

Pension Reform In China: Under the Shadow of the World Bank

by

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LL.B., East China University of Politics & Law, 2003

A Thesis Submitted in Partial Fulfillment of the
Requirements for the Degree of

MASTER OF LAWS

in the Faculty of Law

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ABSTRACT

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This thesis situates the ongoing changes to pension schemes in China within the macro legal and economic conditions in that country, and contextualizes these changes in light of international influences, particularly the influence of the World Bank. Drawing on such contextualization, this thesis explores a number of related factors, including the rule of law, economic development and pension reform strategy in order to understand both the need for and flaws in pension reform in China during the past three decades.

This thesis argues that the pension system has mirrored China's economic reforms. The marketization process that began in the late 1970s impelled China to make fundamental pension reforms. The fact that China has not yet achieved the rule of law further complicates the pension reform process. This thesis concludes that the pension reforms that have been inspired by the World Bank pension model have not been ideal reform choices for China; however, several steps on the way to fundamental reform are suggested as being worth trying in China's current economic and legal climate.

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Acknowledgments

Completing this thesis has been a long journey with more than a few ups and downs. However, I have been blessed with many people who have helped and supported me along the way. First and foremost, I would like to express my heartfelt thanks to my supervisor, Dr. Judy Fudge, who has expertly guided and patiently helped me during all the stages of my Master's program. Her valuable insight, expertise, challenging questions and advice made the completion of my thesis possible. Also, thanks to my co-supervisor, Dr. Feng Xu, for her direction, time and encouragement. A substantial thank-you is owed to Professor Freya Kodar, whose scholastic excellence and guidance significantly inspired me in the development of my thesis. I am also grateful to Dr. Ronald Davis for serving as my external examiner. Thank-you for your valuable comments and suggestions. I owe a special thanks to Kerry Sloan for her expert editorial advice and willingness to accommodate a tight schedule.

The Law Foundation of British Columbia, the Social Science and Humanities Research Council of Canada and the University of Victoria Law Faculty provided me with financial support, for which I am most thankful.

I also acknowledge my colleagues from the Shanghai Social Security Centre (Jing'an Branch) who have provided me with invaluable information throughout my study. Your friendship is one of my most cherished assets.

Finally, to my parents and my partner Wenhuan Teng, I cannot thank you enough. Mom and Dad, I am so lucky to have your endless love and long-distance support. Wenhuan, thank-you for letting me cry in your arms and cheering me up when I didn't

think I could do it. Thank-you for always being there and for your unwavering belief in my abilities.

Dedication

For my Mom and Dad

INTRODUCTION

It is said “life is drama”. A drama with a happy ending is always the most welcome kind. Life is just the same: we all want the happiness of enjoying a decent life in old age. However, during my four years working at the Shanghai Social Security Centre (Jing’an Branch), I realized that it is not easy for most Chinese people to achieve such a happy ending. I have witnessed an elderly woman, who relied on her spouse for income, burst into tears when she learned that she would not have any pension benefits when her husband passed away. I have seen workers, who were seriously injured at work, worry about potential reduction of pension benefits due to having taken sick leaves. I have also noticed the envious looks of rural migrant workers, who do not even dare to enter the Centre because they know that they do not have access to the pension plan that is only available to the urban residents of Shanghai.

Martin Luther King had a dream that blacks and whites would coexist harmoniously as equals one day. I also have a dream that rural and urban residents, full-time, part-time and contract workers, the rich and the poor, will all enjoy security and respect when they are at the last stages of the drama of their lives. I believe my dream will come true one day, and I hope that this thesis can make a contribution to shortening the time before my dream is realized.

Although China has been subject to several reforms during the past three decades, the pension system is still underdeveloped. The absence of a national pension law and the lack of a unified pension system are the best illustrations of this. The ultimate goal of this thesis is to provide some pension reform proposals that I believe are suitable for China. In

order to fulfill this goal, it is, therefore, important to examine the internal conditions as well as the external influences that have shaped the changes to the pension system.

In the following chapters, I first examine the legal and economic conditions in which the pension system is embedded. The legal climate in China is explored because it plays an important role in all kinds of reforms. Reforms should eventually be legitimated by law, and pension reform is no exception. However, law in China exhibits some distinctive characteristics. Has China achieved the rule of law, or is law just another form of Chinese Communist Party policy? This question deserves a thorough discussion, since the answer to it will influence the legitimacy of pension reform in China. In addition, the economic conditions in China deserve exploration because economic reform, which started in the late 1970s, gradually contributed to the collapse of the original pension system in China, and resulted in calls for a pension system more compatible with the market economy. After the examination of the internal conditions relevant to pension reforms, I next turn to a discussion of external influences. I highlight the position of the World Bank, not only because it has been actively involved in both the marketization process and the pension reform process, but also because of its massive impact on pension reform strategy in China. Most importantly, China is currently reforming its pension system using the pension model that was proposed by the World Bank in 1994.

Chapter One provides a theoretical discussion of the rule of law and its relationship to economic development. Since the World Bank is a major proponent of the relationship between the rule of law and economic growth, its position is emphasized. The state of the legal system in China is then reviewed based on the theoretical discussion, and I conclude that China has not yet achieved the rule of law.

Chapter Two provides an overview of the establishment of the original social security system in China, the “iron rice bowl” system, as well as the fundamental economic reform towards a socialist market economy in China. A case study of Shanghai is provided to illustrate the characteristics of the original pension system and its incompatibility with the market economy. The demographic transition that has further strengthened the urgency of pension reform is reviewed in detail. I argue that the pension system in China was a split or bifurcated system from its inception, and that the marketization process failed to provide necessary security for workers, which required government intervention. I also point out that demographic pressures further pushed the national government to launch pension reform.

Chapter Three addresses the debate about pension reform strategies between two major international organizations, the World Bank and the International Labour Office (“ILO”). By reviewing both the World Bank and the ILO reform strategies and their changing positions during the past year, I extract three important lessons that I believe are useful for China. The major pension reforms in China, which started in the mid-1980s, and which were greatly influenced by the World Bank, are also reviewed.

Chapter Four examines the World Bank pension model in the context of China based on the lessons that have been drawn from the previous chapter. It turns out that the consequences of the implementation of such a pension model are unsatisfactory, and, in fact, the three conditions that are required to implement such model are all absent in China. I conclude that China’s current choice of basing pension reform on the 1994 World Bank model might not be the best one.

I conclude my thesis by proposing some reforms that I believe are particularly suitable for China, together with providing some suggestions for further research.

In order to fulfill the goal of this thesis, I employ three methods. I use jurisprudential review in Chapter One to discuss the general concept of the rule of law as well as the specific conditions of the Chinese legal system. I apply a quantitative approach in Chapters Two and Three in order to analyze the serious demographic pressures, the pension coverage problem and the adequacy issue. The third method I use in my thesis, particularly in Chapter Four, is document analysis, in which I compare the different positions of the ILO and the World Bank regarding pension reform strategies.

CHAPTER ONE:

WHAT IS THE RULE OF LAW?

I. Introduction

Pension reform in China dates from the beginning of the country's marketization process in the early 1980s. China's reforms have been fundamental and ongoing, but not yet successful enough to achieve a unified national pension scheme. In order to evaluate pension reform over the past 30 years, it is necessary to examine the economic and legal context in which it is embedded, and it is also important to investigate external factors, such as international influences. One goal of this thesis is to situate the ongoing changes to the pension regime during the past three decades in light both of China's legal system and the recommendations of the World Bank. In order to do this, I draw on the theoretical literature that enables me to examine the relationship between economic development, the rule of law and pension reform, as well as the position of the World Bank.

In this chapter, I provide a literature review of the theory of the rule of law and its relationship to economic development. I highlight the position of the World Bank, because the World Bank has been a major proponent of the relationship between the rule of law and the economic development, and also because the World Bank's prescriptions have had a noticeable impact on China's marketization and pension reform processes. I then draw on the rule of law theory to examine the condition of China's legal system, as pension reform is embedded in the legal system. I argue that China has not yet achieved the rule of law, and this failure to achieve the rule of law could hamper the progress of pension reform.

II. Rule of Law Theory

To fulfill the goal of my thesis, it is necessary to develop an understanding of the rule of law. The “rule of law” is an “essentially contested concept”,¹ and it belongs to “the category of open-ended concepts which are subject to permanent debate”.² The phrase regularly accompanies economic development, human rights protection, democracy and other objectives, and all of these objectives are believed to depend largely on the rule of law.³ Thus, the rule of law has been so frequently invoked with so many issues today that “the precise meaning ... may be less clear today than ever before”.⁴ Judith Shklar concluded that the rule of law has become meaningless thanks to ideological abuse and general over-use.⁵ Joseph Raz has also commented on such tendency to use the rule of law as a general explanation for every positive aspect of a certain political system or every good:

Not uncommonly when a political ideal captures the imagination of large numbers of people its name becomes a slogan used by supporters of ideals which bear little or no relation to the one it originally designated.⁶

¹ M. J. Radin, “Reconsidering the Rule of Law” (1989) 69 *Boston University Law Review* 781 at 781.

² R. Grote, “Rule of Law, Rechtsstaat and Etat de Droit,” in C. Starch, ed., *Constitutionalism, Universalism and Democracy: A Comparative Analysis* (Baden-Baden: Nomos Verlagsgesellschaft, 1999) 269 at 271.

³ For instance, the United Nations (UN) explicitly expressed in its report that achieving Millennium Development Goals rested on the development of the rule of law. The Millennium Development Goals are eight goals that the UN hopes to achieve by 2015 in response to the world’s greatest development challenges. See UN Millennium Project, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*, online: <<http://www.unmillenniumproject.org/documents/MainReportComplete-lowres.pdf>> (accessed November 24, 2008).

⁴ R. H. Fallon, “‘The Rule of Law’ as a Concept in Constitutional Discourse” (1997) 97 *Columbia Law Review* 1 at 1 [Fallon].

⁵ For Shklar, the rule of law has become nothing more than a slogan. She further states that, “It may well have become just another one of those self-congratulatory rhetorical devices that grace the public utterances of Anglo-American politicians. No intellectual effort need therefore be wasted on this bit of ruling-class chatter.” See J. N. Shklar, “Political Theory and the Rule of Law” in A.C. Hutcheson & P. Monahan, eds., *The Rule of Law: Ideal or Ideology* (Toronto: Carswell, 1987) 1 at 1.

⁶ J. Raz, “The Rule of Law and its Virtue” in *The Authority of Law: Essays on Law and Morality* (Oxford: Clarendon Press, 1979) 210 at 210 [Raz].

Historical Review

The rule of law is a historically contested ideal, and the controversy and uncertainty about its meaning dates back to its origin.⁷ Although some commentators identify Plato⁸ to be the first theorist to discuss the rule of law, Aristotle is usually regarded as the founder of the rule of law tradition.⁹ However, according to Jeremy Waldron, the implications of Aristotle's rule of law notions were inconsistent and "no one quite knows what to draw from him".¹⁰ For example, Waldron suggests that while Aristotle said that as many matters as possible must be settled in advance by general rules, he also said that for hard cases the rule of law consists in a legal specification of the individual or group that must take personal responsibility for the decision. (For those cases, Aristotle said the law controls the decision indirectly by controlling the process of appointment and basis on which appointees are educated.) Moreover, Aristotle also recommended that if there are likely to be many hard cases, then the law should adopt a less rigid rule.¹¹

In modern times, perhaps the most famous exposition of the rule of law is from A.V. Dicey, who saw the rule of law as the fundamental principal of the British constitution.¹² However, he also claimed that the sovereignty of Parliament was the other fundamental

⁷ J. Waldron, "Is The Rule of Law an Essentially Contested Concept (In Florida)?" (2005) 21 Law & Philosophy 137 at 140 [Waldron].

⁸ World Bank, "Rule of Law in Western Thought", online: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20763590~isCURL:Y~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062,00.html> (accessed 17 November 2008).

⁹ Waldron, *supra* note 7 at 141.

¹⁰ *Ibid.*

¹¹ *Ibid.*, citing Aristotle, *The Politics*, S. Everson, ed. (Cambridge: Cambridge University Press, 1988) at 78; Waldron also cited Montesquieu's work to illustrate the uncertainty and contested nature of the rule of law from its very origin. See Waldron, *supra* note 7 at 142.

¹² Fallon, *supra* note 4 at 1.

principle. He tried to reconcile the rule of law and parliamentary sovereignty, although these two ideas appear to stand in opposition to each other.¹³ He argued that the sovereignty of Parliament favoured the rule of law.¹⁴ Because the British Parliament consisted of the Crown, the House of Lords and the House of Commons, the power of Parliament could only be expressed through the combined action of its three constituent parts and, therefore, had to be expressed by means of formal legislation. According to Dicey, “the will of Parliament can be expressed only through an Act of Parliament”.¹⁵ Meanwhile, Dicey asserted that the rule of law also favoured parliamentary sovereignty.¹⁶ Under complex conditions, such as war or disorder, the rigidity of law would hamper the action of the executive and, in order to keep the peace or fulfill its duties, the government could only choose to obtain arbitrary authority from Parliament.¹⁷

Although Dicey’s argument concerning the relationship between the rule of law and parliamentary sovereignty might be controversial, his exposition of the rule of law became the classical articulation. He listed three meanings of the rule of law.¹⁸ First, it means “the absolute supremacy or predominance of regular law as opposed to the influence of arbitrary power” and also “excludes that existence of arbitrariness, of prerogative, or even of wide discretionary authority on the part of the government”.¹⁹ Second, it means “equality before the law, or the equal subjection of all classes to the

¹³ See A.V.Dicey, *Introduction to the Study of the Law of the Constitution*, 10th ed. (London: Macmillan, 1959).

¹⁴ *Ibid.*, at 350.

¹⁵ *Ibid.*, at 350-351.

¹⁶ *Ibid.*, at 354.

¹⁷ *Ibid.*

¹⁸ *Ibid.*, at 198.

¹⁹ *Ibid.*

ordinary law courts”.²⁰ Lastly, the rule of law may be used as a formula for expressing the fact that the law of the British constitution is a consequence of the rights of individuals, and the constitution is the result of the ordinary law of the land.²¹

Overview of the Literature on the Rule of Law

After Dicey’s classic definition of the rule of law, theories of the rule of law have developed, and they can generally be divided into two types: thin and thick (formal and substantive),²² which provide different views of the true meaning and value of the rule of law. Although the distinctions between thin and thick conceptions of the rule of law differ slightly between scholars, there are some common understandings. Here I borrow the definition of Randall Peerenboom to distinguish these two types. Thin theory refers to the formal or instrumental aspects of the rule of law – those features that provide the core meaning and basic elements of rule of law upon which a legal system functions effectively as a system of laws.²³ Thick theory combines thin theory with those historical and social conditions in which the rule of law is embedded, such as particular economic arrangements–free market capitalism, forms of government –multi-party democracy, conception of human rights–liberal interpretation of human rights.²⁴

²⁰ *Ibid.*

²¹ *Ibid.*, at 199.

²² Although the thin and thick dichotomy is the most common in academic literature, there are other classifications. For example, Fallon divides theories of the rule of law into four ideal types: historicist, formalist, legal process related and substantive. See Fallon, *supra* note 4. See also World Bank, “Rule of Law as a Goal of Development Policy”, online: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20763583~isCURL:Y~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062,00.html> (accessed 17 November 2008). The theory of rule of law distinguishes between formal, substantive and functional.

²³ R. Peerenboom, *China’s Long March Toward Rule of Law* (Cambridge: Cambridge University Press, 2002) at 3 [Peerenboom].

²⁴ *Ibid.*, at 3.

Many scholars have identified a number of core elements and values that should be included in a thin rule of law system. Lon Fuller is one of the first and most influential thinkers in this area. He spells out eight features of the rule of law: law should be (1) general, (2) publicly promulgated, (3) prospective, (4) intelligible, (5) consistent, (6) practicable, (7) not too frequently changeable and (8) actually congruent with the behaviour of the officials of the regime.²⁵ Similarly, John Finnis has identified eight other principles: rules should be prospective, possible to comply with, promulgated, clear, coherent with one another, and sufficiently stable; in addition, the making of decrees should be limited, and officials should be accountable for compliance with the rules, creating government *sub lege*.²⁶ John Rawls, by contrast, confines the key elements of the rule of law into four requirements: “ought” implies “can”; similar cases should be treated similarly; there should be no offense without a law; and, natural justice is to be observed (an accused person is entitled to a fair trial).²⁷ Joseph Raz also spells out eight principles, which are derived from one basic idea –“that the law should be capable of providing effective guidance”. Raz states that laws should be prospective, open, clear, and relatively stable, and adds that lawmaking must be guided by open, stable, clear and general rules. In addition, he states that there must be an independent judiciary, accessible courts, and fair trials must be guaranteed. Courts must also have power to review implementation of other principles, and the discretion of crime-preventing agencies should not be allowed to pervert the law.²⁸

²⁵ L.L. Fuller, *The Morality of Law, Revised Edition* (New Haven: Yale University Press, 1969) at 39.

²⁶ J. Finnis, *Natural Law and Natural Rights* (Oxford: Clarendon Press, 1980) at 270.

²⁷ J. Rawls, *A Theory of Justice* (Oxford: Oxford University Press, 1971) at 236-239.

²⁸ Raz, *supra* note 6 at 214-219.

It is apparent that the precise meaning of a thin theory of the rule of law varies from scholar to scholar. However, it is not necessary to weigh one meaning against another or to pick the best meaning, as there is considerable overlap among these different interpretations concerning the minimum elements or characteristics of a thin theory of the rule of law. Notions such as the supremacy of law, the equality of all before the law, and the necessity of restricting the arbitrariness of government are all reflected in different interpretations. What is important is that these interpretations all identify clear prescriptive criteria for rule of law systems and set out the minimum standards they must meet, instead of providing mere general descriptions.

In contrast, proponents of a thick theory of the rule of law see the content and value of the rule of law in a different way. Ronald Dworkin, for example, adopts a broader, more substantive concept of the rule of law than those scholars mentioned above. His take on the rule of law is as follows:

It assumes that citizens have moral rights and duties with respect to one another, and political rights against the state as a whole. It insists that these moral and political rights be recognized in positive law, so that they may be enforced upon the demand of individual citizens through courts or other judicial institutions of the familiar type, so far as this is practicable. The rule of law in this conception is the ideal of rule by an accurate public conception of individual rights. It does not distinguish ... between the rule of law and substantive justice; on the contrary it requires, as part of the ideal of law, that the rules in the book capture and enforce moral rights.²⁹

Friedrich Hayek also takes a different approach than Fuller and other proponents of a thin theory of the rule of law. He takes a liberal approach, which suggests the rule of law not only as a means of governance, but also as a necessary guarantee for liberty. For

²⁹ R. Dworkin, *A Matter of Principle* (Cambridge, Mass.: Harvard University Press, 1985) at 11-12.

Hayek, the rule of law means something like the rule of spontaneously emerging norms.³⁰

The ascendancy of legislation is not totally compatible with the rule of law, even if legislation were drafted and enforced in a way that satisfied the principles of the proponents of thin theory. On his account, the principle of rule of law should distinguish a free country from a country under arbitrary government.³¹

However, the most influential statement on a thick rule of law is that of the International Commission of Jurists, who argue that the objective of the rule of law consists of enabling human flourishing in the most expansive sense of the word. In the New Delhi Declaration of 1959, they asserted that the

... function of the legislature in a free society under the rule of law is to create and maintain the conditions which will uphold the dignity of man as an individual. This dignity requires not only the recognition of his civil and political rights but also the establishment of the social, economic, educational and cultural conditions which are essential to the full development of his personality.³²

Those who defend a thick rule of law conception insist that fundamental values such as democracy and human rights must be incorporated into the rule of law. They argue that a thick theory requires not only formal existence of the rule of law, but the substantive content of the laws that rule. In short, the rule of law requires “good law”.³³ Those who object to a thin theory do so primarily because they find that thin theory lacks sufficient substantive, normative content. Nazi Germany is brought forward as an example of a

³⁰ F.A. Hayek, *Law, Legislation and Liberty: Volume I – Rules and Order* (Chicago: University of Chicago Press, 1983) at 94.

³¹ F.A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1994) at 72.

³² International Commission of Jurists, “New Delhi Declaration”, online: <http://www.icj.org/article.php?id_article=3088&id_rubrique=11&lang=en> (accessed 16 January 2009).

³³ There are different interpretations of “good law”, but it usually incorporates substantive, normative elements such as justice and human rights. See, for instance, H. Berman, “The Rule of Law and the Law-Based State (Rechtsstaat)” in *Towards the “Rule of Law” in Russia: Political and Legal Reform in the Transition Period* (New York: M.E. Sharpe, 1992) 43. Berman claims democracy and human rights as the normative foundation of good law.

regime whose legal system that might have met the standards of thin theory, but was not worth pursuing, as it lacked the fundamental normative content of rule of law.³⁴

The relationship between a thin theory of the rule of law and a thick one is described by Peerenboom in terms of concentric circles: in the smallest circle are the core elements of a thin rule of law, which is embedded within a larger circle of thick rule of law conceptions. In turn, the thick rule of law circle is part of the largest circle of broader social and political philosophy.³⁵

Advantages of Thin Theory

Whether a thin theory of the rule of law is superior to a thick theory or *vice versa* is contested. The divergence in academic understanding has led to divergence in and even barriers to the practice of promoting the rule of law.³⁶ To start a useful conversation, a thin theory of the rule of law is preferable for the following reasons.

One important value of thin theory is that it helps to build conceptual clarity. If one looks back to the concentric circle theory of Peerenboom, the core elements and values of thin theory are shared by proponents of both thick and thin theories, and these characteristics in fact “form the lowest common denominator of the wide diversity of rule of law conceptions”.³⁷ Moreover, as the rule of law is perceived to require a shared broad

³⁴ See Peerenboom, *supra* note 23 at 69.

³⁵ *Ibid.*, at 70-71.

