced) at a range of different administrative levels (county, province, etc.). In addition to the urban pension system and pensions for public servants there are pilot rural pensions (pre-2009), post-2009 rural pensions (under State Council Guidance 2009 (No. 32)), pensions for land loss farmers, various pensions systems for migrant workers, etc. Each system is financed and operated (at least in part) by different government units. Having such a diversity of pension systems is likely to create great difficulties in co-ordination of pensions. This is particularly important in China in that, although 40% of the population may be engaged in agriculture today, the speed of structural change in the Chinese economy would suggest that a 20 year old rural worker who becomes insured under the new rural pension system today, is rather unlikely to remain a rural worker for his or her full working life.

3. The European experience

In considering the European experience, it is important to bear in mind that there are many structural differences – both economic and political – between China and the EU. On the one hand, the level of economic development in the EU is significantly higher than that which has currently been achieved by China. For that reason, we will look not only at the current policy position in European countries but also at how that position was arrived at over time and the type of policies which were adopted at a time when European countries were closer to China in terms of the composition of the labour force. The most recent Chinese statistics indicate that in 2007, 41% of the workforce was employed in primary industry (agriculture) (China Statistical Yearbook, 2008)². In contrast, in England – the leading country in the industrial revolution – as early as 1831 only 31% of men (aged over 20) were employed in agriculture (Wrigley, 2004, table 4.8).³

On the other hand, the EU is not, unlike China, a single nation but is rather a quasi-federal arrangement involving limited pooling of sovereignty in certain policy fields by a group of nations. The EU itself (unlike the central Chinese government) has very limited competence in relation to social security matters and responsibility for social security policy remains primarily a matter for the member states.

3.1 Pooling in Europe today

In general, it can be said that horizontal pooling as it applies to most main social insurance schemes (in relation to most if not all of the issues outlined in part 2) occurs at the level of the nation.⁴ However, it must be recalled that EU nations are more comparable (in terms of population size) with Chinese provinces and there is no pooling at EU level.⁵ The only pooling which takes place at EU level is indirectly through the system of co-ordination of pensions for migrant workers (under Regulation 1408/71)

² This varied from only 6% in Beijing and Shanghai to 50% or over in Guansu, Guanxi, Guizhou, Hainan, Henan, Hunan, Inner Mongolia, Tibet, Yunnan and Xinjiang.

³ By 1861, only 19% of the employed population in England was engaged in agriculture and this continued to fall to 7% by 1911.

⁴ There are some, limited, exceptions to this such as the introduction of a scheme of care insurance by the Flemish government in Belgium. It can also be argued that the tendency towards privatisation of European social protection systems is indirectly reintroducing vertical pooling as occupational and private arrangements tend to be more segregated by occupational sector.

⁵ As discussed above, the EU has very limited policy competence in this area.

whereby contributions paid in the country of employment can be taken into account in the country of residence (within the EU) in order to qualify for pensions. This has the effect that countries which have had a high level of out migration (such as Ireland) receive, in effect, a net transfer from countries of in-migration by way of the pensions paid to by the latter countries to the nationals of the former who often return to their 'home' country on retirement.

3.2 Development of pooling in Europe

As discussed above, there are very significant differences in terms of, for example, the current composition of the labour force, between Europe and China and it may, therefore, be interesting to look at the development of pension pooling over time beginning in the nineteenth century. The focus here is on the development of policy in the leading country in the industrial revolution: England.⁶

In the early 1800s, there was no scheme of social insurance in England and the main form of welfare payment was the 'poor law'. Although there was a national poor law, in reality it has been argued that this simply provided a national framework for a number of discrete regional poor law regimes (King, 2000). Poor relief (after 1834) was administered locally through about 600 poor law unions which had considerable autonomy in terms of poor relief policy.⁷ The tax (known as rates) to fund the poor relief was decided locally as was the level of benefit. Thus pooling took place largely at the level of the poor law union. In addition, there was what was known as the 'law of settlement'. This meant that the union was only responsible for persons 'settled' in that union. Settlement was usually acquired through birth, being sufficiently wealthy to acquire property in an area, having secure employment or marriage. Persons who were not settled in the union and who applied for relief could be 'removed', i.e. sent back to their original 'home' area. Thus migrant workers who might have worked in an area for a considerable period but without acquiring settlement could be removed if they lost employment and applied for relief.

The settlement law was condemned by Adam Smith in his classic *Wealth of Nations* as both a barrier to the free circulation of labour and 'an evident violation of natural liberty and justice' (Smith, 1776). However, although some reforms of settlement were introduced over the nineteenth century (Feldman, 2003), the union remained the main pooling level until the introduction of the New Liberal reforms in the early twentieth century.

⁶ Throughout the nineteenth century, England formed part of the United Kingdom of Great Britain and Ireland. England was both the largest and most industrialised part of the United Kingdom.

⁷ Somewhat different systems of poor relief operated in Ireland and Scotland.

The first major reform in the United Kingdom was the introduction of the old age pension in 1908. This was a non-contributory (means tested) pension and, in total contrast to the previous system of poor relief, was applied uniformly across the United Kingdom despite the significant variations in incomes and prices across the component parts of the UK. Thus, the same pension rate applied in all parts of the UK and the cost of the pension was met primarily from the Imperial Exchequer (see generally Gilbert, 1966; Hennock, 2007; Macnicol, 1988; Thane, 2002). Subsequently, in 1911, the UK introduced systems of national health insurance (Gilbert, 1966; Hennock, 2007) and unemployment insurance (Harris, 1972). In the case of unemployment insurance, the system applied across the UK and there was no horizontal division of pooling by region. There was, in effect, an element of vertical pooling in that the scheme initially applied only to a narrow range of industries but this was expanded over the first half of the twentieth century. In the case of the national health insurance scheme, there were again no regional variations.⁸ However, there was an element of vertical pooling in that the NHI scheme was initially administered not by a state agency but by commercial and associative 'approved societies' (although many of these operated on a national basis and recruited workers from a wide variety of employments). In the UK, pooling became fully national after World War 2, with the introduction of the National Insurance Act, 1946 (following on from the recommendations of the famous Beveridge report).