³⁶ For instance, the International Development Law Organization (IDLO) claims that the lack of unanimity among various stakeholders as to a definition of rule of law is one of its main shortcomings in promoting the rule of law. See International Development Law Organization, *Rule of Law Inventory Report: Practice Part*, Discussion Paper for the High Level Expert Meeting on the Rule of Law of 20 April 2007, online: <http://www.idlo.int/ROL/ROLcv/Inventory_Report_Practice_Part_by_IDLO1.pdf> (accessed 16 January 2009).

³⁷ Hague Institute for the Internationalization of Law (HIIL), *Rule of Law Inventory Report: Academic Part*, Discussion Paper for the High Level Expert Meeting on the Rule of Law of 20 April 2007, online: <http://www.hiil.org/uploads/File/1-947-Rule_of_Law_Inventory_Report_2007.pdf> (accessed 16 January, 2009) at 13.

moral or political ideology, it can hardly be said to have an independent meaning, since substantive values like democracy or human rights themselves are highly contested concepts. Thus, under thick theory, the rule of law becomes a very complex notion, which is simply equivalent to the ideal of a just society and thus is hard to use and analyze.³⁸ As Raz points out:

If rule of law is the rule of the good law then to explain its nature is to propound a complete social philosophy. But if so the term lacks any useful function. We have no need to be converted to the rule of law just in order to believe that good should triumph.³⁹

Another advantage of thin theory is that it can promote discussion and communication between different cultures and political regimes on the rule of law. As thin theory excludes substantive ideals and focuses clearly on general agreement about the rule of law, it allows communication and makes discussion possible and effective in a pluralistic society, especially at an international level. Consensus can be reached between socialist and liberal, democratic and authoritarian regimes, without becoming trapped in sensitive yet complex moral or political philosophy. One scholar has stated this advantage very clearly:

... attempts to export a particular form of the rule of law reflecting specific political or economic values that are not part of the core values of the rule of law and that are in fact rejected by the target country may be viewed at best as misguided and at worst as imperialistic.⁴⁰

On a practical level, a thin theory of the rule of law is more useful than a thick theory, because it reduces complexity. There are fewer and clearer standards when a thin theory is adopted. This clarity makes it particularly important in practice, because it

³⁸ *Ibid.*, at 13-14.

³⁹ Raz, *supra* note 6 at 211.

⁴⁰ J.C. Reitz, "Export of the Rule of Law" (2003) 13:2 *Transnational Law & Contemporary Problems* 429 at 434-435.

makes it easier for actors to analyze, evaluate and promote the rule of law. Moreover, since theoretical and practical problems associated with substantive ideals among different cultures are avoided, criticisms or suggestions are more likely to be taken seriously and result in actual change, given a shared clear understanding of the rule of law.⁴¹ In short, it is more manageable to build or promote a rule of law system from the smallest circle of the concentric rule of law circles than to jump to the larger one.

III. The World Bank: The Rule of Law and Economic Development

Although there is no consensus on the definition of the rule of law, this does not prevent scholars, governments and organizations from devoting research and effort to the practice of the rule of law. According to the International Development Law Organization (“IDLO”), there have been more than 2,500 different projects conducted in the broad field of the rule of law by more than 500 different actors during the four-year period from 2004 to 2007.⁴² The World Bank has also been actively engaged in promoting the rule of law. There are approximately 600 World Bank-financed projects related to the rule of law reform worldwide.⁴³ In the case of China, between 1994 and 2004, the World Bank launched a 10-year rule of law promotion project, and another project was begun in 2003.⁴⁴ One reason that so many actors are engaging in the

⁴¹ Peerenboom, *supra* note 23 at 68.

⁴² IDLO, *supra* note 36 at 1.

⁴³ World Bank, *Initiatives in Legal and Judicial Reform* (Washington DC: The World Bank, 2004) at 2, online: <http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2004/03/01/000012009_20040301142827/Rendered/PDF/250820040Edition.pdf> (accessed 20 January 2009) [World Bank].

⁴⁴ *Ibid.*, at 28-29

promotion of the rule of law is the belief that such exercises will help to improve economic performance.⁴⁵

Rule of Law and Economic Development: For and Against

The belief that the rule of law is necessary to sustain economic development, although not highly contested, is not unchallenged. Interestingly, China is always used as a vivid example to prove the belief to be wrong.⁴⁶ However, as indicated above, most rule of law promotion practices are based on the assumption that the development of the rule of law helps to accelerate and sustain economic growth. If this assumption is proved to be mistaken, then the major incentive behind rule of law promotion would be eliminated, leading to the question of the necessity of world-wide promotion itself. Thus, the relationship between the rule of law and economic development deserves thorough examination.

Max Weber was one of the first theorists to draw a connection between law and economic development.⁴⁷ He found one of the factors that contributed to the emergence of capitalism in western Europe to be its legal system. According to Weber, this type of legal system is a logically formal and rational one.⁴⁸ Such a legal system means that the law is equally applicable to all people and institutions. Moreover, the law is autonomous in the sense that laws are the products of rational reasoning. Weber believed that such a

⁴⁵ World Bank, *Economic Development and the Quality of Legal Institutions*, online: <http://siteresources.worldbank.org/INTLAWJUSTINST/Resources/LegalInstitutionsTopicBrief.pdf> (accessed 20 January 2009).

⁴⁶ For instance, Carothers describes: “Yet the case of China flies squarely in the face of the argument – to achieve economic development, the rule of law is a necessity.” T. Carothers, “Promoting the Rule of Law Abroad: the Problem of Knowledge”, Democracy and Rule of Law Project, Working Papers No. 34 (Washington: Carnegie Endowment for International Peace, 2003) at 6.

⁴⁷ See A. Chen, “Rational Law, Economic Development and the Case of China” (1999) 8:1 Social & Legal Studies 97 [Chen].

⁴⁸ *Ibid.*, at 97.

legal system could provide certainty and predictability to participants in a market economy, which are elements necessary for the growth of economies.⁴⁹

Derived from Weber, the modernization theory became influential after World War II, and was borrowed by the law and development movement in the 1960s.⁵⁰ Members of the law and development movement agreed with scholars of the theory of modernization that the main reason many “third world” countries lacked development is that they lacked modern western institutions, practices, and values.⁵¹ To remedy this problem, it was thought necessary to adopt the entire western system, a critical element of which is the western legal system. It was believed that such a system would serve to protect contract and property rights, and provide market incentives via the legal system’s characteristics of predictability and certainty.⁵² As a consequence, economic growth and the legal system itself would work together to foster political development in order to limit arbitrary government actions and, finally, to establish a liberal democratic government.⁵³

Holding the belief that legal reforms would lead to economic growth and political justice, members of the law and development movement “took their crusade to developing countries”.⁵⁴ In practice, their attention was mainly focused on the poorly educated bar and judiciary, and their practice became a program of legal education

⁴⁹ M. Rheinstein, ed., *Max Weber on Law in Economy and Society* (Cambridge, Mass.: Harvard University Press, 1954).

⁵⁰ See J. A. Gardner, *Legal Imperialism: American Lawyers and Foreign Aid in Latin America* (Madison: University of Wisconsin Press, 1980).

⁵¹ See W. Rostow, “Stages of Economic Growth” (1959) 12:1 *Economic History Review* (New Series) 1.

⁵² D. M. Trubek, “Toward a Social Theory of Law: An Essay on the Study of Law and Development” (1972) 82 *Yale Law Journal* 1 at 6-8.

⁵³ See, Peerenboom, *supra* note 23 at 452.

⁵⁴ *Ibid.*

reform,⁵⁵ hoping that lawyers and judges could be trained to appreciate the developmental role of law and become “social engineers”.⁵⁶ However, the results were mixed and not very promising. Many countries failed to achieve economic development, while others remained authoritarian in nature even though economic development was achieved.⁵⁷

The 1990s saw the rise of the new law and development movement, which is based on neoclassical growth theory. The neoclassical theorists, such as Douglass North, saw property rights as having the highest importance for economic development.⁵⁸ North believed that the absence of well-defined and effectively enforced property rights in many developing countries was a major factor contributing to high transaction costs and poor economic performance over time.⁵⁹ North argued that enforceable property rights and fair rules for competition allowed participants in the economy to secure their own benefits, while reducing the state’s capacity for expropriation.⁶⁰

The new law and development movement, inspired by neoclassical theory, perceived law and legal institutions as central to promoting economic growth. The rule of law, by providing protection of property rights and restraining the state, would ensure the proper

⁵⁵ E. Burg, “Law and Development: A Review of the Literature and a Critique of ‘Scholars in Estrangement’” (1977) 25 *American Journal of Comparative Law* 492 at 512.

⁵⁶ R. Messick, “Judicial Reform and Economic Development: A Survey of the Issues” (1999) 14:1 *The World Bank Research Observer* 117 at 126.

⁵⁷ Peerenboom, *supra* note 23 at 452.

⁵⁸ D. North, *Institutions, Institutional Change, and Economic Performance* (New York: Cambridge University Press, 1990).

⁵⁹ D. North & R. Thomas, *The Rise of the Western World: A New Economic History* (Cambridge: Cambridge University Press, 1973).

⁶⁰ *Ibid.*

functioning of a market economy.⁶¹ The movement thus emphasized the need for clear and enforceable property rights and sound commercial laws, as well as proper institutions, like an independent and competent judiciary and an autonomous and qualified legal profession.⁶²

Position of the World Bank

The World Bank's rule of law reforms have expanded considerably since the 1990s.⁶³ Some believe that neoclassical economic theory has significantly influenced the World Bank and that the Bank plays a role in the new law and development movement.⁶⁴ Nevertheless, like many other actors in rule of law promotion, the World Bank's starting point and rationale is purely economic. There are few discussions of the rule of law itself by the World Bank, but the World Bank is very interested in the link between the rule of law and development. The World Bank describes the incentives for promoting the rule of law in the following terms:

[T]he rule of law promotes effective and sustainable economic development and good governance. Lack of the rule of law significantly hinders economic growth ... and this goal [to encourage domestic and foreign private investment] could not be reached without modifying or overhauling the legal and institutional framework and firmly establishing the rule of law to create the necessary climate of *stability* and *predictability*.⁶⁵

⁶¹ D. Trubek "The 'Rule of Law' in Development Assistance: Past, Present, and Future", (Paper given at Conference on Law and Economic Development: Critiques and Beyond. Harvard Law School, Cambridge MA, 12-13 April 2003).

⁶² Peerenboom, *supra* note 23 at 453.

⁶³ World Bank, *supra* note 43 at 3.

⁶⁴ G. Barron, "The World Bank & Rule of Law Reforms" (2005) Development Studies Institute Working Paper Series No. 05-70 [Barron].

⁶⁵ World Bank, *supra* note 43 at 1-2 [emphasis in original].

Undoubtedly, the World Bank believes that the rule of law is the *sine qua non* of development.⁶⁶ Promoting the rule of law lays the foundation for the World Bank to achieve its ultimate mission, which is to promote economic growth and alleviate poverty.⁶⁷ The role of the rule of law in development is clearly instrumental.

Before the World Bank can decide how to promote the rule of law in certain countries or areas, it is important first to define the rule of law. It is interesting to find that “the World Bank’s working definition of the rule of law has tended to reflect the particular views of its reigning General Counsel”.⁶⁸

At present, the World Bank follows the interpretation of its current General Counsel, Ko Yung Tung. Tung described his understanding of the rule of law in a 2002 speech he gave to the Federal Judicial Council of Argentina.⁶⁹ The World Bank has employed Tung’s understanding and similar definitions have been used in many of the World Bank’s publications.⁷⁰ These definitions are on some level substantive, and more like a thick theory of the rule of law. The World Bank states that the rule of law prevails where:

(1) [T]he government itself is bound by the law; (2) every person in society is treated equally under the law; (3) the human dignity of each individual is recognized and protected by law; and (4) justice is accessible to all. The rule of law requires transparent legislation, fair laws, predictable enforcement, and accountable

⁶⁶ See World Bank, *supra* note 43.

⁶⁷ World Bank, *Legal and Judicial Reform: Strategic Directions* (Washington DC: The World Bank, 2004) at 1, online: <http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2003/10/24/000160016_20031024092948/Rendered/PDF/269160Legal0101e0also0250780SCODE09.pdf> (accessed 10 January 2009).

⁶⁸ Barron, *supra* note 64 at 13.

⁶⁹ K.Y. Tung, “Rule of Law” (Speech delivered to the Federal Judicial Council of Argentina, Palacio de Justicia, Buenos Aires, 4 December 2002), online: <<http://siteresources.worldbank.org/INTLAWJUSTINST/Resources/ArgConsejo1204.pdf>> (accessed 10 January 2009).

⁷⁰ See, for example, World Bank, *Legal and Judicial Reform: Observations, Experiences, and Approach of the Legal Vice Presidency* (Washington DC: The World Bank, 2004) at 1, online: <http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2002/12/06/000094946_0211260401346/Rendered/PDF/multi0page.pdf> (accessed 10 January 2009). See also World Bank, *supra* note 43.

governments to maintain order, promote private sector growth, fight poverty, and have legitimacy.⁷¹

However, previously the World Bank adopted the definition of Ibrahim Shihata, the Bank's Counsel from 1983-1998, and this definition "lasted for the duration of Shihata's term as General Counsel".⁷² Shihata saw the rule of law as "a system, based on abstract *rules* which are actually applied and on functioning *institutions* which ensure the appropriate application of such rules".⁷³ In detail, the rule of law required that:

a) there is a set of rules which are [is? check cite] known in advance; b) such rules are actually in force; c) mechanisms exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures; d) conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body; and e) there are known procedures for amending the rules when they no longer serve their purpose.⁷⁴

The difference between Tung's and Shihata's definition is the difference between a thin theory of the rule of law and a thick one. While Shihata adhered to the World Bank's economic rationale, Tung added some substantive components. Shihata's definition, considering the World Bank's rationale, is quite clear: the rule of law is a legal system that provides certainty and predictability to economic participants. Tung found it necessary to incorporate substantive ideas such as "human dignity" and "accountable, legitimate government", which goes beyond the World Bank's interest. However, Gordon Barron insists that "at the heart of the Bank's rule of law remains a stark formalism" despite the fact that "language has changed".⁷⁵

⁷¹ World Bank, *supra* note 43 at 3.

⁷² Barron, *supra* note 64 at 13

⁷³ *Ibid.*, citing I. Shihata, *et al.*, *The World Bank in a Changing World: Selected Essays* (Boston: M. Nijhoff, 1991) at 85 [emphasis in original].

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*, at 15.

Thus, the tension between thin and thick conceptions of the rule of law is visible in the definitions used by the World Bank. However, not only does a thin theory have certain general advantages, especially for the practice of promoting the rule of law, there are reasons specific to the World Bank for preferring Shihata's thin interpretation.

One factor is that the World Bank has limits on the scope of its intervention. The World Bank is explicitly prohibited from considering political criteria in its practice. Its Charter explicitly notes that political activity is prohibited, and the only consideration is economic affairs. Article IV, section 10 of the World Bank's *Articles of Agreement* states,

The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions ...⁷⁶

Thus, the World Bank's activities in rule of law promotion should only relate to economic interests. All rule of law promotion should be understood to contribute to the economic development of the Bank's clients. In practice, for example, the revision of criminal law and the management of penitentiary institutions are considered too political for the World Bank.⁷⁷ Thus, the goal of protecting human dignity or building an accountable, legitimate government through rule of law promotion is beyond the World Bank's interest and scope.

Another reason for preferring a thin interpretation comes from experience. It is beyond the World Bank's capacity to achieve substantive ideals, such as democracy, as

⁷⁶ World Bank, "International Bank for Reconstruction and Development Articles of Agreement," online: <<http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,contentMDK:20049557~menuPK:63000601~pagePK:34542~piPK:36600~theSitePK:29708,00.html>> (accessed 10 January 2009).

⁷⁷ World Bank, "The World Bank and Legal Technical Assistance: Initial Lessons", Policy Research Working Paper No. 1414 (Washington DC: The World Bank, 1995) at 14, online: <http://www-wds.worldbank.org/external/default/WDSContentServer/TW3P/IB/1995/01/01/000009265_3970311121413/Rendered/PDF/multi_page.pdf> (accessed 10 January 2009).

envisioned by thick rule of law theory. The World Bank's Venezuelan project is one example. The World Bank started its flagship rule of law project in Venezuela in the late 1990s, which ultimately cost US\$84.34 million.⁷⁸ The project included infrastructure building, courtroom administration, and judicial training and administration.⁷⁹ The project did not go smoothly. First, it was delayed for two years because of political strife and, following that, a judicial statute was passed that implied that every judge ran the risk of losing her or his position if she or he did not apply the law in the manner the government preferred.⁸⁰ Obviously, the World Bank was not able to prevent these developments.⁸¹ The World Bank acknowledged that rule of law reform, in fact, is "highly dependent on political will".⁸² If rule of law reform has to rely on political will, then even the will of an authoritarian government has to be depended on to carry out the reform. It is hard to imagine that the World Bank could promote democracy or other substantive political ideas through rule of law reform in such situations.

Considering the legal limitations of its Charter and its own interests and capacity, it is preferable for the World Bank to follow a thin understanding of the rule of law. A thick understanding does not help to achieve the World Bank's ultimate mission. Thus, it is the best for the World Bank to adhere to a thin theory in order to promote its purpose of fostering economic development.

⁷⁸ Barron, *supra* note 64 at 29.

⁷⁹ *Ibid.*

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

⁸² *Ibid.*, citing World Bank, "Implementation Completion Report: West Bank and Gaza", online: <<http://www.docstoc.com/docs/1002899/West-Bank-and-Gaza>> (accessed 12 April 2009).

The World Bank and China

There were not as many World Bank-sponsored legal and judicial projects in China, such as pension reform, as there were in other areas. In fact, there have been only two World Bank projects in China to date, one in early 1993 and the other in 2003, the first of which is the more crucial. The 1993 project was one of legal reform, and focused mainly on adopting laws from countries with developed legal systems and market economies, in order to promote China's transition to a market economy.⁸³ More than 50 laws and regulations were drafted and executed, most of which pertained to economic law.⁸⁴ The 1993 project was characterized as "one of the most successful of the Bank's Technical Assistance Projects in China" and it ensured China's accession into the World Trade Organization ("WTO").⁸⁵ Moreover, the 1993 project was the first legal reform project of the World Bank to be completed.⁸⁶ The 2003 project was a Rural Land Contracting Law Project, which focused mainly on drafting and implementing laws.⁸⁷

The main components of the 1993 project were:

- a. Strengthening the legislative process, including (i) preparing laws and regulations included in the legislative agenda of the National People's Congress (NPC) and the State Council and (ii) enhancing the skills of local drafters through knowledge-sharing and education;
- b. Training; and
- c. Institutional strengthening of key agencies such as the legal offices of the legislature and the executive and the Ministry of Justice.⁸⁸

⁸³ World Bank, *supra* note 43 at 28.

⁸⁴ *Ibid.*, at 29.

⁸⁵ *Ibid.*, at 29.

⁸⁶ *Ibid.*, at 4.

⁸⁷ *Ibid.*, at 29.

⁸⁸ *Ibid.*, at 28.

However, a great deal of emphasis was placed on transplanting laws from marketized countries in order to help China to understand the “rules of the game” when transiting to a market economy. Many economic laws such as the *Contract Law*, the *Insurance Law*, the *Partnership Law*, the *Sole Enterprise Law* and the *Trust Law* were drafted. In addition, several laws and regulations were under consideration or revision, including: the *Property Law*, the *Bankruptcy Law*, and the *Anti-Monopoly Law*.⁸⁹

The 2003 project was a Rural Land Contracting Law Project. There were five main components:

- a. Drafting regulations for the “Rural Land Contracting Law” (RLCL), and making recommendations for secondary and subsidiary legislation based on a thorough analysis of the provisions of this law;
- b. Implementing the RLCL;
- c. Developing supporting institutions for rural land tenure reforms by (i) undertaking comparative research and analysis of local circumstances, (ii) training judges and legal aid staff, (iii) developing administrative institutions for dispute resolutions under the RLCL, and (iv) developing recommendations for national and regional land tenure related institutions;
- d. Designing training for local officials about rural land tenure laws and policies; and
- e. Assessing the long-term impacts of RLCL implementation on agricultural reform objectives.⁹⁰

It is worth emphasizing that the rationale for promotion of the rule of law in China has been purely economic. The World Bank’s purpose for carrying out its first legal reform project in China was “developing a legislative agenda that would facilitate China’s move to a market economy”.⁹¹ This project was designed to help China

⁸⁹ *Ibid.*, at 29.

⁹⁰ *Ibid.*

⁹¹ World Bank, “Implementation Completion Report No. 32265” (2005), online: <http://www-wds.worldbank.org/external/default/WDSContentServer/WDS/IB/2005/06/23/000012009_20050623103311/Rendered/PDF/322650rev.pdf> (accessed 20 January 2009).

familiarize itself with the “rules of the game” in a market economy, without any attention to building or promoting substantive ideals.

IV. Has China Achieved the Rule of Law?

It is well known that China has achieved tremendous economic growth since the marketization process that started in the late 1970s. Does this economic success mean that the World Bank’s rule of law reform project has met with such success that China has qualified as a rule of law state? Has the achievement of the rule of law contributed to China’s sustainable economic growth? In this section, I will examine three core elements of the rule of law – the supremacy of law, an independent judiciary, and the legislative system – in order to examine whether China has achieved the rule of law.

Legal System of China

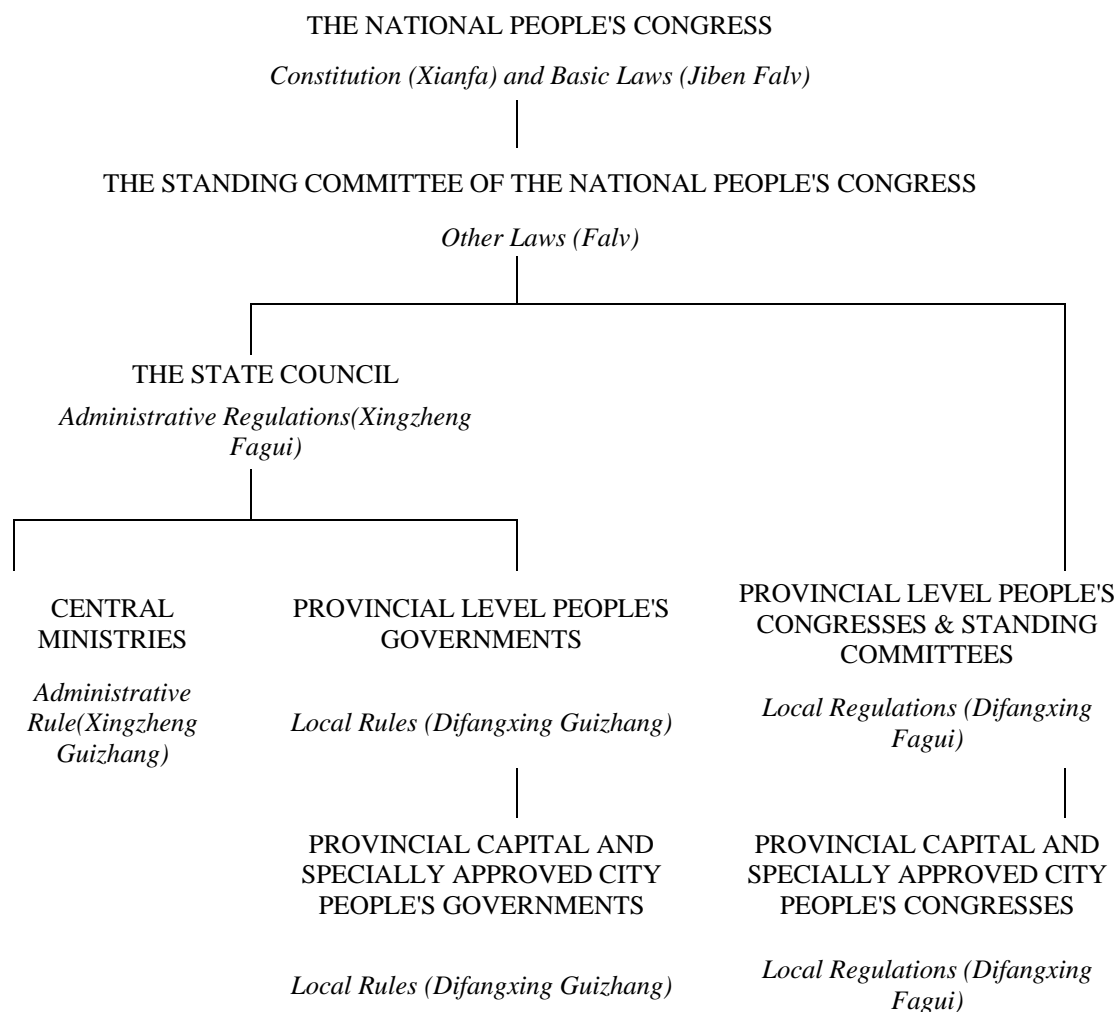
Before evaluating China’s legal system to see if it conforms to a thin conception of the rule of law, it is necessary to briefly outline the legal system of China.⁹² There are several sources of law in China. *The Constitution of the People’s Republic of China, 1982* (the “*Constitution*”)⁹³ stands at the apex of law and has the highest authority. *Falv, xingzheng fagui, difangxing fagui* and *xingzheng guizhang* are the other kinds of laws which can be roughly categorized as statutes, administrative regulations, local regulations and administrative rules. There are several state organs identified in the *Constitution* that have the capacity to enact all kinds of laws. The National People’s Congress is the supreme source of state authority and it is also the supreme legislative organ in China.

⁹² See *The Legislation Law of the People’s Republic of China, 2000*.

⁹³ *The Constitution of the People’s Republic of China, 1982*, as amended in. 1988, 1993, 1999 and 2004 [*Constitution*].

Article 58 of the *Constitution* directs that the National People's Congress and its Standing Committee can exercise the legislative power of the state. Statute law (*falv*), which can only be passed and caused to come into effect by the National People's Congress and its Standing Committee, is subordinate only to the *Constitution* and has higher authority than the other forms of law. The State Council is the executive

Figure. 1 Legislative Structure of China



body of the National People's Congress and the highest organ of state administration. It has the right to enact administrative regulations (*xingzheng fagui*) which have the force of law all over the country.⁹⁴ The ministries of the State Council can issue administrative

⁹⁴ *Ibid.*, Article 89.

rules (*xingzheng guizhang*), which usually provide more detailed interpretations of the administrative regulations of the State Council. Turning from the national level to the local level, the provincial People's Congresses and their standing committees may enact local regulations (*difangxing fagui*).⁹⁵ Local people's governments may issue local rules (*difangxing guizhang*), which usually provide the details of local regulations. While *falv*, *xingzheng fagui*, and *difangxing fagui* can all support a legal appeal to the courts, *xingzheng guizhang* and *difangxing fagui* do not have the same legal status (See Figure 1).

Supremacy of the Rule of Law

The supremacy of the law is the most basic characteristic of a rule of law system. It implies that all are equal before and under the law, and it prevents the arbitrary exercise of authority by the government or other public officials. China is a single party country. The Chinese Communist Party ("CCP" or the "Party") has been and continues to be the ruling political party since the birth of People's Republic of China. However, according to a thin theory of the rule of law, the type of political regime is not a criterion of the rule of law. Thus, in theory, there is a possibility that China qualifies for the status of a rule of law country, although it is not a liberal democratic one. The supremacy of the rule of law is the first condition to be met in order to qualify for the rule of law. However, I will argue that the fact that the CCP's will and policy is supreme over law has prevented China from meeting this condition.

In the era before marketization began, CCP policies substituted for, or trumped, laws.⁹⁶ Since China began implementing its economic reforms, there has been a boom in

⁹⁵ *Ibid.*, Article 100.

⁹⁶ R. Peerboom, "Let One Hundred Flowers Bloom, One Hundred Schools Contend: Debating Rule of Law in China" (2002) 23 Michigan Journal of International Law 471 at 501.

the creation of all kinds of laws, especially economic laws. The increase in these new laws can be seen as a sign that law plays an increasingly important role in the economic development process.⁹⁷ While this is true in the sense that law at least exists, the distinction between law and Party policy is vague. The policies of the Party are seen as the foundation of socialist law, and laws are perceived as a mature form of Party policy.⁹⁸ This understanding of law and the Party is most obvious in the economic arena. While the *Constitution* is said to be fundamental and supreme, it has often been the case that certain economic activities were practised under Party policy even if some of their activities were in violation of the *Constitution*. Examples of such activities that are permitted by the Party but prohibited under the *Constitution* are the individual contractor system and land leasing.⁹⁹ In China, scholars have debated whether the best approach is to introduce laws to guide economic reforms before the reform policies are actually implemented, or to introduce reforms and corresponding laws simultaneously, or to wait until some experience with reform policies has been gained before enacting laws to confirm the policies.¹⁰⁰ However, in practice in most cases, China adopted the third approach. Policies were implemented without legal basis, and sometimes laws were just ignored. After some experience was gained, policies would eventually be confirmed in the form of law. Law, to a great extent, was used as an instrument by the Party to promote economic development rather than to implement rule of law values. As Murray Scot Tanner

⁹⁷ Peerenboom, *supra* note 23 at 213.

⁹⁸ J. Chen, "To Have the Cake and Eat it too?: China and the Rule of Law" in D. Gwenthner & K.A. Ziegert, ed., *Law and Legal Culture in Comparative Perspective* (Stuttgart: Franz Steiner Verlag, 2004) 313 at 318.

⁹⁹ See Peerenboom, *supra* note 23.

¹⁰⁰ See M. Han, "Research on the Contradictions Confronted by Legislative Work in the Reform Era and Relevant Strategies" [in Chinese] (1989) 3 *China Legal Science* 28.

observes: “[L]aws play ambiguous roles as policy instruments: as vehicles for cementing policy changes in a more permanent form.”¹⁰¹

Whether Party policy could be supreme over law in the field of economic reform gave rise to a huge debate among jurists concerning “benign unconstitutionality” in 1996.¹⁰² Some jurists argued that, although unconstitutional practices existed, they were benign and, since they did not deviate from the spirit of the *Constitution*, they were acceptable. Others held the belief that violation of the *Constitution*, whether it was benign or not, was illegal. However, regardless of the debate among jurists, the supremacy of the Party over the law is obvious. The Party has the power to allow unconstitutional economic activities to be practiced. If a practice is successful in promoting economic development, then the *Constitution* will be changed in order to create compatibility with that practice. As I see it, this is far from what occurs under the rule of law. The core requirement of the rule of law is the supremacy of law and the equality of all before the law. Since the Party still has the power to override laws, it is far too early to claim that China has achieved the rule of law.

Independent Judiciary

Another core element of the rule of law is the independence of the judiciary. So far, this condition has not been achieved in China. One problem is that courts are subject to the dual leadership system: they are governed by the Party Committee at the same administrative level, and by the high-level courts.¹⁰³ In addition to external leadership,

¹⁰¹ M. S. Tanner, “How a Bill Becomes a Law in China: Stages and Processes in Lawmaking” (1995) 141 *China Quarterly* 39 at 43.

¹⁰² See, for example, T. Hao, “The Benign Unconstitutional Issue” (in Chinese) (1996) 4 *Chinese Journal of Law* 89.

¹⁰³ Peerenboom, *supra* note 23 at 280.

individual judges generally have to obtain the approval of the division head, vice-president, president, or the court's adjudicative committee before issuing a judgment of the court.¹⁰⁴ Thus, with too many leaders, individual judges lack the independence to decide cases on their own.

The other factor that undermines the independence of the judiciary is that the Party may interfere in the judicial decision-making process.¹⁰⁵ This is not to say that the Party interferes in the process of litigation explicitly, or demands judges to ignore the law whenever it suits the interests of the Party. Interference in judicial decision-making happens when it comes to certain sensitive cases, especially cases in the area of political and civil rights or cases that are connected to the Party's leaders.¹⁰⁶ The composition of the judiciary has confirmed the interdependence of the Party and judicial institutions. The majority of judges are Communist Party members, and chief judges of all levels of court, with no exception, are Party members. They are appointed, like all the other cadres in other bureaucracies, by the Party's organization department.¹⁰⁷ This appointment process has determined the dependence of the courts on the Party and has made it difficult for judges to make independent decisions concerning sensitive issues.

Clear Legislative System

As described above, the legislative system in China is complex. Many entities have been authorized to legislate, which has resulted in inconsistent laws, regulations and

¹⁰⁴ *Ibid.*, at 281.

¹⁰⁵ J. Thornton, "Long Time Coming: The Prospects for Democracy in China" (2008) 87 *Foreign Affairs* 2 at 12.

¹⁰⁶ R. Peerenboom, "More Law, Less Courts: Legalized Governance Judicialization and Dejudicialization in China," (2008) La Trobe Law School Legal Studies Research Paper No. 2008/10 at 2, online: <<http://ssrn.com/abstract=1265147>> (accessed 12 April 2009).

¹⁰⁷ Peerenboom, *supra* note 23 at 305.

provisions. A survey in the 1980s in three provinces in China demonstrated that about two-thirds of local regulations were inconsistent with the *Constitution*.¹⁰⁸ Local laws and regulations are often inconsistent with both the letter and spirit of the superior legislation.¹⁰⁹ What is even worse is that China lacks an effective means to resolve the conflicts between the *Constitution*, laws, regulations and other enactments. For conflicts between the *Constitution* and other laws, there is no independent constitutional review body because the Party rejects separation of powers.¹¹⁰ For inconsistency between laws and regulations, the State Council, lower-level people's congresses, and governments have all been reluctant to intervene.¹¹¹ The inconsistency between different laws has undermined the stability and procreativity of the law which is required even by a thin theory.

Notwithstanding the development of the legal system in China during the past three decades, the obvious supremacy of the Party and the lack of an independent judiciary and practical legislative system prevent China from meeting the conditions of even a thin theory of the rule of law. The best description of the legal system in China is contained in the *Constitution*. When literally translated, the *Constitution* reads, "The People's Republic of China governs the country according to law and building a socialist legal

¹⁰⁸ P. Corne, *Foreign Investment in China: The Administrative Legal System* (Hong Kong: Hong Kong University Press, 1996) at 152.

¹⁰⁹ Peerenboom, *supra* note 23 at 242.

¹¹⁰ *Ibid.*, at 259, citing D. Cai, "Constitutional Supervision and Interpretation in the People's Republic of China" (1995) 9 *Journal of Chinese Law* at 219.

¹¹¹ Peerenboom, *supra* note 23 at 260.

country”.¹¹² Similarly, J.J. Spigelman points out, “It is rule by law, rather than rule of law”.¹¹³

The Obstacles on China’s Path Towards the Rule of Law

It is generally considered that law plays a crucial role in liberal societies. “Legal institutions and norms occupy an important role in liberal capitalist societies, for they are central to the exercise and legitimacy of power ...”¹¹⁴ China, by contrast, has had no tradition remotely similar to the concept of “rule of law”, whether in feudal times or during the years of the People’s Republic of China before marketization. Neither extreme – the arbitrary power of all levels of bureaucrats in feudal society nor the endless catastrophic movements and campaigns during the Mao period – saw a place for law. “There was no conception of governmental powers being limited by law, or of individual rights enforceable against the state or other authorities in the social hierarchy.”¹¹⁵ After more than 2,000 years of governance via bureaucracy, Chinese people are used to the ingrained tradition of rule by man rather than rule of law.

The social structure of China as a socialist country which is built on Marxism also explains why it is challenging to realize even a thin rule of law in China. According to Marx, law is seen as a tool of the ruling class and, in a socialist society, law expresses the will of the masses under the leadership of the proletariat. In the case of China, the CCP is the representative of the masses and holds the leadership of the country. This interpretation of law is still fundamental in today’s China. The first course for every law

¹¹² *Constitution, supra* note 93, Article 5 [translation by author].

¹¹³ J.J. Spigelman, “China: Rule of Law or Rule by Law?” (2002) 46: 9 *Quadrant* 36 at 36.

¹¹⁴ B. Bakken, “Engaging the Law in China: State, Society, and Possibilities for Justice” (2007) 58 *China Journal* 157 at 158.

¹¹⁵ *Ibid.*, at 159.

student in China is Jurisprudence, and the first lesson of Jurisprudence is to give students the definition of law as a tool of the ruling class. Constitutional law is described as being required to protect the rights of the masses in contrast to the capitalist constitution, which is the mask for capitalist domination. The frequent amendments to the *Constitution* during the marketization process can be seen as the best illustration of this understanding of law. Almost every amendment was made to correspond to the conclusion of each congress of the CCP. This explains why the Party has supremacy over law and reveals the instrumental nature of law in China.

V. Conclusion

To fulfill my goal of situating the changes to the pension regime during the past three decades in the condition of the legal system in China, as well as in relation to the impact of World Bank legal projects, I have drawn on the theory of the rule of law and its relationship to economic development. I have argued that, although there are two broad conceptions of the rule of law, a thin theory has certain advantages, especially on the practical level. I have also argued that the prevailing view is that the relationship between the rule of law and economic development is causal. There are, however, as many theories and experiences that support this claim as there are those that contradict it. In addition to the academic literature review, I explored the theoretical and practical position of the World Bank, an institution which has had a massive impact on China's marketization and pension reform processes. I concluded that it is important for the World Bank to employ a thin theory to promote the rule of law, especially in consideration of the limitations on its scope of intervention and its goal of boosting economic growth. I then examined whether three core elements of the rule of law are met

in China, and I concluded that China has not achieved the rule of law. Having identified some of the problems of China's legal system that prevent China from achieving the rule of law, I will turn to my ultimate goal, which is to review the pension reform process, which has been in the shadow of the World Bank, and to propose possible reform choices. The lack of a clear legislative system may delay the emergence of a unified national pension law, and the fact that the Party and government policy is supreme over law undermines the legitimacy of pension law.

CHAPTER TWO: ECONOMIC REFORM AND ITS IMPACT ON THE PENSION SYSTEM

I. Introduction

China's first pension scheme was introduced in 1951 and remained relatively stable until the 1980s, when economic reforms began to take place. Economic reform, which aimed to transform China's economy from a "planned" model to a market one, has had a very significant impact on the Chinese pension system. Pressures associated with the marketization process led to the collapse of the original pension scheme and to calls for a new pension system compatible with a market economy. This chapter will examine the economic context in which pension reform is embedded.

This chapter starts by tracing the establishment of the original social security system in China, the "iron rice bowl" system, which mirrored the economic structure at that time. It also demonstrates that the pension system in China was a split or bifurcated system from the very beginning. Economic reform, which has had a massive impact on the pension system, is then reviewed. The negative effects of economic reform on both urban and rural residents are highlighted. I argue that, although the original pension system became ineffective under the market economy, the marketization process has failed to provide necessary security for workers. Thus, government intervention is necessary in order to legitimate economic reform and to keep the economy growing. Following that discussion, I provide a section that comprises a case study of Shanghai, which illustrates the rural and urban inequities in terms of pension benefits, as well as the need to launch

pension reform. A detailed description of the demographic transition, which is seen as the most direct spur to pension reform, is also provided, followed by the conclusion.

II. The Original Social Security System in China

For almost 40 years, the concept of the “iron rice bowl” was a distinct feature of China’s social security system. The concept was used to mirror the characteristics of the so-called “planned” economy.¹¹⁶ China followed a Soviet planned economy model after the People’s Republic of China was established in 1949.¹¹⁷ A fundamental characteristic of this type of economy is that resource allocation decisions are made in response to commands from planners rather than in response to prices. The most important signals in this system are commands from the administrative hierarchy, rather than prices from the market.¹¹⁸ In other words, the state is the real employer for almost all enterprises. Enterprises are required to produce the quality and quantity of products assigned by the government and to sell these products at prescribed prices. Generally, a planned economy implies public ownership, lifelong employment, restricted labour mobility, and non-existent unemployment.¹¹⁹ Under socialist ideology and a planned economy, it is natural that the planner – the state – has the responsibility to provide certain kinds of social security.

Enterprises, what the Chinese called *danwei* (“work units”), were the principal institutions carrying out such responsibility. Work units held many more responsibilities

¹¹⁶ T. Trinh, “China’s Pension System”, Deutsche Bank Research, Current Issue (February 2006) at 17, online: <http://129.35.230.60/PROD/DBR_INTERNET_DE-PROD/PROD0000000000196025.pdf> (accessed 20 February 2009) [Trinh].

¹¹⁷ Chen, *supra* note 47 at 101.

¹¹⁸ B. Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (Cambridge: Cambridge University Press, 1995) at 26 [Naughton].

¹¹⁹ Trinh, *supra* note 116 at 17.

than modern enterprises do.¹²⁰ They were the lowest level of a multi-tiered hierarchy linking each individual with the state and CPP infrastructure.¹²¹ It was natural that work units became the primary executives of the social security system, the “iron rice bowl”.

The Establishment of the Original Social Security System: The “Iron Rice Bowl”

The original social security system in the People’s Republic of China was established in 1951, and it continued to operate through to the 1966 Cultural Revolution. In China, the first administrative regulation concerning pension benefits, which was part of a comprehensive social security system, was issued by State Council¹²² in 1951, two years after the founding of the Chinese Republic. The 1951 *Regulation of the People’s Republic of China on Labour Insurance* (the “*Regulation*” or “1951 *Regulation*”)¹²³ laid the foundation of the original social security system of China – the “iron rice bowl” system. It imposed on the work unit the responsibility to provide broad social welfare benefits as well as social security protection without requiring employees to make contributions.

The 1951 *Regulation* was comprehensive, providing rules on benefits related to pensions, free health care, work-related injuries, funeral subsidies and maternity benefits. The *Regulation* also established various welfare institutions, such as nursing homes, kindergartens and sanitariums. In terms of pensions, a work unit was required to

¹²⁰ Workers were bound to their work units for life. The influence of a work unit on the life of an individual was substantial. For example, permission had to be obtained from the work unit before undertaking everyday events such as travel, marriage, or having children. See K. Lieberthal, *Governing China: From Revolution Through Reform*, 2d ed. (New York: W.W. Norton & Company, 2003) at 184-185 [Lieberthal].

¹²¹ *Ibid.*

¹²² The State Council, namely the Central People’s Government, is the highest executive and administrative authority of the People’s Republic of China. See *Constitution*, *supra* note 93, Article 85.

¹²³ State Council, *Regulations of the People’s Republic of China on Labour Insurance*, 1951.

contribute 3% of its payroll as a social insurance fee, and employees did not have to contribute anything. Thirty percent of the contribution went to the All-China Federation of Trade Unions (“ACFTU”) and the remaining 70% was kept by the work unit to pay for the various benefits.¹²⁴

The pension scheme was one of the most important aspects of the *1951 Regulation*.¹²⁵ The *Regulation* clearly listed retirement eligibility and benefits for the very first time. The retirement age for men was 60, while for women it was 50. Male retirees who had worked for 25 years, 10 of which were at their current work unit, and female retirees who had worked for 20 years, 10 at their current work unit, could enjoy a pension benefit that was equal to between 35% and 60% of their pre-retirement income.¹²⁶ However, the *Regulation* only applied to those work units that had more than 100 employees.

Table 1. Retirement Eligibility and Benefits: A Comparison

	1951	1953	1958	1978
Retirement age				
Male workers	60	60	60	60
Female workers	50	50	50/55 (managers)	50/55 (managers)
Total working years required				
Male workers	25	25	20	10
Female workers	20	20	15	10
Years required at current work units				
Male workers	10	5	5	none
Female workers	10	5	5	none
Pension Benefits (as a percentage of the pre-retirement wage)	35-60	50-70	50-70	60-90

Source: Song & Chu, “Social Security Reform in China: The Case of Old-Age Insurance” (1997) 15 *Contemporary Economic Policy* at 87.