The UK was one of the few European countries in the nineteenth century to have a national system of poor relief. Many European countries relied more on local initiative and systems of poor relief were based on the city or region rather than on the nation state (for France: see Gueslin, 1988; for Germany: Steinmetz, 1993). Research indicates that 'settlement' laws also operated in other European countries (Winter, 2008).⁹

As in the case of the UK, reforms in the late nineteenth and early twentieth century moved towards a national system of pooling (for Germany: see Hennock, 2007; for the French pension system: see Dumons and Pollet, 1994).¹⁰ However, in countries such as Germany pooling was vertically segregated in that different schemes were established for different types of employment and benefits and contributions varied accordingly. Again the Second World War marked a key turning point in many European countries with the process of post-war rebuilding including a reconstruction of the national systems of welfare (Baldwin, 1990). As Baldwin describes, in some cases, this led to a lessening of vertical segregation of pooling and a further move to a more uniform (and unified) national level. The extent of developments in this area related, not primarily to

⁸ Although, for political reasons, the scheme did not apply fully in Ireland.

⁹ In Ireland, in contrast, there was no settlement law but the Irish system of poor relief did not generally allow the payment of outdoor relief to the unemployed.

¹⁰ Obviously space allows only a very summary account of developments which varied by country. For a more detailed discussion the reader is referred to the sources cited herein.

'technical' factors, but to the respective political strengths of different social groups. As Baldwin shows, in the UK the strength of the trade union movement assisted in ensuring that all employees (and the relatively small groups of self-employed) were incorporated into one unified social security system. In other countries, the political strength of self-employed groups (such as farmers) meant that they were excluded from social security cover (as in Ireland) or were incorporated on favourable terms (as in France). However, over time – and with the declining importance of the farming vote in many European countries – most occupational groups were incorporated into (more or less) unified national systems of social security by the end of the twentieth century (although an element of vertical segmentation remains in a number of EU countries and some regional variations can still be found in relation to social assistance payment in some countries).

3.3 Analysis of European developments

If we can see a clear trend from quite local pooling in the early-mid nineteenth century to national pooling today, what is the explanation for this trend? One factor which might be explored is the relative levels of labour mobility in European societies. Arguably a more mobile labour force requires a higher level of pooling. However, while it would be difficult to construct a simple measure of labour mobility, there is little indication that decisions in relation to pooling levels were primarily influenced by 'technical' issues such as the level of labour mobility in a society. The key stages in the shift from local to national pooling (the late 1800s-early 1900s) and the immediate post-World War 2 period do not clearly correspond to any significant changes in labour mobility. Rather decisions in relation to pooling levels formed part of the broader decisions about the growth and structure of the welfare state and were influenced in different countries by the different balances of power between the social classes in those countries (as shown by Baldwin, 1990).

Even in seventeenth and eighteenth century England – when pooling was at a very local level – it has been argued that England was a 'highly mobile society' in the sense that most people died in a parish other than that in which they had been born (Feldman, 2003). Clearly, as in China today, pooling at a local level did not prevent high levels of labour mobility (although, of course, we cannot say that it might have been even higher with more flexible arrangements).

Thus, while decisions about pooling levels are no doubt influenced to some extent by issue such as the level of labour mobility and communications technology, fundamentally history would suggest that decisions about pooling levels are more political than technical and are related to the building of national welfare states in a particular political conjuncture.

4 Policy messages

The discussion above leads to the following policy messages which may be relevant in a Chinese context.

4.1 Pooling not determined by economic factors

One cannot, of course, directly predict the likely development of the Chinese pension pooling system on the basis of the European historical experience. There are simply too many differences which need to be taken into account, including the geographic and demographic scale of the nations involved. While, for example, China may now have a proportion of the total labour force engaged in agriculture which is similar to that in England in the earlier nineteenth century, other conditions in the two societies (such as communications and transport infrastructure) are entirely different. The more important point to be taken from the European record, however, is that there is little to indicate that decisions as to pooling levels were determined by particular levels of labour mobility or by the structure of the labour force.

4.2 Pooling requires political decisions

This would suggest (as would the Chinese experience over the last decade) that pooling at provincial level is unlikely to come about by evolution (at least over a relatively short period of time). The European experience indicates that significant moves in relation to higher levels of pooling came about as a result of high level political decisions which were enforced nationally. This would indicate the need in a Chinese context for a clear decision as to the level of pooling required and for a clear plan as to how to get there over a given period of time.

4.3 A step by step approach

Given the scale and size of China and the Chinese pension system, it may well be that China should adopt a step-by-step approach to implementing higher level pooling. For example, given the variation in wage levels within some provinces, it may be appropriate not to move immediately to uniform provincial pension rates in all cases. The most important factor would be to provide for provincial pooling of funds so as to address factors concerning variation in resources, increasing the insurance element,



facilitating effective planning and efficient fund management, and supporting labour mobility (as discussed in section 2).

4.4 Pension portability

A further critical issue in terms of labour mobility (which will only be partially addressed by provincial pooling) is portability of pension entitlements. It is understood that the MHRSS has recently established a pilot project on pension portability in certain provinces. The lessons from this pilot need to be studied and different approaches to portability examined.



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