¹²⁴ *Ibid.*, Article 9.

¹²⁵ Other aspects include disability, survivorship and maternity.

¹²⁶ Pension benefits depended on the total number of working years.

During the 15 years following the introduction of the *1951 Regulation*, the system remained comparatively stable with only minor amendments. There were two major changes concerning the pension scheme, which took place in 1953 and 1958 respectively (see Table 1 for comparison). Generally, coverage was broadened, eligibility was eased and benefits were improved.

In 1953, the *1951 Regulation* was amended. Coverage was broadened and retirement became easier. While only those work units which had 100 employees or more were subject to the *1951 Regulation*, the 1953 Amendment (the “*Amendment*” or “*1953 Amendment*”)¹²⁷ broadened coverage to employees whose work units had fewer than 100 employees. Retirement eligibility was also expanded. The *1953 Amendment* lowered the number of working years at current work units to five. In addition, the *Amendment* raised the level of pension benefits for both men and women who were eligible for retirement from 35 to 60% and from 50 to 70% respectively.

In 1958, the National People’s Congress promulgated the *Provisional Regulations on the Retirement of Workers and Staff* (the “*Regulation*” or “*1958 Regulation*”).¹²⁸ This *Regulation* further broadened coverage to those employees who worked for the government. Thus, civil servants could enjoy the same benefits as workers in other enterprises. In addition, the *1958 Regulation* lowered total required working years for retirement to 20 for men and 15 for women. Notably, this *Regulation*, for the first time, distinguished the retirement age for female workers from that for female managers. The

¹²⁷ State Council, *Amendment to Regulation of the People’s Republic of China on Labour Insurance (1951)*, 1953.

¹²⁸ National People’s Congress – Standing Committee (China), *Provisional Regulations on the Retirement of Workers and Staff*, 1958.

retirement age for female workers was 50, while for female managers it was 55.¹²⁹ The difference in retirement ages for female workers and female managers is still in effect.

The promulgation of the *1958 Regulation* perfected the establishment of the original social security system, which is usually known as the “iron rice bowl” system. One can easily tell from the phrase what this original social protection system meant to Chinese people. “Iron” symbolizes a life-long security that can never be broken. The “iron rice bowl” system was truly a cradle-to-grave system which offered decent social security, but was limited only to the urban population who worked in the formal public sector.¹³⁰ Since social security benefits were the responsibility of the work unit,¹³¹ at that time people were viewed as “unit people” rather than as individuals because all the social security benefits they could receive were based on the unit they worked in. The work unit was not only a work place, it also played a quasi-state role. Social security benefits provided by the work unit included not merely the basic elements of social security mentioned above, but even daily commodities such as towels, shampoo and tissues. Some large work units even had walk-in clinics for their employees and kindergartens for their children.¹³²

However, after the Cultural Revolution began in 1966, the ACFTU and all levels of labour departments responsible for the social security system were paralyzed and the

¹²⁹ *Ibid.*, Article 1.

¹³⁰ The term “public sector” refers to government organizations, state owned utilities (hospitals, schools, etc.) and state-owned enterprises (“SOEs”).

¹³¹ J.B. Williamson & C. Deitelbaum, “Social Security Reform: Does Partial Privatization Make Sense for China?” (2005) 19:2 *Journal of Aging Studies* 257 at 259 [Williamson & Deitelbaum].

¹³² Lieberthal, *supra* note 120 at 184.

social security system fell into confusion.¹³³ The 3% contribution to social security was also cancelled. Some work-unit-based programs dissolved, as did some departments in charge of them.¹³⁴ After 10 years of chaos, the Cultural Revolution finally came to an end in 1976.

1978 saw the passage of *Provisional Regulations on the Retirement and Resignation of Workers*¹³⁵ and *Provisional Regulations on the Settlement of the Old, the Weak, the Sick and the Disabled Cadres*¹³⁶ (together, the “1978 Regulations”) by the Standing Committee of the National People’s Congress. These two regulations aimed to rebuild the social security system that was ruined during the Cultural Revolution. One significant contribution of these regulations was the introduction of the “minimum pension” idea. These two regulations provided generous pension benefits as well as greater eligibility. Total working years were reduced to 10 for both male and female workers and there was no requirement for a number of years to be worked in the current work units. Most significantly, pension benefits were increased to 60% to 90% of pre-retirement wages.

A Split System

Generally, the “iron rice bowl” system worked well during the period before the economic reforms. It provided broad and strong social security to those who worked in the urban public sector. In terms of old age security, the original pension system had three main features. First, the coverage was wide and limited. It was wide because most

¹³³ K. Dong & X. Ye, “Social Security System Reform in China” (2003) 14 *China Economic Review* 417 at 418.

¹³⁴ *Ibid.*, at 419.

¹³⁵ National People’s Congress – Standing Committee (China), *Provisional Regulations on the Retirement and Resignation of Workers* –, 1978 (suggested by the State Council).

¹³⁶ National People’s Congress – Standing Committee (China), *Provisional Regulations on the Settlement of the Old, the Weak, the Sick and the Disabled Cadres*, 1978 (suggested by the State Council).

urban workers were covered, as most were employed in the public sector, and the unemployment rate was quite low.¹³⁷ It was limited because the rural population, which accounts for approximately 80% of the total national population,¹³⁸ was entirely excluded. Workers in the urban population who engaged in part-time jobs or who worked in the non-public sector were also neglected. Second, the retirement benefit was generous and based on a defined benefit¹³⁹ model. In terms of pension entitlement, urban workers could enjoy a pension as high as 60% to 90% of their pre-retirement income, and eligibility for pension was easy to establish. Combined with free health care and free housing, the pension system ensured that urban retirees enjoyed a decent retirement. Lastly, this pension system was financed solely by the work unit without any social insurance contributions from employees. According to Cherrie Zhu and Chris Nyland,

The [“iron rice bowl”] system was a non-contributory, defined-benefit, pay-as-you-go regime, which was primarily financed and managed at the work unit level in the urban public sector and assumed employees were largely immobile.¹⁴⁰

Yet, the flaws of such a system were obvious because it was a bifurcated or split system. One crucial division was that between the urban and rural populations. Although “iron rice bowl” offered complete social protection to those worked for work units in the public sector in urban areas, the rural population had no share in such a system, and rural

¹³⁷ Low unemployment rates were due to the recruitment system. Employees were not recruited by enterprises, but assigned to them by the government. This led to the low unemployment rate as well as low efficiency (usually enterprises had more employees than they actually needed).

¹³⁸ According to the National Statistical Bureau, the rural population was 82.08% of the total population in 1978. National Statistical Bureau, “Population and Its Composition”, online: <<http://www.stats.gov.cn/tjsj/ndsj/2008/html/D0301e.htm>> (accessed 12 April 2009).

¹³⁹ “Defined benefit” implies a guarantee by the insurer or pension agency that a benefit based on a prescribed formula will be paid. See World Bank, *Averting the Old Age Crisis* (New York: Oxford University Press, 1994) at xxi [World Bank, *Old Age Crisis*].

¹⁴⁰ C.J.H. Zhu & C. Nyland, “Marketization and Social Protection Reform: Emerging HRM Issues in China” (2004) 15:4-5 *International Journal of Human Resource Management* 853 at 857 [Zhu & Nyland].

people still relied on their families for survival like their ancestors did thousands of years ago. The reason for the division in the pension system was the household registration system (*hukou*),¹⁴¹ which prevents or impedes population movement between the urban and rural sectors, combined with the fact that it was beyond the economy's capacity to apply the "iron rice bowl" system comprehensively.¹⁴² Another division was among the urban population, between those who worked for the public sector and those outside the public sector. While work unit employees could enjoy decent social welfare and social security benefits without making any contributions, those falling outside the sector were, like rural residents, expected to rely on themselves and their extended families. Peter Saunders and Xiaoyuan Shang called such phenomenon a "dual split", which reflects the fact that Chinese society was a deeply segmented one.¹⁴³ Regretfully, the dual split problem has still not been completely solved.

III. Economic Reform and Its Impact on the "Iron Rice Bowl" System

When effort was put into reconstructing the social security system in 1978, the government made another much more vital decision that year, which led China towards a

¹⁴¹ The *hukou* system was established in cities in the People's Republic of China in 1951 and extended to the rural areas in 1955. It was formalized as a permanent system in 1958 according to the *Regulations on Hukou Registration in the People's Republic of China*. The system remains unchanged in nature to date. The *hukou* system distinguishes between urban and rural residents as well as between agricultural and non-agricultural people. Although the official interpretation argues the *hukou* system as serving the consolidation of the socialist system and public interests, it is widely believed that such a household registration system served as an instrument to prevent and control rural-urban migration. Others think the *hukou* system was set up for the purpose of state administration. It provides the state with means and information that could be used for securing social and political order and other related objectives. See Q. Zhang, "Basic Facts on the Household Registration System" (1988) 22:1 *Chinese Economic Studies* 106; T. Cheng & M. Selden, "The Origins and Social Consequences of China's *Hukou* System" (1994) 139 *China Quarterly* 644; H. Mallee, "China's Household Registration System Under Reform" (1995) 26 *Development and Change* 1; See also Trinh, *supra* note 116 at 18.

¹⁴² P. Saunders & X. Shang, "Social Security Reform in China's Transition to a Market Economy" (2001) 35: 3 *Social Policy & Administration* 274 at 276 [Saunders & Shang].

¹⁴³ *Ibid.*

socialist market economy. The profound economic reforms began in 1978. Over the past three decades, China has enjoyed remarkable economic growth. All of the figures that are used to measure economic performance – GDP, average income, export amount, foreign investment – rose at a double-digit pace.¹⁴⁴ This dramatic economic growth generates a stronger capacity to face the old age crisis. However, the marketization process itself has created several risks to old age security and has had a significant impact on the “iron rice bowl” system.

Economic Reform

The Third Plenary Session of the Eleventh Central Committee of the Communist Party of China in 1978 is generally considered to be a watershed in the history of China’s economy because the Central Committee officially accepted Vice-Chairman Deng Xiaoping’s proposal to launch economic reform.¹⁴⁵ However, the cause of this economic reform is controversial. Some scholars argue that Deng embraced the goal of economic development because he “recognized the dangers to China of falling so dramatically behind the growth rates being achieved elsewhere in East Asia ... and [he] realized that China had to find a way to generate productivity growth”.¹⁴⁶ Others see economic reform as the inevitable consequence of China’s leaders’ failure to rehabilitate the planned economy after 10 years of stagnation during the Cultural Revolution.¹⁴⁷ In any event, China began its marketization process towards a so-called socialist market economy after the end of the Cultural Revolution.

¹⁴⁴ National Statistical Bureau, *China Statistical Yearbook – (Various Years)*, online: <<http://www.stats.gov.cn/tjsj/ndsj/>> (accessed 1 February 2009) [National Statistical Bureau, *Various Years*].

¹⁴⁵ Lieberthal, *supra* note 120 at 136.

¹⁴⁶ *Ibid.* at 128

¹⁴⁷ Naughton, *supra* note 118.

China's process towards a "socialist market economy" can be understood as a gradual liberalization of the non-public (private) economic sector¹⁴⁸ and the enlargement of the production and management autonomy of the public economic sector, particularly State-Owned Enterprises ("SOEs").¹⁴⁹ On the one hand, the private economy was beginning to play a more important role in the marketization process. The private economic sector turned from being a "complement" to a "major" component of the state economy. The 2004 Amendment of the *Constitution* stated that the "non-public economy" was not only the major component of a socialist economy, but was encouraged to expand in order to contribute to the socialist market economy.¹⁵⁰ In contrast, the 1982 *Constitution* saw the non-public economy only as "a complement to the socialist public economy".¹⁵¹ The private sector was not only legalized in the *Constitution*, but began to play an increasingly important role in China's economic development.

Between 1980 and 2006, the number of people in the urban population working in the private sector surged from 24.25 million to 218.8 million – a sharp increase of 802%. In contrast, the SOEs' share of urban employment declined from 76.19% to 22.71% over the same period (see Table 2). In terms of the Gross Industrial Output Value, 28.5% of the national value was produced by SOEs in 1996, compared to 64.9% in 1985.¹⁵²

¹⁴⁸ Enterprises in the non-public sector include collectively owned enterprises ("COEs"), privately owned enterprises ("POEs"), foreign joint ventures and wholly foreign-owned ventures.

¹⁴⁹ J.C.B. Leung, "Social Security Reforms in China: Issues and Prospects" (2003) 12:2 *International Journal of Social Welfare* 73 at 74 [Leung].

¹⁵⁰ *The Constitution*, as amended in 2004, Article 11.

¹⁵¹ *The Constitution*, 1982, Article 11.

¹⁵² National Statistical Bureau, *China Statistical Book 1997*, online: <http://www.stats.gov.cn/tjsj/ndsj/> (accessed 5 February 2009).

Table 2 Number of Employed Persons in Urban Areas

Year	Subtotal	State-Owned enterprises (SOEs)		Private Sector	Self-employed
	(Million)	(Million)		(Million)	(Million)
1980	105.25	80.19	76.19%	24.25	0.81
1990	170.41	103.46	60.71%	60.81	6.14
2000	231.51	81.02	35.00%	150.49	21.36
2006	283.1	64.3	22.71%	218.8	30.12

Source: National Bureau of Statistics of China, *China Statistical Yearbook (Various Years)*.

On the other hand, it became increasingly difficult for SOEs to survive in a market economy. SOEs were transformed from being non-profit-seeking enterprises under the planned economy to being given a great deal of production and management autonomy under the market economy. However, they had to bear business risks themselves. In this context, the vast amount of social security expenditure, including pension benefits, became an unbearable burden. According to a survey conducted among 508 enterprises, 57.66% of SOEs' payrolls comprised social protection expenses, while the percentage was much lower in collectively owned enterprises, foreign-owned enterprises and privately owned enterprises, namely 18.74%, 20.29% and 18.18% respectively.¹⁵³ With the rapid emergence of private enterprises, the majority of SOEs lost their competitiveness on account of their heavy burden as primary welfare providers. Another burden on SOEs was that they had many more employees than they actually needed. During the planned economy period, an individual's job was assigned by the government and SOEs did not have autonomy with respect to recruitment. SOEs had to employ those

¹⁵³ M. Wang, *Restructuring China's Social Security System: Funding, Operation and Governance* [in Chinese] (Beijing: China Development Publisher, 2001) at 56-87.

workers assigned to them. Therefore, SOEs often had surplus employees.¹⁵⁴ Not surprisingly, the majority of SOEs eventually went bankrupt.¹⁵⁵

Impact on the “Iron Rice Bowl”

As marketization progressed, the formal social security system became more and more unsuitable and incompatible with marketization. The “iron rice bowl” system was endangered and both urban and rural populations were profoundly affected by marketization.

For urban employees who worked in the public sector, the bankruptcy of the majority of SOEs left thousands of their retirees without pensions.¹⁵⁶ Official figures show that 8.9 million employees were laid off by the end of 1998.¹⁵⁷ The number of unemployed increased from 2.9 million in 1991 to 5.8 million in 1999.¹⁵⁸ Not only did many workers lose their jobs, they also lost a wide variety of benefits.

Meanwhile, private sector enterprises aimed to seek as much profit as they could in the market economy, and, thus, did not want to provide adequate retirement benefits. More importantly, there were no laws requiring them to provide pensions.¹⁵⁹ Providing retirement benefits implied extra cost to those private sector enterprises and it became a

¹⁵⁴ Zhu & Nyland, *supra* note 140 at 858.

¹⁵⁵ National Statistical Bureau, *supra* note 152.

¹⁵⁶ X. Ru, *Blue Book of China's Society: Analysis and Forecast of China's Social Development* (Beijing: Social Science Academic Press, 1998) [in Chinese].

¹⁵⁷ Ministry of Labour and Social Security, People's Republic of China, “1998 Statistics Bulletin of the Development of National Labour and Social Security of the People's Republic of China” [in Chinese], online: <http://www.molss.gov.cn/gb/zwxx/2005-12/14/content_99527.htm> (accessed 10 February 2009).

¹⁵⁸ National Statistical Bureau, *China Statistical Book 1991 & 1999*, online: <<http://www.stats.gov.cn/ndsj/information/zh1/d011a> & <http://www.stats.gov.cn/ndsj/zgnj/2000/E01c.htm>> (accessed 10 February 2009).

¹⁵⁹ E.X. Gu, “Forging a Labour Market in Urban China: the Legacies of the Past and the Dynamics of Institutional Transformation” (2001) 28: 2 *Asian Affairs: An American Review* 92.

“rational” choice for them not to offer pensions under a market economy. According to Zhu and Nyland, “[T]he tendency for non-state enterprises to act as free riders was manifest in that the non-state enterprises were more inclined to take advantage of loopholes in the regulations ...”¹⁶⁰

Rural residents suffered the most, since China’s market-oriented reform had not only changed its economic structure, but also its social structure. In rural areas, the traditional family support system was also endangered. The marketization process encouraged labour mobility, as millions of rural workers migrated to urban areas to seek jobs. Most were absorbed by enterprises in the private economic sector. In 2006, the proportion of the labour force engaged in agriculture was 42.6%, a drop from 68.7% in 1980.¹⁶¹ With the increasing number of rural workers moving to urban areas, the traditional means for providing economic security to the elderly were disrupted. As noted above, the elderly in rural China rely heavily on their extended families. As more and more young rural workers migrate to cities, the elderly risk being abandoned by their families. While some migrants still take responsibility for their elderly rural kin by sending home remittances, other migrants just disappear.¹⁶²

Dissatisfaction among workers who lost their jobs or pension entitlements as a consequence of the process of marketization eventually burst out in a range of different forms of protest and rebellion. The official ACFTU counted 97 strikes in 1987, and over

¹⁶⁰ Zhu & Nyland, *supra* note 140 at 873.

¹⁶¹ National Statistical Bureau, *China Statistical Book 2007*, online: <http://www.stats.gov.cn/tjsj/ndsj/2007/indexch.htm> > (accessed 10 February 2009).

¹⁶² J. Leung, “Family Support for the Elderly in China: Issues and Challenges” (1997) 9:3 *Journal of Aging and Social Policy* 87 at 97.

100 in 1988.¹⁶³ The largest took place in Zhejiang Province, with approximately 1,500 workers participating. The longest was the one in Xian, lasting more than three months from 1987 to 1988. In Shanghai, in the first quarter of 1989, there were 15 strikes touched off by workers' grievances regarding bonus allocations and lay-offs.¹⁶⁴ Social stability is endangered by unregulated marketization.

Karl Polanyi's "double movement" argument has found another illustration in China. In his book *The Great Transformation*, Polanyi argues that as a free market expands, social protection is a spontaneous reaction to the social destruction caused by a self-regulating market. He calls this the "double movement".¹⁶⁵ He also shows that, while the market induces a demand for social insurance, the "invisible hand" commonly fails to adequately satisfy this demand.¹⁶⁶ What the foregoing data make clear is that the "iron rice bowl" system ceased to be effective under the market economy, while the marketization process failed to provide even moderate security for many workers. When the Chinese government realized that strikes and protests could cause significant chaos and social disorder, they were compelled to intervene to resolve the insecurity created by free markets. Social security reform, especially pension reform, was then inevitable.

IV. The Case of Shanghai

Shanghai is a coastal city located in the southeastern part of China. It is among the four cities that are directly administered by the central government, not belonging to any

¹⁶³ C. Lee, "Pathways of Labour Insurgency" in Selden, ed., *Chinese Society: Change, Conflict and Resistance*, 2nd ed. (London: Routledge, 2003) 71 at 77 [Lee].

¹⁶⁴ *Ibid.*

¹⁶⁵ K. Polanyi, *Origins of Our Time: The Great Transformation* (London: Victor Gollancz, 1945).

¹⁶⁶ *Ibid.*

provinces.¹⁶⁷ Shanghai is one of the biggest and most developed cities in China. It consisted of 20 counties before 1980s, 10 of which (Huangpu, Nanshi, Luwan, Xuhui, Changnin, Zhabei, Jingan, Hongkou, Yangpu and Putuo) were urban areas and the rest of which (Shanghai, Baoshan, Jiading, Chuansha, Nanhui, Qingpu, Songjiang, Fengxian, Jingshan and Chongming) were suburban.¹⁶⁸ Shanghai residents, like all other citizens in China, were labelled according to their *hukou*. While urban residents could enjoy work unit-based pension benefits and other welfare provisions, peasants in Shanghai suburbs (considered to be “rural” workers) had little or no access to these benefits.

This section reviews the different retirement patterns of urban and rural workers in Shanghai before the mid-1980s, when pension reform took place.

The Urban Elderly: Retirement Eligibility and Benefits

Shanghai urban workers enjoyed generous pension benefits as well as other welfare benefits and services under “iron rice bowl” system. Almost all urban workers worked in enterprises which were owned by the state. The *1951 Regulation*, the *1953 Amendment*, the *1958 Regulation* and the *1978 Regulations* mentioned above were all applicable to Shanghai urban workers. Eligibility requirements for pension benefits were clear: retirement age, total working years, and current work unit working years were the only criteria. (See Table 1 for details.) As well, the requirements were lowered every time a new regulation was issued. Between 1951 and 1957, 2,500 urban workers retired.

¹⁶⁷ The other three cities are Beijing, Tianjin and Chongqing.

¹⁶⁸ Shanghai Chorography Office, *Local Chronicles*, [in Chinese], online: <<http://www.shtong.gov.cn/node2/node2247/node4562/node79051/node79055/userobject1ai101957.html>> (accessed 20 February 2009) [Shanghai Chorography Office].

Another 40,000 urban workers retired between 1958 and 1978. At the end of 1985, the total number of urban retirees in Shanghai reached 1.36 million.¹⁶⁹

Pension benefits of these retirees were relatively generous under the “iron rice bowl”. As described above, when the benefit accounted for 35% to 60% of their pre-retirement wages according to the *1951 Regulation*, retirees could enjoy as high as 60% to 90% of their wages after the promulgation of the *1978 Regulations*. In 1985 in Shanghai, 6% of retirees received more than 1,200 *yuan* (*renminbi* or “RMB”) per year, 20% received 850 to 1,200 RMB and 27% received 600 to 850 RMB.¹⁷⁰ When the economic reforms began in 1979, due to the rapid rise of the price of daily necessities, the Shanghai government issued several local regulations to subsidize urban retirees.¹⁷¹ There were subsidies for food, water, edible oil, electricity and gas, which added up to 720 RMB per retiree annually. In 1984, for those retirees who had a dependent spouse, pension benefits were raised to 720 RMB per year, and raised again to 960 RMB in 1988. Ninety thousand retirees benefited from this policy. In 1986, there was an increase in pension benefits for all retirees. Pension benefits were raised by 5%, 10% or 15%, depending on the retiree’s total working years as well as the time she or he participated in the labour market.¹⁷² However, while retirees enjoyed the increase in pension benefits, work units had to carry an even heavier burden because they were responsible for funding the entirety of the pension benefits.

¹⁶⁹ *Ibid.*

¹⁷⁰ M. Hayward & W. Wang, “Retirement in Shanghai” (1993) 15:3 *Research on Aging* 3 at 5 [Hayward & Wang].

¹⁷¹ See Shanghai Chorography Office, *supra* note 168.

¹⁷² *Ibid.*

The Rural Elderly: Retirement Patterns

By the end of 1985, there were 578.4 thousand people over age 60 in the suburban areas of Shanghai, 527.1 thousand of whom were rural workers.¹⁷³ However, rural workers in Shanghai, like those in other districts, faced a vastly different retirement pattern. Prior to economic reform, rural residents worked in communes, and the land was collectively owned by commune members.¹⁷⁴ Communes were required to fulfill the production quotas set by the state. Since the inception of economic reform, the traditional collective management system broke down and the household contract responsibility system was established. The state grain production offices began to sign contracts directly with family households.¹⁷⁵

Notably, in the suburban areas of Shanghai, the collective economy remained relatively active during the early stages of economic reform.¹⁷⁶ The net profits derived from collective-based enterprises provided the rudiments of pension support in the early to mid-1980s.¹⁷⁷ However, the eligibility criteria and benefit levels were set up by each local collective.¹⁷⁸ According to a survey conducted in the suburbs of Shanghai in 1985, most of the elderly had to wait until the age of 65 before they could enjoy pension benefits.¹⁷⁹ Moreover, pension benefits were relatively low compared to those of urban

¹⁷³ S. Gui, "A Report from Mainland China: Status and Needs of Rural Elderly in the Suburbs of Shanghai" (1988) 3 *Journal of Cross-Cultural Gerontology* 149 at 149 [Gui].

¹⁷⁴ Hayward & Wang, *supra* note 170 at 6.

¹⁷⁵ See D. Deborah, "Chinese Retirement: Policy and Practice", in *Current Perspectives on Aging and the Life Cycle*, Vol. 1, Z.S. Blau, ed. (Greenwich, CT: JAI Press, 1985).

¹⁷⁶ Hayward & Wang, *supra* note 170 at 6.

¹⁷⁷ *Ibid.*

¹⁷⁸ *Ibid.*

¹⁷⁹ Gui, *supra* note 173 at 155.

retirees. More than half of the rural aging population received pensions below 100 RMB per year, and 22.4% had no pension benefits.

Rural and urban inequities were just as obvious in other areas of China as in Shanghai. When the economic reforms took place, both urban and rural residents had to face the negative effects the changing economy had on the pension system. The urban workers of Shanghai had to face the risk of the bankruptcy of their work units, which could deprive them of their pension benefits. Aging rural workers had to worry about being abandoned when their younger counterparts migrated to urban counties. What exacerbated the situation in Shanghai was that it had the largest aging population. According to the 1982 Census, the proportion of the elderly aged over 60 in greater Shanghai was 11.5% and the number was 12.9% in urban Shanghai.¹⁸⁰ The negative effects of economic reform in conjunction with demographic challenges made pension reform inevitable in Shanghai.

V. Nation-Wide Demographic Challenges

Not only did Shanghai start to face a demographic problem beginning in the early 1980s, but the entire nation has been experiencing demographic challenges since that time. Continuous declines in both fertility and mortality led to the rapid growth in the proportion of the elderly in China. Low fertility is largely perceived as the consequence of the “one child policy” population control measures that were implemented in the 1980s. The national birth rate, which was 2.228% in 1982, declined to 1.403% in 2000 and continued to drop to 1.209% in 2006. The death rate fluctuated around 0.66% over this period, with a slight increase from 0.66% in 1982 to 0.681% in 2006. The natural

¹⁸⁰ *Ibid.*

growth rate has decreased by more than 1% over this period, reaching only 0.528% in 2006 (see Table 3). Between 1982 and 2006, the proportion of children under the age of 15 decreased sharply from 33.59% to 18.47% of the population.¹⁸¹

Meanwhile, due to the impressive improvement in health care, life expectancy was an average of 71.4 years in 2000, and the figure is even higher in coastal areas such as Shanghai (78.14), Beijing (76.10), Zhejiang (74.70) and Jiangsu (73.91). Thus, there has been a rapid growth in the elderly population during the past three decades. The proportion of the population aged 65 and above almost doubled between 1982 and 2006, increasing from 4.91% in 1982 to 9.08% in 2006 (see Table 4). According to a United Nations estimate, the annual rate of the growth of the population over 65 will be 3% between 2000 and 2025, and 1.9% from 2025 to 2050. The proportion of those aged 60 and over of the total national population in China will reach 18.5% in 2025 and 26.2% in 2050, while for those aged 65 and over, the figure is estimated to be 12.2% by 2025 and 19.4% by 2050.¹⁸²

As one of the fastest-aging nations, China will soon have an age profile similar to those of the oldest member countries in the Organization for Economic Cooperation and Development (“OECD”).¹⁸³ Therefore, “China has to face all the social and economic issues of elderly care that are found in developed countries. Yet its economy is still that of a developing country.”¹⁸⁴ Rapid demographic change has thus become the most direct spur to pension reform.

¹⁸¹ See National Statistical Bureau, *Various Years*, *supra* note 144.

¹⁸² International Labour Office (“ILO”), *Social Security Pensions: Development and Reform* (Geneva: International Labour Office, 2000) at 648 [ILO, *Social Security Pensions*].

¹⁸³ World Bank, *Old Age Crisis*, *supra* note 139.

¹⁸⁴ Leung, *supra* note 149 at 76.

Table 3 Demographic Change

Year	Birth Rate (‰)	Death Rate (‰)	Natural Growth Rate (‰)
1982	22.28	6.6	15.68
1990	21.06	6.67	14.39
2000	14.03	6.45	7.58
2006	12.09	6.81	5.28

Source: National Bureau of Statistics of China, *China Statistical Yearbook (Various Years)*.

Table 4 Population Structure Change

Item	1982	1990	2000	2006 ①
Total Population (10,000 persons)	100,818	113,368	126,583	n/a
Population by Age Group (%)				
0-14	33.59	27.69	22.89	18.47
15-64	61.5	66.74	70.15	72.45
65 and over	4.91	5.57	6.96	9.08
Elderly Dependency Ratio (%) ②	7.98	8.35	9.92	12.53

Notes: ①② calculated based on data from www.stats.gov.cn (National Bureau of Statistics of China's official website)

Source: National Bureau of Statistics of China, *China Statistical Yearbook (Various Years)*.

VI. Conclusion

The “iron rice bowl” system has a close connection to the planned economy. Social welfare worked well for urban workers in China under the planned economy, but failed thoroughly under a market economy. The marketization process had negative effects on the original pension system for both urban and rural residents. Meanwhile, the market itself was unable to provide even moderate security in retirement. Numerous strikes and protests have proven that people in China, while they appreciate the higher living standard that the marketization process has created, do not want to enjoy it at the expense of losing social security benefits. Thus, the government was called upon to intervene, otherwise social stability would have been compromised, which could in turn have

harmed economic reform itself. Pension reform, as part of social security reform, had been inevitable for the Chinese government since the 1980s. However, it is not easy now to find an appropriate reform strategy, since there is no one-size-fits-all pension reform solution. Debates about the most appropriate strategy have arisen in the academic field as well as in practice. It is an enormously difficult task that the Chinese government faces.

CHAPTER THREE: THE WORLD BANK AND THE ILO: DEBATE AND CONVERGENCE

I. Introduction

The negative effects of market-oriented economic reform on the “iron rice bowl” system, in addition to demographic pressures, created a major challenge for the Chinese government in the 1980s. The government was forced to find an adequate pension scheme that would be compatible with the socialist market economy. However, China was not the only country that needed to initiate pension reform. The combination of an aging population, economic growth and rapid globalization, has ensured that old age income security has become a worldwide challenge. In fact, according to the International Labour Office (“ILO”), a large number of countries have also started making changes to their original pension schemes since the 1980s, and now there is almost no country that has not put pension reform on the political agenda.¹⁸⁵ The difference is largely a matter of the scale of the reform – whether a country chooses a comprehensive reform or a parametric one.¹⁸⁶

The complexity of the economy and the specific context of various nations make it hard to imagine a one-size-fits-all strategy for solving the old age crisis. Not surprisingly, debates about the most appropriate strategy have arisen and there is as yet no consensus among academics or policymakers as to the best strategy. The World Bank and the ILO

¹⁸⁵ ILO, *Social Security Pensions*, *supra note 182 at 3*.

¹⁸⁶ So-called “parametric” reform usually emphasizes modification of some parameters of the existing scheme, such as changing the retirement age or the benefit formula.

are two prominent participants in the pension debate. The World Bank has been involved in pension reform in its client countries for nearly 20 years.¹⁸⁷ Its influential 1994 publication *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* was claimed to be the first comprehensive, global examination of old age security arrangements.¹⁸⁸ In this report, the World Bank clearly expressed a strong preference for a three-pillar pension system, with much emphasis on the second pillar: a mandatory, privately managed, fully funded saving scheme.¹⁸⁹ It was claimed by the World Bank that such a three-pillar system would serve to protect the elderly and increase growth as well. Although the 1994 publication attracted as much criticism as applause, the claim that it would simultaneously protect the elderly and generate economic growth has made this model influential and attractive to various countries, China among them. However, the ILO,¹⁹⁰ another international organization which has long been active in the field, has been reserved and sceptical about the Bank's approach to pension reform. Its 2000 publication *Social Security Pensions: Development and Reform* can be seen as a response to the World Bank's pension model.¹⁹¹

China initiated pension reform in the early 1980s. Several major steps have been taken to reform the pension system since then, and the World Bank has been actively

¹⁸⁷ World Bank, *The World Bank Pension Conceptual Framework*, online: <http://siteresources.worldbank.org/INTPENSIONS/Resources/395443-1121194657824/PRPNoteConcept_Sept2008.pdf.pdf> (accessed 20 March 2009).

¹⁸⁸ World Bank, *Old Age Crisis*, *supra* note 139 at xiii.

¹⁸⁹ The other two pillars refer to a mandatory, publicly managed, tax-financed scheme and a voluntary supplementary pillar respectively. See section II for more details of this pension model.

¹⁹⁰ The ILO is a specialized agency of the United Nations with the mandate to promote labour rights as well as social justice. In order to fulfill its mandate, the ILO has a unique tripartite structure whose governing organs comprise governments, employers and workers. The International Labour Office, which was established in Geneva, is its headquarters. The Social Security Department is one of its several departments at headquarters. See ILO, *Social Security Pensions*, *supra* note 182 at xxi.

¹⁹¹ ILO, *Social Security Pensions*, *supra* note 182.

involved in this process. In its 2007 report, the Bank proudly acknowledged its involvement and influence on China's pension reform.

The World Bank has played an important role in China's pension reform in general. ... The strategy proposed by World Bank and the actual policies issued by the Chinese government form a coherent and well argued policy and implementation strategy.¹⁹²

Notwithstanding Chinese policymakers' favouring of the Bank's three-pillar pension model, it is valuable to trace the development of the Bank's position in the pension arena and the debate between the Bank and other institutes and organizations about such a pension model. In this chapter I will provide an overview of the debate about pension reform strategies between two major international organizations, the ILO and the World Bank. By reviewing both the World Bank and the ILO reform strategies, I will clarify whether they hold some principles in common and whether these principles could be applied in the context of China. Major pension reforms in China, which have been greatly influenced by the World Bank, will also be reviewed.

II. The World Bank and the ILO

When German Chancellor Otto von Bismarck introduced his country's national old age pension program in 1889, the first of its kind in the world, he probably did not foresee that old age security would become such an important issue in the next century. The first half of the 20th century saw the rise of public old age programs and public spending on old age support through the creation of new contributory, pay-as-you-go

¹⁹² World Bank, *Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance (Background Paper – China Country Study)* (Washington, DC, World Bank, 2007) at 19 [World Bank, *Pension Reform*].

(“PAYG”)¹⁹³ pension schemes in many European countries. Thus, poverty in old age was substantially reduced during the 1960s and ’70s.¹⁹⁴ The success of the PAYG pension scheme made it popular around the world. According to the ILO, approximately 166 nations have set up social security schemes, most of which more or less adopt the PAYG model.¹⁹⁵ However, worldwide demographic pressures, together with the process of economic globalization, have made most existing schemes, which are based on a PAYG model, unsustainable.¹⁹⁶

No ideal strategy for solving the worldwide old age crisis has yet been found. Obviously, the World Bank and the ILO, two international organizations which have been influential in the pension field, have held very different opinions about pension reform strategy. These differing opinions were best reflected in their first publications on the subject in 1994 and 2000 respectively.

During the years after these initial publications, some believe that, due to the coordination and cooperation in the countries with which they work, the positions of the ILO and the World Bank on pension issues have increasingly converged,¹⁹⁷ while others argue that “the controversy is stalled and actors have settled for a *modus vivendi* rather than a convergence of the conflicting views developing”.¹⁹⁸ Whether it is convergence or

¹⁹³ In its strictest sense, PAYG is a method of financing whereby current outlays on pension benefits are paid out of current revenues from an earmarked tax, often a payroll tax. See World Bank, *supra* note 139 at xxii.

¹⁹⁴ World Bank, *Old Age Crisis*, *supra* note 139 at 1.

¹⁹⁵ ILO, *Social Security Pensions*, *supra* note 182 at 193-194.

¹⁹⁶ See World Bank, *Old Age Crisis*, *supra* note 139; see also ILO, *Social Security Pensions*, *supra* note 182.

¹⁹⁷ See M. Queisser, “Pension Reform and International Organizations: From Conflict to Convergence” (2000) 53:2 *International Social Security Review* 31 [Queisser].

¹⁹⁸ V. Wodsak, “Conflict or Convergence — Change or Continuity? The World Bank and the Global Discourse on Old Age Security” (Paper presented on the Conference on Social Policy in a Globalizing World:

modus vivendi, it is useful to trace both these international organizations' initial positions and their debate with each other, as well as the changes in their positions during the past decade. Studying these changing positions can provide some lessons for China in choosing a suitable pension reform path.

The World Bank's Initial Position

Old age security was not on the World Bank's agenda until the 1990s. The success of pension reform in Chile, the collapse of the social security systems in the countries of the former Soviet Union (the Bank's new clients), and the Bank's own interest in the potential of pension funds for developing capital markets all contributed to the Bank's involvement in this field and its now famous publication *Averting the Old Age Crisis*.¹⁹³ This report clearly advocates a three-pillar pension scheme, drawn from Chile's privatization pension reform model.¹⁹⁹ It comprises three different pillars (or plans): one public pension plan and two savings plans; one mandatory and the other voluntary (see Table 5). The mandatory public pillar would serve to provide a limited social pension that could be backed by taxation. However, it was suggested it should be modest in size, providing a minimum pension guarantee in order to allow room for the other pillars. A second mandatory pillar would be a fully funded, privately managed and defined contribution plan. The second pillar was said to be able to link benefits actuarially to costs and to carry out an income-smoothing or saving function. This link would avoid the

Developing a North – South Dialogue, University of Florence, 8 September 2007), online: <<http://www.unifi.it/confsp/papers/pdf/Wodsak.doc>> (accessed 15 March 2009) [Wodsak].

¹⁹⁹ Chile instituted a new defined contribution pension scheme in 1981. The new scheme replaced the old PAYG pension system with a capitalization system based on individual retirement accounts managed by private companies known as *Administradoras de Fondos de Pensiones* or Pension Fund Administrators (“AFPs”). All new employees must enter the private pension scheme. Self-employed workers, however, have the option of remaining outside the system. See ILO, *Social Security Pensions*, *supra* note 182 at 542.

economic and political distortions to which the World Bank claimed the first public pillar was prone. This mandatory pillar would take the form of either personal savings accounts or occupational plans. The third pillar was an additional voluntary savings plan which would provide additional protection for people who voluntarily saved more for their old age.²⁰⁰ It was argued that this multi-pillar system would diversify risks and produce better results in terms of better-targeted redistribution, more productive savings and lower social costs.²⁰¹ The 1994 model is the pension system that China is now trying to fully implement.

Table 5: World Bank's Initial Pension Model

Pillar	Characteristics	Participation	Financing
1	Means-tested, minimum pension guarantee, or flat	Mandatory	Tax-financed
2	Personal savings plan or occupational plan	Mandatory	Regulated, fully funded
3	Personal savings plan or occupational plan	Voluntary	Fully funded

Source: World Bank, *Averting the Old Age Crisis*, (New York: Oxford University Press, 1994).

Flaws of the PAYG Pension System According to the World Bank

According to the World Bank, the traditional PAYG system has many inherent design flaws that will eventually make it unable to meet the demands of the aging population. The PAYG system is said to have a negative effect on pensioners, the labour market and eventually on the economy. The nature of a PAYG system is to redistribute income from younger generations to older cohorts. When the population ages rapidly (which also implies there are not enough younger workers contributing), and especially when the economy is not expected to grow, there would inevitably have to be an increase

²⁰⁰ World Bank, *Old Age Crisis*, *supra* note 139 at 15-16.

²⁰¹ Wodsak, *supra* note 198 at 2.

in the contribution rates to maintain the benefit level for retirees. This increase, in turn, would create a heavy burden on both the employees and the employers. Such a heavy burden could result in reduction of workers' disposable wages, contribution evasion, migration of employees and firms to the informal sector, and early retirement. All of these consequences would distort the labour market and harm productivity, which, in turn, would have a negative impact on the whole economy.²⁰²

In addition, the World Bank claims that public pension systems run deficits that are ultimately covered by the general treasury, which may, reduce the provision of other public goods. Publicly managed pension funds are also criticized for their poor interest rates, which are perceived as the consequence of mismanagement and interference from government.²⁰³

The World Bank also noted that PAYG systems are not fair between generations and may not be fair even within the same generation. According to the Bank, such systems fail to redistribute from rich to poor within one generation because members of the upper-income class usually enter the labour force later and live longer, so they contribute less and receive more than lower-income people. Referring to intergenerational redistribution, it is always the case that earlier generations benefit more than later generations. The redistribution from younger to older generations can only be equitable if the younger generations have much higher incomes than the older ones, or if investment return grows rapidly. However, all empirical evidence shows that earlier generations have done better than later generations.²⁰⁴

²⁰² See World Bank, *Old Age Crisis*, *supra* note 139 at 120-130.

²⁰³ *Ibid.*

²⁰⁴ *Ibid.*

Advantages of the Three-Pillar Pension System

By contrast, the World Bank clearly expressed its strong support of the three-pillar pension system in *Averting the Old Age Crisis*. In this report, the Bank spent most of its effort advocating for the second pillar, i.e. the privately managed, fully funded component of the system. By introducing such a plan, it said that the effect of aging would be dealt with properly and economic development would eventually be achieved as well on account of the increase in savings (investment capital). A paradigmatic reform of switching to funded savings pillars and reducing the public PAYG component was therefore advocated by the Bank.

In terms of economic growth, privately managed funded systems are said to have positive effects on capital accumulation and capital market development, which can be achieved with fewer or no labour market distortions. Under a PAYG system, there is no direct link between contribution and benefit. Some do not get as great a benefit as they contribute, while others can get benefits even if they do not contribute. So, workers who must bear the contribution may try to evade it, whereas employers may reduce the number of workers they demand. Under a funded system, although contributions remain mandatory, since workers eventually recoup their contribution with interest, they are less likely to see contributions as taxes.²⁰⁵ And since accounts belong to individuals, they can be carried with workers regardless of whether they change jobs. Therefore, labour mobility would be encouraged and contribution evasion would become much rarer. In addition, there would be increased long-term savings that could be invested in capital markets. As a result, capital market development would be accelerated, investment in

²⁰⁵ *Ibid.*

productive capital would be boosted and such changes would enhance economic growth in the long run.

Regarding the public good, the funded system is said to have fewer fiscal implications for government than a PAYG public plan, since workers receive only the value of their own contributions plus interest. Consequently, the pressure to increase public spending on pension benefits is absent.

As for the so-called unfair redistribution between generations in a PAYG system, the funded pillar is said to successfully avoid the large intergenerational redistribution in PAYG systems, because contributions and benefits are directly linked.

In summary, according to the World Bank, the privately managed funded savings pension system is good for the economy, the public and pensioners. Therefore, such a plan can not only solve the pension problem, it can increase the development of the market economy – one of the most important reasons the World Bank is involved in the pension policy field.

Criticism of the World Bank's Model

Since the publication of *Averting the Old Age Crisis*, there have been numerous criticisms of it from other international organizations such as the ILO and the International Social Security Association (“ISSA”), as well as from academics and individuals. First, the Bank is accused of an excessive focus on the financial feasibility and sustainability of pension policies while the well-being of the elderly is neglected.²⁰⁶ It is pointed out that the funded pension system relies heavily on a stable capital market

²⁰⁶ R. Beattie & W. McGillvray, “A Risky Strategy: Reflections on the World Bank Report *Averting the old age crisis*” (1995) 48:3-4 *International Social Security Review* 5 [Beattie & McGillvray].

and positive long-term investment returns, which cannot be guaranteed even in the most developed countries. This reliance on the performance of the capital market — as the 2008-2009 financial crisis demonstrates – puts individuals at considerable risk, as they are directly exposed to possible financial crises, high inflation, and poor investment returns. Members of vulnerable groups such as women and disabled people are also put into more dangerous positions, since there is a close link between the level of contribution and the retirement benefit. For example, women usually have less participation in the paid labour market than do men, because of so-called “desirable” activities, such as taking care of children and other family members. Women’s lower labour force participation results in less contribution to the pension system since childcare and other work in the home is not economically rewarded. Those suffering from sickness, unemployment and low-income before retirement have to bear the decline in the retirement benefit in their old age, which may result in their life-long poverty.²⁰⁷

Secondly, the Bank is criticized for exaggerating the problems of the PAYG system and for being overly optimistic about the privately managed funded system. On the one hand, PAYG is said not to be entirely unsustainable. The ILO points out that most PAYG systems can be consolidated by raising the age limit and making adjustments to benefits.²⁰⁸ On the other hand, based on empirical experience, the funded systems are found to have many problems. Low coverage is a most significant issue, as it occurs everywhere in the world where the funded system has been adopted, such as in Latin America, eastern and central Europe and Asia.²⁰⁹ The reduction in the replacement rate of

²⁰⁷ *Ibid.*, at 8.

²⁰⁸ Queisser, *supra* note 197 at 36.

²⁰⁹ ILO, *Social Security Pensions*, *supra* note 182.

pensions is another wide-spread and significant problem. In a privately managed funded system, contributors have to bear the uncertainty of the rate of return, of the amount of money that is deducted in the form of charges and commissions, and of the terms which are applied when the accumulated savings are converted into an annuity. If any of these factors do not go well for individuals, there would be a reduction in the replacement rate of pensions.²¹⁰ In addition, the ILO argued that high transition and administration costs make it less favourable than is suggested by the World Bank.

Last, but not least, the determination of whether the funded pension system has a positive impact on the economy is generally inconclusive. Peter Orszag and Joseph Stiglitz list 10 myths pertaining to the positive effect of a funded pension system on the economy on the macro and micro levels and even on the political economic level.²¹¹ For instance, on the macroeconomic level, assertions such as “private defined contribution plans raise national savings” were contested and seen as popular myths. Orszag and Stiglitz argue that privatization is neither necessary nor sufficient for increasing national savings.²¹² Consider a system of individual accounts that is pre-funded: if individuals offset any contributions to their accounts through reducing savings in other forms, then total private savings are unaffected. And, if public savings are unaffected, then national savings are unchanged.²¹³ Moreover, when considering administrative and transition costs, the rate of return of individual accounts under funded pension systems could not be higher for a longer period than under PAYG systems. Further, relatively low return rates

²¹⁰ Beattie & McGillivray, *supra* note 206 at 18.

²¹¹ See P. Orszeg & J. Stiglitz, “Rethinking Pension Reform: Ten Myths About Social Security Systems,” in R. Holzmann & J. Stiglitz, eds., *New Ideas About Old Age Security Toward Sustainable Pension Systems in the 21st Century* (Washington, DC: World Bank, 1999) 17.

²¹² *Ibid.*

²¹³ *Ibid.*

on PAYG funds actually imply that the funds are mature enough that the rates are not volatile – they increase steadily but are not high– rather than implying fundamental problems with PAYG systems. On the microeconomic level, the most popular myth is that private defined contribution plans create better labour market incentives. However, according to Orszag and Stiglitz, the ultimate concern should be the welfare of the elderly and not the labour supply itself. It is naive to adopt a pension system that increases labour incentives by reducing welfare. In addition, it is hard to assess how a pension system affects the efficiency of the labour market when considering other distortions in that market. Another popular myth is that the low administrative costs under private defined contribution plans result from competition. Competition, however, does not ensure low cost but only prevents excess rents. Orszag and Stiglitz also address the myth that corruption and inefficient governance are more serious problems under public systems. However, public malfeasance can be as dangerous under private accounts as under public systems. The key issue is the construction of monitoring regimes. The final myth relates to public pressure on governments. It is claimed that government will experience greater pressure under a public defined benefit system than under a private defined contribution scheme. In fact, government has to regulate the private sector and also has to provide assistance to those individuals who become poor due to wrong investment decisions. Such responsibilities also put great pressures on government.²¹⁴

²¹⁴ For more details, see Orszag & Stiglitz, *supra* note 211.

The ILO's Position on Pension Policy

In 2000, the ILO published *Social Security Pensions*, a comprehensive volume on pension policy.²¹⁵ In this report, the ILO acknowledged that a single public PAYG system is not sufficient and expressed its support for a multi-pillar pension system, which was said to have the merit of splitting the risks inherent in pension schemes.²¹⁶ However, unlike the World Bank, the ILO was unwilling to recommend a one-size-fits-all pension system. Instead, the ILO suggested a four-pillar pension system as a possible system that could be adopted by interested countries (see Table 6). The four-pillar model comprised a “zero pillar” which was intended to cover the poor and act as a poverty alleviation pillar. It would be financed from general revenues. The second pillar was a PAYG-defined benefit pillar, mandatory and publicly managed, which would provide a moderate replacement rate (around 10 or 50 % of lifetime average earnings, which would also be indexed). The third pillar was a mandatory defined contribution pillar, possibly privately managed. The fourth pillar was a voluntary defined contribution pillar, which would also be managed privately.²¹⁷ When compared with the 1994 World Bank model, it is obvious that the ILO made the adequacy of benefits and broad coverage higher priorities. As Monika Queisser described, the “ILO is fundamentally unwilling to accept systems which cannot guarantee insured persons with a full contributions record any more than benefits at the subsistence level”.²¹⁸

²¹⁵ See ILO, *supra* note 182.

²¹⁶ *Ibid.*, at 27.

²¹⁷ *Ibid.*

²¹⁸ Queisser, *supra* note 197 at 37.

In terms of pension reform choice, the ILO did not see the old age crisis as the inevitable consequence of a PAYG system. Thus, solving the old age crisis could also be achieved by parametric reform to the PAYG system.²¹⁹ The ILO actually has relatively strong faith in the PAYG system. According to the ILO, “[t]wo main problems ... at the heart of the issues facing pension schemes in almost all countries of the world ... are questions of coverage and governance”,²²⁰ not the inherent nature of PAYG.

Table 6: ILO’s Pension Model in 2000

Pillar	Form	Participation	Financing
0	Means tested anti-poverty	Mandatory	General revenues
1	Publicly managed, defined benefit which provides moderate replacement rate	Mandatory	PAYG
2	Defined contribution, possibly privately managed	Mandatory	Individual Contribution
3	Defined contribution, possibly privately managed	Voluntary	Individual Contribution

Source: ILO, *Social Security Pensions* (Geneva: International Labour Office, 2000).

Interestingly, the ILO in this report also supported a notional defined contribution (“NDC”) scheme. An NDC pension scheme is essentially a PAYG model that contains some elements of a defined contribution plan. Contributions are also used to pay the pensions of the current retirees. The difference is that, although individuals have their own accounts, the accounts and the investment income and interest are not fully funded (notional). The interest rate applied is not the market rate of interest but some other indicator, such as rate of growth of productivity, or growth of real wages, or labour force growth. However, the retirement benefit is calculated based on the notional amount of the

²¹⁹ ILO, *Social Security Pensions*, *supra* note 182 at 496.

²²⁰ *Ibid.*, at 23.

accounts, thus linking benefits closely to contributions. This change from defined benefit to defined contribution means that the incentive structure of funded systems remains intact. NDC accounts are very flexible in terms of their pay-out phase. The benefit is calculated according to life expectancy at age of retirement. At retirement age, individuals can choose to continue to work, but for fewer hours, since the annuity can be recalculated according to preferences. Sweden is usually seen as a representative of the NDC scheme.²²¹

After the publication of its report in 2000, the ILO did not issue another specific publication on pension policy. However, I am assuming that the ILO's position has been relatively constant since then.

Changes to the World Bank Position on Pension Policy

During the past decade, the World Bank has been involved in pension reform in more than 80 countries and “[t]his experience has significantly expanded the knowledge and insights of Bank staff and stimulated an ongoing process of evaluation and refinement of the policies and priorities that guide the work in this area”.²²² As a consequence, 10 years after the publication of *Averting the Old Age Crisis*, the World Bank stated its new position in its 2005 publication *Old Age Income Support in the 21st Century*.²²³ Although most of the new report still argued that a funded personal saving scheme was the best choice, the Bank stressed that it would only be the best choice when certain conditions were met, and added that other reform approaches (such as parametric

²²¹ See E. Palmer, “Exit from the Labour Force for Older Workers in Sweden: Can the NDC Pension System Help?” (1999) 24: 4 *The Geneva Papers on Risk and Insurance* 461.

²²² World Bank, *Old Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform* (Washington, DC: World Bank, 2005) at 1.

²²³ *Ibid.*

reforms within a PAYG system) could also have satisfactory outcomes. While the Bank acknowledged that parametric reforms were important and that the majority of countries had already chosen these kinds of reforms in recent decades, they saw parametric reform only as a precursor to paradigmatic reform. The Bank did not believe that parametric reform alone could be successful. Meanwhile, the report announced that the World Bank's primary goal was "to provide adequate, affordable, sustainable, and robust retirement income",²²⁴ not merely to contribute to financial sustainability and economic development. In addition, the Bank expressed its concern about coverage by stating that

Experience with low income countries has brought into focus the need for a basic or zero (or noncontributory) pillar that is distinguished from the first pillar in its primary focus on poverty alleviation in order to extend old-age security to all of the elderly.²²⁵

The most significant change in the World Bank's 2005 report is the introduction of a zero pillar and a fourth pillar. The zero pillar is a non-contributory social pension which is usually financed by general revenues. In its report, the World Bank acknowledged the importance of the zero pillar, as it could deal more explicitly with the poverty alleviation objective by more broadly extending pension coverage.²²⁶ Meanwhile, the introduction of a fourth pillar was an explicit recognition of informal arrangements, such as family support, personal savings and home ownership. The fourth pillar was added because "a large part of retirement consumption may be derived from sources that are not formally defined as pensions".²²⁷ Thus, the fourth pillar was a formal acknowledgement of these informal sources. Another development in the 2005 report is the Bank's strong support

²²⁴ *Ibid.*, at 6.

²²⁵ *Ibid.*, at 3-4.

²²⁶ *Ibid.*, at 3.

²²⁷ *Ibid.*, at 83.

for an NDC scheme, which was also advocated in the ILO's 2000 publication. All in all, the definition of a multi-pillar system was widened; the former three-pillar system was extended to a five-pillar system (see Table 7).

Table 7: Modified World Bank Pension Model in 2005

Pillar	Target group	Form	Participation	Financing
0	Lifetime poor, formal and informal sectors	“Basic” or “social pension” i.e. social assistance (universal or means tested)	Universal or residual	Budget or general revenues
1	Formal sector	Public pension plan, publicly managed (defined benefit or notional defined contribution)	Mandatory	Contributions, perhaps with some financial reserves
2	Formal sector	Occupational or personal pension plans (fully funded defined benefit or fully funded defined contribution)	Mandatory	Financial assets
3	Lifetime poor, formal and informal sectors	Occupational or personal pension plans (partially or fully funded defined benefit or funded defined contribution)	Voluntary	Financial assets
4	Lifetime poor, formal and informal sectors	Access to informal support (family), other formal social programs (health care), and other individual financial and nonfinancial assets (home ownership)	Voluntary	Financial and nonfinancial assets

Source: World Bank, *Old Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform* (Washington, DC: World Bank, 2005).

Convergence and Lessons for China

When comparing the position of the World Bank and the ILO, it appears that they have converged, at least along several lines that I will discuss.

First, there appears to be agreement that the ultimate purpose of pension reform is the alleviation of poverty and the promotion of well-being for people in old age, not

national economic development.²²⁸ Economic growth should contribute to the well-being of the elderly as well as other age cohorts, not reduce the welfare of the population. Therefore, the coverage and adequacy of the pension system is a key issue. Both organizations acknowledge that all elderly people should be covered, without consideration of their labour market participation, contribution amounts or income, through the support of a zero or basic pillar. It is also accepted that the adequacy of pensions is a primary concern. Although the definition of “adequacy” deserves more discussion and perhaps varies between countries, it is good to start with what the ILO Social Security (Minimum Standards) Convention (No. 102) suggested: “adequacy” means no less than 40 percent of the earnings of the standard beneficiary or of the average wage of an ordinary adult male labourer.²²⁹ The World Bank has also agreed with this replacement rate in its newly published book *Old Age Income Support in the 21st Century*.²³⁰ Second, a multi-pillar pension system is preferred, although the size and weight of each pillar may vary across countries. This multi-pillar approach simply reflects the wisdom of risk sharing. As the ILO stated, “such a structure would have the merit of splitting the risks inherent in pension schemes – the risks associated with public management of defined benefit schemes and the market-based risks associated with defined contribution schemes.”²³¹

Last but not least, both PAYG and funded systems are vulnerable to an aging population and both could be successfully modified to withstand the old age crisis, depending more on the specific context of each country than on the inherent nature of

²²⁸ World Bank, *Old Age Income Support*, *supra* note 222; ILO, *Social Security Pensions*, *supra* note 182.

²²⁹ ILO, *Convention Concerning Minimum Standards of Social Security*, No. 102, 1952.

²³⁰ World Bank, *Old Age Income Support*, *supra* note 222.

²³¹ ILO, *Social Security Pensions*, *supra* note 182 at 27.

PAYG and funded systems.²³² Old age pensions are only one part of the total public program. Pension reform has to be discussed in an overall social, economic and historical context. As indicated by the World Bank, options for reform depend on country-specific considerations, including economic development levels, governance capacities, and maturity of capital markets.²³³ It is insufficient to discuss pension reform choices without considering the other public programs and specific environments of individual countries. Feasible reform options are co-determined by the inherited system and the financial and social cost, together with many other considerations. It is also interesting to note that the mix of PAYG and funded plan NDC pension systems is advocated by both organizations; however, there has not been enough evidence to justify calling such a mixed pension system an ideal one.

III. Reforming China's Pension System

Although there has been debate for many years about which is the best pension reform strategy, Chinese policymakers have favoured the 1994 World Bank pension model. Three sets of reforms have been implemented since the 1980s, and most of these reforms were implemented due to the strong influence of the World Bank. The first set was introduced between 1985 and 1990, as part of reforms aimed at separating social security from SOEs. The second stage began in 1991, when *Decision on Reform of Enterprise Employees' Pension System* ("Document No. 33"), issued by the State Council, indicated that the state, enterprises and individuals all have to share responsibility for

²³² World Bank, *Old Age Income Support*, *supra* note 222 at 5. See also ILO, *Social Security Pensions*, *supra* note 182 at 496.

²³³ World Bank, *Old Age Income Support*, *supra* note 222 at 9.

pension contributions.²³⁴ The idea of the individual social insurance account was introduced in 1995, which reveals the emphasis of the second stage – strengthening individuals’ responsibility for old age income security. As I shall discuss in the next section, 1997 is seen as a watershed in China’s pension reform process²³⁵ because Document No. 26, which was enacted by the State Council in that year, demonstrated China’s acceptance of the World Bank pension model. Since then, there have been several other policies put into effect, most of which have focused on how to fully implement the World Bank model.

China’s Pension Reform Process and the World Bank’s Influence

Stage 1: 1985-1990

Owing to the lack of a national law on pensions, all pension reform policies were issued by the State Council in the form of decisions or notices.²³⁶ In 1985, the establishment of pooled funds for pension provision was encouraged by the State Council. The next year saw the implementation of the *Provisional Regulations on Institution of a Labour Contract System in State-Owned Enterprises*, issued by the State Council.²³⁷ According to this regulation, both enterprises and employees had to contribute to a funding pool. The total contribution rate was set at approximately 15% of an employee’s monthly wages, with the employee’s contribution not allowed to exceed 3%. Since then, a number of pooled funds have been established at all levels: 13 at the provincial level;

²³⁴ State Council (China), *Decisions on Reform of Enterprise Employees’ Pension System*, 1991 (Document No. 33), Article 2.

²³⁵ See World Bank, *Pension Reform*, *supra* note 192.

²³⁶ Leung, *supra* note 149 at 77.

²³⁷ State Council (China), *Provisional Regulations on the Institution of a Labour Contract System in State-Owned Enterprises*, 1986, repealed in 2001.

and 11 within different national trade sectors (e.g. railways, banking, and electricity). The rest were established at the city level.²³⁸ These pooled funds were managed by local labour bureaus and operated on a pay-as-you-go basis. Therefore, the responsibility of SOEs was shared among enterprises that contributed to the funding pool, and retirees could always get their pensions from the pooled fund even if their former enterprises went bankrupt. The goal in establishing pension funds was to shift the responsibility for social insurance from SOEs to local government.²³⁹ However, the various sizes and levels of these funds made the pension system in China a fragmented one. Thus, it was very difficult to evaluate the efficiency of pension pooling and to enable supervision by the central government.²⁴⁰ The fragmented pension system established at the beginning of the pension reform era also set up a barrier for China in creating a unified pension system.

The World Bank was not actively involved in this stage of pension reform. Yet, the Bank documented the process of reform during this stage and recommended further reform of various programs in China's social security system, including old age insurance and unemployment insurance, in its 1990 report.²⁴¹

Stage 2: 1991 - 1996

In response to the reform of SOEs and the fragmented pension system, the State Council issued "Document No. 33" in 1991.²⁴² The decision stated that the nation,

²³⁸ Leung, *supra* note 149 at 78.

²³⁹ Saunders & Shang, *supra* note 142 at 280.

²⁴⁰ Williamson & Deitelbaum, *supra* note 131 at 260.

²⁴¹ World Bank, "China: Reforming Social Security in a Socialist Economy," Report No. 8074-CHA, (1990).

²⁴² See *Supra* note 234.

enterprises, and individuals should all share responsibility for pension contributions. Employees had to contribute at a starting rate of 3% of payroll. The contribution rate for employees was set to grow gradually.

The *Notice on Further Reform of Enterprise Employees' Pension System* ("Notice on Further Reform") was enacted in 1995.²⁴³ It is in this notice that the State Council first introduced the ideas of a social pooled fund and a separate individual social insurance account, ideas that could be perceived as China's first step towards implementing the World Bank model. The establishment of individual accounts was intended to give incentives for individuals to contribute, and to keep an eye on their employers to make sure they contributed on time. The Notice on Further Reform offered two operational choices, one with a focus on the individual account function and the other with a focus on the social pooled fund function. Unfortunately, the definition and guidelines were ambiguous, and hundreds of different pension schemes at different levels were established.²⁴⁴ Therefore, a huge disparity among these schemes existed. For example, the contribution rate of individual accounts could vary from 3% to 17%.²⁴⁵ Various levels of individual accounts, together with various levels of fund pooling at various levels of jurisdiction, made the pension system in China even more fragmented than it was before.

It was also in 1995 that a World Bank Mission visited China. In the report prepared after the visit (known as the "Agarwala Report"), the Bank proposed a typical three-pillar pension system for China. Pillar one was to cover basic benefits, based on 9% of the wage paid by enterprises; pillar two would require a contribution of 8% of the worker's

²⁴³ State Council (China), *Notice on Further Reform of Enterprise Employees' Pension System*, 1995.

²⁴⁴ Saunders & Shang, *supra* note 142 at 281.

²⁴⁵ Leung, *supra* note 149 at 79.

individual wage. This pillar was seen as being fully funded. Pillar three would comprise supplementary pensions, either offered by employers or established by individuals; the fund was to be managed by private providers or insurance companies. It would be fully funded and portable.²⁴⁶ It was this report that attracted the support of many Chinese officials and it “was studied and discussed at the most senior levels of policy”.²⁴⁷

Stage 3: 1997 – present

In 1997, not long after the World Bank’s proposal for China in the Agarwala Report, the *Decision on Establishing a Unified Pension System for Enterprise Employees* (“Document No. 26”) was issued by the State Council.²⁴⁸ This document is seen by the World Bank as a milestone for pension reform in China. Most importantly, “[Document] No. 26 regulations followed the Agarwala report quite closely.”²⁴⁹ The main features of Document No. 26 were as follows. First, it proposed a unified three-pillar pension system for the first time. Second, full funding was emphasized. Individuals were required to contribute to their own social insurance accounts, eventually reaching 8% of their monthly wages, while their employers also had to contribute to both the unified pooling fund and employees’ individual accounts. The rate of the employer’s contribution to the pooled fund was to be determined by the local authority, but the maximum rate was 20% and the employer’s contribution to individual accounts would eventually be 3%. Last, coverage was to be extended to all enterprises, whether they were state-owned or belonged to the private sector. In essence, Document No. 26 intended to establish a three-

²⁴⁶ World Bank, *Pension Reform*, *supra* note 192 at 15.

²⁴⁷ *Ibid.*, at 19.

²⁴⁸ State Council (China), *Decision on Establishing a Unified Pension System for Enterprise Employees*, (Document No. 26), 1997.

²⁴⁹ World Bank, *Pension Reform*, *supra* note 192 at 19.

pillar pension system including a mandatory PAYG basic pillar which aimed to provide a flat benefit, a mandatory fully funded individual account pillar which linked retirement benefits to individual contributions and a voluntary supplementary occupational pillar. By comparing the details of the Agarwala Report and Document No. 26 (Table 8), it is clear that the system outlined in Document No. 26 was consistent with the Bank's proposal. It therefore announced China's embrace of the World Bank's three-pillar model.

As stated above, China implemented the three-pillar pension system in 1997. The initial intention was to build a three-pillar pension system with a PAYG unified fund and a fully funded individual account system. However, in reality, individual accounts are notional – what the Chinese call “empty accounts”. Although both employers and employees have to pay extremely high contributions (25%-30% of the total payroll), only 11% of the contributions are allocated to individual accounts; the others are allocated to the unified funds to pay current beneficiaries. However, the financial gap between current pension payments and current accumulation to the unified fund remains large. Therefore, contributions to individuals' accounts are transferred in order to fill the gap. Consequently, individual accounts become notional (empty) accounts that only exist on paper.²⁵⁰ The Chinese government confirmed that the total pension deficit was as high as 800 billion RMB²⁵¹ in 2006.²⁵²

Determined to fully implement the three-pillar system, which requires fully funded individual accounts, the Chinese government launched a pilot project in Liaoning

²⁵⁰ World Bank, *Old Age Security: Pension Reform in China*. (Washington, DC: World Bank, 1997). Someone has categorized China as a NDC system, which is not appropriate, as China never intended to build an NDC system; the individual accounts were initially designed to be fully funded.

²⁵¹ Equivalent to approximately US\$120 billion.

²⁵² Finance, *Choice of Social Insurance*, [in Chinese], online: <<http://biz.cn.yahoo.com/061227/128/ket13.html>> (accessed 1 March 2009).

This pilot project was aimed at operating unified pooled funds and individual accounts separately, thus ensuring there would not be any cross-subsidization. In other words, the project intended to achieve real full funding of individual accounts.²⁵⁴

Table 8: Comparison Between the World Bank Proposal and China's Pension Policy

World Bank's proposal for China ^①		Document No. 26	Document No. 42
Social Pooling	Contribution 9 percent	Contribution 17 percent	Contribution 20 percent
	Benefit 0.6 percent per year (40 years => 24 percent)	Benefit 20 percent + additional benefit above 15 years service 15 years vesting	Benefit 20 percent + 0.6 percent per additional year after vesting 15 years vesting
Individual Account	Contribution 8 percent	Contribution 8 percent (e'ee) + 3 percent (e'er)	Contribution 8 percent (e'ee only)
	Estimated benefit 35 percent	1/120 monthly annuity	1/120 monthly annuity

Notes: ^①also known as the Agarwala Report.

Source: World Bank, *Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance (Background Paper – China Country Study)* (Washington, DC: World Bank, 2007).

The major features of the Liaoning pilot project were as follows. Employees were to bear the sole responsibility of contributing to individual accounts, and the rate was 8% of the employee's wage. Contributions by the enterprise were to be maintained at around 20%. In addition, no contributions from enterprises were to be allocated to individual accounts. All social pooling pension account funds were to be managed separately from those of individual accounts, and no subsidies for social pooling were to be drawn from

²⁵³ World Bank, *Pension Reform*, *supra* note 192 at 9.

²⁵⁴ According to the World Bank, full funding means the accumulation of pension reserves that total 100 percent of the present value of all pension liabilities owed to current members. See World Bank, *Old Age Crisis*, *supra* note 139.

individual accounts.²⁵⁵ (See Table 8.) This project was extended to the entire nation in 2006. Therefore, it is clear that China firmly adheres to the three-pillar system proposed by the World Bank in 1994.

Since the Agarwala Report, the World Bank has spent most of its efforts and loans to China on information technology (“IT”) infrastructure development through a Learning and Innovation Loan (“LIL”) project and a pension policy reform program started in 1998. By developing IT infrastructure, the new features of Document No. 26 were able to be implemented through an IT framework. In addition, there were some Analytical and Advisory Assistance (“AAA”) sub-projects, comprising projection analysis and policy training, mainly in using the Pension Reform Options Simulation Toolkit (“PROST”) model.²⁵⁶

In general, the World Bank has had a strong influence on China’s pension reforms. IT assistance under the LIL pension reform project was well accepted. The PROST training programs have reached every province in the country.²⁵⁷ Most importantly, in terms of policy development, the implementation of Document No. 26 and Document No. 42 and the most recent reforms all indicate that China is moving towards the World Bank pension model.

²⁵⁵ World Bank, *Pension Reform*, *supra* note 192 at 9.

²⁵⁶ A PROST model is a computer-based toolkit developed by the World Bank. The model is designed to promote informed policymaking, bridging the gap between quantitative and qualitative analyses of pension regimes by modelling pension contributions, entitlements, system revenues and system expenditures over a long time frame. PROST is used in more than 80 countries around the world. See World Bank, *PROST*, online: <<http://info.worldbank.org/etools/docs/library/77360/january2002/pdfel2002/prost.pdf>> (accessed 1 March 2009).

²⁵⁷ World Bank, *Pension Reform*, *supra* note 192 at 19.

IV. Conclusion

It is obvious that China has chosen to follow the World Bank pension model and that several reforms have been undertaken to fully implement this model. However, whether this model is the ideal reform choice for China remains questionable. One lesson that can be drawn from the debate between the World Bank and the ILO is that the success of pension reform does not rely on the pension model itself, but on whether a model best fits a specific national context. As the former Chinese leader Deng once said, it doesn't matter if it is a white cat or a black cat – it is a good cat as long as it can catch mice. Another important lesson is that the ultimate purpose of pension reform is the alleviation of poverty and the promotion of well-being for elderly people. Therefore, the goal of pension reform in China should be to build a pension system which provides income security to people in old age, and which would function optimally in a socialist market economy. Thus, in order to examine whether the World Bank's pension model is effective in the context of China, I will draw on these lessons in the next chapter.

CHAPTER FOUR: IS THE WORLD BANK PENSION MODEL RIGHT FOR CHINA?

I. Introduction

The pension system in China has been subject to significant reforms over the past three decades, but, despite these reforms, it is still a system in transition. The World Bank has been influential throughout the reform process. Chinese policy-makers' endorsement of the three-pillar model, which was strongly recommended by the World Bank in 1994, is obvious. The most recent reforms were intended to establish a properly functioning third pillar and a clearly fully funded second pillar.²⁵⁸ However, after exploring the debate between the World Bank and the ILO, especially considering the World Bank's own changing position since 1994, it is necessary to re-examine China's pension reform choices.

Several lessons have been drawn from examining the positions of the World Bank and ILO in the pension field, and some general principles can be seen to be shared by both organizations. I will apply these lessons in the context of China in this chapter and, by doing so, will conclude that China's current choice of pension reform system, based upon the 1994 World Bank model, might not be the most appropriate one.

²⁵⁸ The State Council issued Document No. 20, *Trial Measures for Enterprise Annuity*, and Document No. 23, *Trial Measures for Managing Enterprise Annuity Funds*, in 2004 to provide a framework for the voluntary occupational pension plan (the third pillar) — the Enterprise Annuity. At the end of 2005, the State Council issued Document No. 38, *Decision on Improving the Pension System of Enterprise Employees*, to extend the pilot project in Liaoning, which intended to extend the full funding of individual accounts to the whole nation, with modifications to benefit formulae.

II. The World Bank's Three-Pillar Model in the Context of China

A comparison of World Bank and ILO positions in the pension field was outlined in the previous chapter. One important lesson that has been drawn from this comparison is that the ultimate purpose of a pension system is the alleviation of poverty and the promotion of well-being for the elderly; thus, coverage and adequacy are two key issues. Another important conclusion is that the success of a pension system relies more heavily on the background of the country in which it is employed, than on the merits of the system itself. In other words, both the PAYG system and the private fully funded system could be successful, depending on compatibility with a nation's economic, political and social background. The World Bank's three-pillar model, which focuses mainly on the fully funded second pillar, is acknowledged to be successful when there is a mature capital market, good governance, and relatively low implicit debt.²⁵⁹ In order to find out whether the three-pillar model is the ideal reform choice for China, I will apply these two lessons in the context of China to see whether the pension reforms towards this model have achieved broad coverage and adequate pension benefits, as well as whether the three pre-conditions of such a model are met in contemporary China.

The Coverage Issue

Coverage is a key element of a successful pension system. However, broad coverage has not been achieved in either urban or rural China through implementing the 1994 World Bank pension model. Peasants in rural areas have benefitted little, if at all, from past pension reforms. There are hardly any provisions for old age security in rural areas,

²⁵⁹ See World Bank, *Old Age Crisis*, *supra* note 139. See also World Bank, *Old Age Income Support*, *supra* note 222.

whereas the major pension reforms in line with the World Bank model have been targeting only the urban population. After nearly three decades of pension reform, the rural elderly still have to depend on family support.²⁶⁰

The only reform that aimed at establishing a state-based rural pension system was proposed in 1992, when the Ministry of Civil Affairs (“MOCA”) promulgated the *Basic Program for Rural Social Security Insurance at the County Level*.²⁶¹ The MOCA called for a rural old age insurance system with the county as the basic operational level. Participation was voluntary, and individual contributions were supplemented by collective-sponsored contributions to set up individual accounts, which were managed by the county governments.²⁶² However, this rural old age insurance did not last long. The Ministry of Labour and Social Security (“MOLSS”) took over the responsibility for the rural pension policy from the MOCA in 1998, and considered the rural old age social insurance system immature, because of several implementation problems such as abuse of power in the form of compulsory participation and management risk of pension funds.²⁶³ As a result, the system was replaced by a commercial insurance program in

²⁶⁰ D. Wang, “China’s Urban and Rural Old Age Security System: Challenges and Options” (2006) 14:1 *China & World* 102 at 110 [Wang].

²⁶¹ Ministry of Civil Affairs (China), *Basic Program for Rural Social Security Insurance at the County Level*, 1992, repealed 1999.

²⁶² See Y. Hu, “Pension Reform in China — A Case Study,” Economic and Financial Discussion Paper, No. 06-05, London: Brunel University — School of Social Sciences, online: <<http://dspace.brunel.ac.uk.ezproxy.library.uvic.ca/bitstream/2438/1020/1/0605.pdf>> (accessed 12 April 2009) [Hu]; S. Shi, “Left to Market and Family — Again? Ideas and the Development of the Rural Pension Policy in China” (2006) 40: 7 *Social Policy & Administration* 791 [Shi]; see also Wang, *supra* note 260.

²⁶³ F. Salditt, P. Whiteford & W. Adema, “Pension Reform in China: Progress and Prospects,” OECD Social, Employment and Migration Working Papers No. 53, online: <<http://lysander.sourceoecd.org/vl=6349114/cl=18/nw=1/rpsv/cgi-bin/wppdf?file=514mj1lcbhjl.pdf>> (accessed 12 April 2009) [Salditt]; Shi, *supra* note 262 at 799.

1999.²⁶⁴ In practice, the first and only specific rural old age social insurance system attracted only a small portion of the rural population. The coverage (percentage of peasants insured in the total rural labor force) was 15.4% in 1997 (just before the transfer to the MOLSS), and declined to 11% in 2004.²⁶⁵ According to the National Census in 2000, 43.4% of the rural elderly aged 60 or above had to work to survive while, among those who no longer worked, 86.2% had to rely on family support.²⁶⁶ The China Research Centre on Aging confirmed, according to a national survey the centre conducted in 2006, that only 4.8% of the rural elderly received pension benefits.²⁶⁷

Meanwhile, although the Chinese government launched several pension reforms in urban areas, as described above, these reforms have not brought a broad level of coverage to the urban population either. According to the National Bureau of Statistics of China (“NBS”), as of 2006, the pension system covered only about 141 million out of 283 million urban employees (i.e. a coverage ratio of 49.8% for the urban workforce), while China’s total working population numbered 764 million.²⁶⁸

When discussing the coverage issue in urban areas in China, it is also important to take rural migrant workers into account. It is estimated that, as of 2008, the number of

²⁶⁴ Salditt, *supra* note 263 at 23. Although the fall of the rural old age insurance system could be attributed to immature design as the MOLSS suggested, the underlying cause relates to the fragmented bureaucratic system and the lack of a national law. See the following sections for detail.

²⁶⁵ Wang, *supra* note 260 at 110.

²⁶⁶ National Bureau of Statistics, “The Fifth National Census Statistics” [in Chinese], online: <<http://www.stats.gov.cn/tjsj/ndsj/renkoupucha/2000pucha/pucha.htm>> (accessed 22 March 2009).

²⁶⁷ China Research Centre on Aging, “2006 China Urban and Rural Elderly Survey” [in Chinese], online: <http://www.china.com.cn/news/txt/2007-12/17/content_9392818.htm> (accessed 22 March 2009).

²⁶⁸ National Bureau of Statistics, “China Statistical Book 2007”, online: <<http://www.stats.gov.cn/tjsj/ndsj/2007/indexch.htm> & <http://www.stats.gov.cn/tjsj/ndsj/2007/html/W2333e.htm>> (accessed 22 March 2009).

rural migrant workers in urban areas was 225.42 million.²⁶⁹ Although rural migrant workers work and live in urban areas, they benefit little, if at all, from the urban pension system.²⁷⁰ Rural migrant workers in urban areas were excluded from early pension reform developments. The accessibility problem for rural migrants is largely due to the historical institutional separation between urban and rural populations, which is reflected in the *hukou* system.²⁷¹ Ever since the introduction of the first pension provision (the “iron rice bowl” system) in China, the rural elderly have been excluded from participating in a formal public pension plan. As long as the *hukou* system is in effect, the bifurcated pension system cannot be changed in a fundamental manner. In recent years, intending to take advantage of the relatively young age of most migrant workers, the Chinese government tried to broaden pension coverage to rural migrant workers.²⁷² Such

²⁶⁹ People’s Daily Online, “China’s Rural Migrant Workers Top 225 Million” (25 March 2009), online: <<http://english.people.com.cn/90001/90776/90882/6622313.html>> (accessed 12 April 2009).

²⁷⁰ Hu, *supra* note 262 at 22.

²⁷¹ See *supra* note 141 for details of *hukou* system.

²⁷² Salditt, *supra* note 263 at 38; Hu, *supra* note 262 at 22. It is important to note that by saying that rural migrant workers participate in the urban pension system, this does not imply that those workers are included in the current urban pension plan for those who have urban *hukou*. Rather, rural migrant workers are usually subject to a separate pension plan specifically designed by local urban governments. Usually, the specific plan for rural migrant workers offers less generous pension benefits, and has more restrictions. Take Shanghai, for instance. There is a separate pension plan there for rural migrant workers, which came into effect in September 2002. According to the plan, rural workers in Shanghai can have one old age subsidy (pension) for every 12 months of contributions made in Shanghai. One old age subsidy equals only 4.2% of the average local wage of the year previous to the contribution year. Rural migrant workers can claim for the total subsidies in lump sum when they reach retirement age (60 for men and 50 for women). However, the pension benefits under the urban plan are more generous. The urban elderly can enjoy pension benefits on a monthly basis, as well as a basic flat pension benefit and individual account-related benefits. The annual flat pension benefit alone is much more than the old age subsidy for rural migrant workers. The annual basic flat pension benefit equals 20% of the average local wage of the year previous to an individual’s retirement year (as compared to the contribution year for migrant workers). Although the basic flat pension benefit was reformed to index to individuals’ different contribution years, the minimum basic pension benefit (15% instead of the previous 20%) is still higher than that of rural migrant workers.

action, however, appears to be more of a trial effort than a fundamental reform. By the end of 2008, only 17% of migrant workers participated in the urban pension system.²⁷³

There are several reasons why approximately 50% of the urban working-age population fails to participate in the pension system. The most direct reason is the extremely high contribution rate and relatively low return rate of fund investments. Yu-Wei Hu compared contribution rates for 2004 across 26 countries, including both OECD countries and emerging market economies (“EMEs”).²⁷⁴ It is surprising that China has the second highest contribution rate (30%), second only to that of Singapore (33%).²⁷⁵ In Singapore, however, contributions are also used to finance home ownership and education.²⁷⁶ Therefore, the old age contribution rate in Singapore is actually lower than that in China. The average contribution rate across all the 26 countries was 16%, only about half of China’s rate.²⁷⁷

More seriously, the contribution rate in China is shockingly high if all the other social security contributions are taken into account. Take Shanghai, for example. In addition to the old age contribution, there are contributions for unemployment insurance, maternity insurance, work-related injury insurance and health insurance. The total contribution rate for employers and employees is as high as 37% and 11% respectively (see Table 9). For employers, the high contribution rates means high labour costs while, for employees, they mean less disposable income. In particular, people with higher

²⁷³ The Central People’s Government of the People’s Republic of China, “Response Concerning Rural Migrant Workers” [in Chinese], online: <http://www.gov.cn/zwhd/2009-02/05/content_1222457.htm> (accessed 12 April 2009).

²⁷⁴ Hu, *supra* note 262 at 21.

²⁷⁵ *Ibid.*

²⁷⁶ *Ibid.*

²⁷⁷ *Ibid.*

incomes may feel even less incentive to contribute, because their pension benefits are calculated mainly in relation to the local average income. (See Table 8 in Chapter Three for benefit formula.) Because most of the contributions of private enterprises are used to pay the unfunded liabilities of SOEs, only SOEs have benefitted much from such high contribution rates.²⁷⁸ The lack of incentives for both employers and employees inevitably triggers evasions, which are reflected in low coverage levels.

Table 9. Breakdown of Shanghai Social Security Scheme

		Shanghai urban plan		suburban plan*	
contribution	based on	employee's income – range from 60%-300% of average local income (previous year)		60% of average local income (previous year)	
	contributor	employer	employee	employer	
	rate (%)	pension	22	8	17
		health care	12	2	5
		unemployment	2	1	2
		maternity	0.5		0.5
		work-related injury	0.5		0.5
total	37	11	25		

*Enterprises in suburban areas of Shanghai are subject to the suburban plan. However, because of its low pension benefits, enterprises can also apply to be subject to the urban plan.

When such high contribution rates yield only low return rates, the unwillingness of both employers and employees to contribute increases. In contrast to high contribution rates, in practice, the investment return is relatively low. Funds from the first pillar (pooled funds) are currently invested in government bonds and bank deposits with long-term average real interest rates of 2-3%.²⁷⁹ As for the second pillar (individual accounts), according to current regulations, the majority of these accumulated assets should also be

²⁷⁸ R. Jackson & N. Howe, *The Graying of the Middle Kingdom* (Washington, DC: Center for Strategic & International Studies, Prudential Foundation, 2004 at 20.

²⁷⁹ Trinh, *supra* note 116 at 12.

invested in bank deposits and government bonds.²⁸⁰ In addition, despite the fact that the second pillar is designed to be fully funded, in practice, as previously described, contributions to individual accounts are constantly transferred to fill the cash gap in the first pillar (PAYG component) of the pension system. In other words, the accounts are funded in name, but empty in reality. In practice, in most cases, local authorities credit individual accounts annually with a return equal to that of government bonds.²⁸¹

Unfortunately, real returns on government bonds in China have been traditionally low; the average real return on government bonds was only 1% during the period 1993-2004.²⁸² However, when considering the nearly 10% growth of GDP every year, and the substantial rise in wages of 5-10%,²⁸³ the situation is much more serious. Estelle James has calculated that, based on the assumption that current employees contribute 8% of their income to their individual accounts for 40 years and receive pensions for 20 years, even with a low income growth rate of 3%, a real return on this account of 2% would yield a replacement rate of only 16% of final wages. In contrast, a real return of 5% is needed to fulfill a replacement rate of just below 40%.²⁸⁴ Given the fact that the real investment returns remain low while income growth climbs quickly, contributors will naturally doubt whether their high contributions can provide them with acceptable pension benefits when they retire.

²⁸⁰ Hu, *supra* note 262 at 25.

²⁸¹ *Ibid.*

²⁸² *Ibid.*

²⁸³ E. James, "How Can China Solve its Old Age Security Problem? The Interaction Between Pension, SOE and Financial Market Reform" (2005) 1:1 *Journal of Pension Economics and Finance* 53 at 70 [James].

²⁸⁴ *Ibid.*

The Adequacy Issue

High contribution rates and low investment returns have reduced both employers' and employees' willingness to contribute, which in turn has resulted in low coverage levels. Broad coverage, one of the key elements of a properly functioning pension system, has not yet been achieved. Another key criterion in evaluating a pension system is adequacy. The definition of "adequacy" is still a matter of discussion, and may vary between nations. However, what is clear is that the pension benefit has actually been lowered in China by reforms designed to implement the World Bank model.

The pension benefit is composed of two parts, a flat pension benefit and an individual account-related benefit. Both parts suffered reduction following adoption of the most recent pension provisions set out in Document No. 38.²⁸⁵ First of all, the former flat pension benefit of pillar one, which provided 20% replacement of local average wages, was changed to build an even closer link between the years of contribution and benefit, i.e. the years of contribution will be credited at the rate of 1% per year. According to the previous policy,²⁸⁶ all retirees enjoyed a basic replacement rate of 20% of the average local wage regardless of the number of years of contribution; however, now individuals have to contribute for 20 years to get the same entitlement. Secondly, the proportion of total contribution to an individual account has been reduced from 11% to 8%. Because of the close link between an individual account and the retirement benefit, the reduction of an individual account will eventually result in a reduced pension. Moreover, Document No. 38 changed the benefit formula, which has further lowered

²⁸⁵ Document No. 38 was issued by the State Council at the end of 2005 and has been in effect since 2006. See *supra* note 258.

²⁸⁶ Set out in Document No. 26. See *supra* note 248.

pension benefits. Individuals used to enjoy a monthly benefit equal to 1/120th of their accounts in addition to the basic 20% pension benefit they were entitled to under the old policy; however, now they are only entitled to 1/195th (retirement at age 50) or 1/139th (retirement at age 60) of their accounts.

These changes have had particularly profound effects on vulnerable groups such as women, who often opt out of labour market participation to take on the social responsibility of caring for children or others, and those who cannot contribute due to unemployment or disability. The design of such a savings-based pension plan has actually exacerbated the financial risks that periods of sickness, unemployment and disability pose for the maintenance of the standard of living during disability, survivorship or old age, and put them entirely on the shoulders of individuals.²⁸⁷

The replacement rate of the pension benefit was 65-90% just before the pension reforms started in the middle 1980s.²⁸⁸ After the most fundamental reform in 1997, the target replacement rate was reduced to 58.5%,²⁸⁹ which was further reduced by the most current reform. However, many scholars are in favour of reducing the replacement rate.²⁹⁰ They argue that the target replacement rate (59.2%) is still higher than the rates in many developed countries, and, thus, could be subject to further reduction in order to reduce the financial strain.²⁹¹ This argument deserves further consideration. Firstly, the

²⁸⁷ M. Cichon, *Financing Social Protection* (Geneva: International Labour Organization, 2004) at 284 [Cichon].

²⁸⁸ See the introduction to the pension system under the sub-heading “iron rice bowl” in Chapter Two for more details.

²⁸⁹ The actual replacement rate did not reach 58.5%. See the following discussion for detail.

²⁹⁰ See Y. Sin, “Pension Liabilities and Reform Options For Old Age Insurance” Working Paper Series, Paper No. 2005-1, online: <<http://siteresources.worldbank.org/INTPENSIONS/Resources/ChinaPensionLiabilities.pdf>> (accessed 12 April 2009) [Sin]; see also Salditt, *supra* note 263; James, *supra* note 283.

²⁹¹ *Ibid.*

59.2% replacement rate is just a target rate, which has not been verified by any empirical data. The target replacement rate of the pension system proposed in Document No. 26 was 58.5%²⁹², while the actual rate was proved to be much lower.²⁹³ Given the reduction of pension benefits in both parts as discussed above, there is reason to doubt whether the target rate of 59.2% could actually be achieved. Secondly, even assuming that the 59.2% replacement rate is achieved, one has to bear in mind that this replacement rate, and those comparatively lower rates in developed countries, only account for pillars one and two. Those developed countries that have established mature three-pillar pension systems have a well-developed pillar three, a voluntary occupational plan or personal savings plan, which is usually supported by the government by means of tax. However, China has not yet established a third pillar. The government-supported personal savings plan is missing. Although the government does encourage an occupational plan,²⁹⁴ because of the high mandatory contributions, very few enterprises have set up occupational plans. Therefore, when taking pillar three into account, many developed countries may have higher replacement rates than the target rate of China. Last but not least, a precious lesson we have learned is that the ultimate purpose of a pension system is the well-being of the elderly. It is never the best choice to launch a financially positive pension reform at the cost of pension benefit adequacy.

²⁹² Trinh, *supra* note 116 at 6.

²⁹³ *Ibid.*, at 15.

²⁹⁴ The MOLSS issued Document No. 20, *Trial Measures for Enterprise Annuities*, in 2004 to encourage enterprises to set up private occupational pension plans such as the enterprise annuity. According to the Document, enterprises with a good operational record, which also fulfill the mandatory pension contribution obligations, could set up the an enterprise annuity, which allows employer contributions of up to 1/12th of the total enterprise's payroll of the previous year, and employee contributions of up to 1/6th of total wages.

It is also worth noting that a possible side effect of lowering the replacement rate is that the unwillingness to contribute would become stronger. Therefore, the already low coverage would become even lower.

By implementing the 1994 World Bank model, China's pension system not only has limited coverage, but has also been subject to a gradual reduction in pension benefits. Coverage and adequacy, the two key issues in assessing the successfulness of a pension system, have not been achieved through the implementation of such a model.

Examining the Three Pre-Conditions of the World Bank Model

Over the past three decades, pension reform based on the World Bank pension model has failed to realize sufficiently broad coverage or adequate pension benefits. Based on the lesson that the success of a pension system relies heavily on national context, it is therefore necessary to examine whether China has the conditions to keep reforming towards such a model. Good governance, a mature capital market, and low implicit debt are the three pre-conditions of a properly functioning World Bank pension model. In this section, I will examine whether these conditions are met in China in order to assess whether the World Bank model is the ideal reform choice in the context of China.

Condition One: Good Governance

“Good governance” is a broad concept and embraces the decision-making process connected with the structure of a pension scheme, the institutional arrangements responsible for its administration, and the implementation of the scheme.²⁹⁵ In China,

²⁹⁵ ILO, *Social Security Pensions*, *supra* note 182 at 217.

however, there are too many departments involved in the process of decision making, and they all have conflicting ideas about what kind of pension reform is most suitable. With regard to institutional arrangements, the decentralized set-up of the pension system leads to a highly fragmented administrative system,²⁹⁶ which in turn impedes the implementation of the pension scheme.

First, regarding the decision-making process, there are too many administration institutions involved.²⁹⁷ The principal ministry responsible for old age security is the Ministry of Labour and Social Security (“MOLSS”). Pension issues relating to the majority of the national labour force are under its jurisdiction. The Ministry of Personnel (“MOP”) is in charge of pension regulations and provisions for civil servants and those working for public institutions (e.g. hospitals, public schools and research institutions). In addition, the Ministry of Civil Affairs (“MOCA”) is responsible for pension provisions for those elderly people who are not covered by any formal pension coverage, or by any family support. The Ministry of Finance (“MOF”), however, carries financial responsibility for the pension system. The National Development and Reform Commission (“NDRC”), the People’s Bank of China (“PBC”) and the China Insurance Regulatory Commission (“CIRC”) are also involved in the decision-making process.²⁹⁸ Within such a fragmented system, the government’s decision-making capacity, even on a national level, is not optimal. As the World Bank mentioned in its 2007 report,

[the] MOLSS has carriage of policy but little power; the MOF, on the other hand, has power but little specialized social security expertise. A notable divide occurs with regard to attitudes towards future debt projections. Comparison of assets and

²⁹⁶ Trinh, *supra* note 116 at 12.

²⁹⁷ Hu, *supra* note 262 at 28.

²⁹⁸ See Shi, *supra* note 262.

liabilities in pension policy gains a far more sympathetic ear from MOF personnel than from MOLSS staff. To further complicate the national decision-making structure, there are also interdepartmental agencies, for example the State Planning Commission and the MOCA, which become involved in pension reform from time to time.²⁹⁹

Given the fact that the different participants involved in the decision-making process have various concerns and interests, it is usually not easy to reach a consensus, and this consequently impedes pension reform. The abolition of the rural old age social insurance system, as described above, was a typical result of the fragmentation of decision-making administrations, and the long-lasting conflicts between them concerning the rural old age security system. While the system developed reasonably well under the guidance of the MOCA, it was dropped in favour of a commercial insurance plan when the responsibility for the affairs of the rural elderly was assigned to the MOLSS, which is primarily concerned about social security systems in the urban sector.³⁰⁰ Meanwhile, the MOF and the CIRC, worried about the financial viability of a public rural plan, complicated the situation by firmly opposing a specific rural pension system as well as any institutional transition. Therefore, the whole issue was set aside without further decision.³⁰¹

Second, the pension administration structure in China is a fragmented one, on both the national and local levels. There are already too many old age administration institutions at the national level. Meanwhile, on the local level, as indicated previously, because of the lack of a clear pension reform plan, and due to vast variations in levels of economic development, demographic structure, and education between regions, hundreds of different pension schemes have been established. It is typical and still common today

²⁹⁹ World Bank, *Pension Reform*, *supra* note 192 at 13.

³⁰⁰ Salditt., *supra* note 263 at 40.

³⁰¹ Shi, *supra* note 262 at 800.

that pension pooling is arranged on a city or county level, which not only decreases the risk-sharing component of social pooling, but establishes a correspondingly fragmented administration system.³⁰² Although pension policies are designed and developed at the national level, these existing schemes were historically managed and financed on different levels.³⁰³ Until recently, many specific policy parameters and administrative details were left to the discretion of the local governments.³⁰⁴ This fragmentation is partly due to the central government's willingness to allow for regional differences, with the underlying logic that this meets local demands for flexibility. This flexibility is expected, in turn, to increase participation incentives.³⁰⁵ While Document No. 26, issued by the State Council in 1997, required that all pooling should be unified at the provincial level, only about half of the provinces (17 out of 31) in China have achieved provincial-level pooling as of the end of 2008.³⁰⁶

Good governance is not reflected in the implementation portion of the pension schemes either. The fragmented administration system makes it hard to identify the division of roles and responsibilities between local and national administrations. There is always a gap between the goals of policy-makers and implementation of policy at the local level. Although the pension reforms described in Document No. 26, and in all consecutive related documents, are meant to be applied nation-wide, in practice, local governments usually do not fully realize these policies due to prioritizing their own

³⁰² Hu, *supra* note 262 at 27.

³⁰³ Sin, *supra* note 290 at 6.

³⁰⁴ *Ibid.*, at 37.

³⁰⁵ Hu, *supra* note 262 at 29.

³⁰⁶ S. Chen, reporter of the 21st Century Economy Report, "Achieving Pooling Funds on the Provincial Level" [in Chinese], online: <http://www.21cbh.com/HTML/2009-2-23/HTML_80M8VH66R3XD.html> (accessed 12 April 2009).

interests. For instance, while Document No. 38 requires a reduction from 11% to 8% for individual accounts, the Shanghai government maintains the 11% level. Although this might be good news for Shanghai contributors, it reflects the fact that large variations exist in pension provisions across the country, and indicates the poor implementation capacity of governments at different levels.

It is also hard to clarify the division of financial responsibilities between the local and national governments during the implementation process. In theory, local pension pooling is supposed to be managed and financed locally but, in practice, the central government has to heavily subsidize local governments in order to prevent local pension systems from financially collapsing.³⁰⁷ It is estimated that, by the end of 2000, the central government had transferred 34 billion RMB (US\$4 billion) to 25 municipalities, amounting to 17% of total pension spending.³⁰⁸

There have been other problems at the operational level throughout the implementation process. The portability problem is typical. In many cases, individual workers who move between different levels of government are not entitled to transfer their pension contributions, which impedes labour mobility and reduces productivity.³⁰⁹ Evasion is another serious problem. Local governments have little incentive to strictly enforce the contributions from enterprises, especially when the economic circumstances are not positive, since the central government will take over financial responsibility eventually. There is also the problem of failure to collect and keep accurate records.³¹⁰ It is important to collect and maintain records of individuals as well as of the whole system

³⁰⁷ Salditt, *supra* note 263 at 41.

³⁰⁸ James, *supra* note 283 at 62.

³⁰⁹ Salditt, *supra* note 263 at 40.

³¹⁰ See Sin, *supra* note 290.

in order to process individuals' benefit claims accurately and to have a clear picture of the entire system. However, accurate record collection is typically not the case in China, for a variety of reasons, such as poorly trained administrative staff, lack of sufficient infrastructure (such as computers), and the existence of a range of different data collection methods.

In summary, governance capacity in connection with the pension system in China is not optimal at either the national or the local level. It is hard to identify good governance in the decision-making process, the institutional arrangements or in the implementation process. Therefore, good governance, one of the conditions for a successful World Bank model, is not met in the context of China.

Condition Two: Low Implicit Pension Debt

The second pre-condition of the World Bank model is low implicit pension debt ("IPD"). IPD is a measure of the present value of projected liabilities under the pension system, which covers both current pensioners and those who will acquire rights in the future.³¹¹ The IPD is seen by the World Bank as a useful indicator to measure the stock of all outstanding liabilities.³¹² However, consensus has not yet been reached about the definition of IPD.³¹³ According to the World Bank, in a broad sense, IPD is understood as the government's obligation to pay benefit entitlements in present value terms. The provision covers current pensioners and those who are still contributing, but with

³¹¹ Sin, *supra* note 290 at 28.

³¹² *Ibid.*

³¹³ See World Bank, *Old Age Crisis*, *supra* note 139; see also Cichon, *supra* note 287; Y. Wang, *infra* note 315.

entitlements accrued in respect of years of service and contributions to date.³¹⁴ Another related concept is the financial gap. There will be a financing gap, since expenditures to pensioners and future retirees must continue when some of the contributions are diverted to fund individual accounts.³¹⁵ IPD and the financial gap are two well-accepted benchmarks for measuring the fiscal sustainability of a pension system, i.e. the financial soundness of the system, now and in the future.³¹⁶

The World Bank has measured China's IPD from time to time. Early estimates ranged between 46% and 69% of GDP for 1994.³¹⁷ According to the 2000 assessment, the IPD climbed to 95% of GDP for 1998.³¹⁸ The latest assessment was released in 2005, which indicates the IPD amounted to 141% of the GDP for 2001, or approximately US\$1.6 trillion.³¹⁹

The financial gap must be covered to move towards a funded plan, and the Chinese government has not yet found a way to accomplish this.³²⁰ In practice, as indicated above, contributions in individual accounts are transferred to the pooled funds to pay current retirees, leading to empty individual accounts. However, the financial gap remains. The total deficit is the same, no matter how it is reflected, in the form of pooled-fund deficits or in the form of individual account deficits. The pooled deficit was as high as 800 billion

³¹⁴ Sin, *supra* note 290 at 29.

³¹⁵ Y. Wang, "Implicit Pension Debt, Transition Cost, Options and Impact of China's Pension Reform" World Bank Policy Research Working Paper No. 2555, (2001) at 10 [Y. Wang].

³¹⁶ *Ibid.*, at 28.

³¹⁷ World Bank, *supra* note 241 at 58.

³¹⁸ Sin, *supra* note 290 at 29.

³¹⁹ *Ibid.*, at 30.

³²⁰ *Ibid.*, at 54.

RMB by the end of 2006.³²¹ More seriously, even when funds from individual accounts are transferred to the pooled funds, there remains the risk of financial collapse of the local pension system. As was described above, the central government has to frequently bail out local pooled funds.

A pilot project was thus launched in Liaoning Province. It was an experiment to see what kinds of resources could be generated to cover the financial gap towards implementing the World Bank model.³²² In order to build a separate pooled fund as pillar one, and achieve real full funding of individual accounts as pillar two, the Liaoning government actually had to rely heavily on the financial support of the central government. It is estimated the massive financial support from the central government amounted to more than 70% of the funds in the relevant individual accounts.³²³

Based on international experience, there are three principal ways to finance transition: reduce the value of IPD; find special assets; and use taxation or issuing debt.³²⁴ In fact, the government has tried to reduce the IPD and finance transition through maintaining high contribution rates while reducing benefits, and by extending coverage to workers in private sectors to raise funding. However, the IPD keeps growing and the financial gap is acknowledged to be large. Therefore, the second condition, low implicit pension debt, also does not exist in China.

³²¹ See *supra* note 252.

³²² *Ibid.*

³²³ B. Zheng, "Assessment for Social Security Pilot in Jilin and Hei Longjiang of China" (2006)14:5 *China & World Economy* 65 at 68.

³²⁴ See Y. Wang, *supra* note 315.

Condition Three: Mature Capital Market

A mature capital market is another condition needed in order to successfully implement the World Bank model. The stock market, the bond market, and the banking system are briefly reviewed in order to determine whether the national capital market is sufficiently mature.

The stock market is important for a pension plan. Empirical data show that a large number of pension assets are invested in equities in order to achieve high potential returns.³²⁵ Under the planned economy, investment in the stock market was discouraged because it was viewed as characteristic of capitalist society.³²⁶ In order to build a socialist market economy, the equity market gradually developed in line with economic reform. The Shanghai Stock Exchange (“SSE”) was established in November 1990, and five months later, the Shenzhen Stock Exchange (“SZSE”) was established.³²⁷ Since then the stock market in China has developed quickly. The number of listed securities on the SSE reached 1,185 and market capitalization amounted to around US\$ 1,642 billion in February 2009.³²⁸

However, the stock market is still relatively small in terms of size (market capitalization/GDP) and efficiency (total value traded/GDP).³²⁹ As of 2004, it was estimated that the market capitalization to GDP ratio for China was 39%, three times

³²⁵ See G. Clark & Y. Hu, *Re-Writing Pension Fund Capitalism 2: The UK Pension Crisis and Trends in Occupational Pension Plan Benefits, 1950-2004*, WPG 0509, Economic Geography Working Paper (England: The University of Oxford, 2005).

³²⁶ Hu, *supra* note 262 at 40.

³²⁷ Shanghai Stock Exchange, “Development of the Stock Market” [in Chinese], online: <<http://www.sse.com.cn/cs/zhs/xxjl/jy/bbyd/yuandi/paper20070709.pdf>> (accessed 1 April 2009).

³²⁸ Shanghai Stock Exchange, “Monthly Statistic (February 2009)” [in Chinese], online: <http://www.sse.com.cn/ps/zhs/yjcb/ybtj/sse_stat_monthly_200902.pdf> (accessed 1 April 2009).

³²⁹ Hu, *supra* note 262 at 40-41.

smaller than that of OECD countries. In terms of efficiency, the ratio of total value traded to GDP was 45% for China, compared to 45% for low income countries, and 113% for OECD countries.³³⁰ In addition, volatility is another major problem of the stock market in China.³³¹ Over the period 1994-2005, the level of volatility was 0.104, while it was 0.064 for emerging markets, and only 0.039 for all developed countries.³³² China's stock market also suffers from poor disclosure of information, overly speculative activities and strong policy influences.³³³

A sound bond market is also important for any pension reform,³³⁴ not only because bonds play an important role in pension fund portfolios, but also because bonds are often issued to cover the financial gap during the transition towards a funded pension system. Therefore, a strong bond market is a pre-condition to transitioning to a funded pension system.³³⁵

China's bond market, just like its stock market, is one of the largest in Asia in absolute value, but is still small as a percentage of GDP.³³⁶ Between 1990 and 2004, the ratio of bond market capitalization to GDP in China was less than that of OECD countries and EMEs. As for 2003, the ratio was only 30% for China, while it was above 90% for OECD countries. Even the ratio of EMEs, i.e. 40%, was higher than that of

³³⁰ *Ibid.*, at 41.

³³¹ See J. Du & S. Wei, "Does Insider Trading Raise Market Volatility?" (2002) 114 *The Economic Journal* 927.

³³² Hu, *supra* note 262 at 42.

³³³ Y. Pai, *Comparing Individual Retirement Accounts in Asia: Singapore, Thailand, Hong Kong and PRC*, Discussion Paper (World Bank, 2006) at 59 [Pai].

³³⁴ See OECD (Organization of Economic Cooperation and Development), *Pension Markets in Focus*, (Paris: OECD, 2005) [OECD, *Pension Markets*].

³³⁵ Hu, *supra* note 262 at 55.

³³⁶ Pai, *supra* note 333 at 60.

China.³³⁷ As to returns, China's long-term government bonds yielded even lower returns than those of EMEs, not to mention those of OECD countries.³³⁸ For example, in 2004, China's long-term bonds had a real return of -0.91%, much lower than a return of 4.42% for EMEs, and of 5.56% for selected OECD countries.³³⁹

While the sizes of the stock and bond markets in China are small in terms of percentage of GDP, the size of China's banking system is disproportionately large. The bank credit to GDP ratio was as high as 167% in China in 2004.³⁴⁰ In all, the relatively large size of China's banking industry indicates the early state of China's financial development.³⁴¹ China's financial system is not only characterized by a dominant large banking sector, but also by the inefficiency of the banking system.³⁴² For instance, the overhead costs relative to bank total assets were three to four times higher than those of selected developed countries.³⁴³

All in all, the stock market and the bond market are both small and inefficient, requiring improvement in various aspects, while the bank system is large in size, but inefficient on an operational level. These factors suggest that the financial market in China is underdeveloped and far from mature. In fact, the immature capital market is

³³⁷ Hu, *supra* note 262 at 56.

³³⁸ *Ibid.*

³³⁹ *Ibid.*

³⁴⁰ *Ibid.*, at 36.

³⁴¹ OECD, *Pension Markets*, *supra* note 334.

³⁴² Hu, *supra* note 262 at 37.

³⁴³ F. Allen, J. Qian & M. Qian, *China's Financial System: Past, Present and Future*, Working Paper 05-17 (Wharton Financial Institutions Centre, University of Pennsylvania, 2005).

usually viewed as one of the major obstacles to pension reform in China.³⁴⁴ Thus, the third condition, a mature capital market, is not found in the context of China.

However, it is worth noting that even within a country that has a mature capital market, there remains a high risk that pension benefits will become vulnerable to that capital market. The 1997 financial crisis in Asia and the most recent economic recession that began in 2008 both highlight the vulnerability of all countries to changing capital markets whether or not the particular capital market in question is considered to be mature.

III. Conclusion

As a result of applying the foregoing analysis of the World Bank's 1994 pension model in the context of the pension system in China, and in relation to China's governance capacity, capital markets and financial gap for transition, I conclude that the World Bank model is not the ideal model for China for two reasons. One is that, over the past three decades, the pension reforms in line with the World Bank model have failed to broaden coverage while they have continuously reduced pension benefits. The other is that the three conditions (i.e. good governance, low implicit pension debt, and a mature capital market) that must be fulfilled before the World Bank model can be implemented are all absent in the context of China.

³⁴⁴ See Trinh, *supra* note 116; Pai, *supra* note 333. See also Y. Wang, *supra* note 315.

CONCLUSION AND PROPOSAL

One goal of this thesis has been to situate the ongoing changes to the Chinese pension regime during the past three decades in light of China's legal and economic systems and in light of the recommendations of the World Bank. I first examined the relationship between economic development, the rule of law, and pension reform, and then looked at the position of the World Bank. I argued that, although there are two general definitions of the rule of law, thin theory has more advantages, especially on the practical level. I also contended that the prevailing view of the relationship between the rule of law and economic development is causal. In addition to providing an academic literature review, I explored the theoretical and practical positions of the World Bank, which have had an immense impact on China's marketization and pension reform processes. Based on my literature review, I examined the legal system in China and concluded that China has not yet achieved the rule of law. I also identified some of the problems of China's legal system that prevent China from achieving the rule of law. After the examination of the legal system in China, I turned to the economic contexts in which the pension system has been embedded. I reviewed the development of the pension system in line with economic reform in China, and I concluded that changes to the pension system have mirrored changes to the economic structure, although not necessarily in a positive way. While the initial pension system, the "iron rice bowl", worked comparatively well under the planned economy, it broke down during the Cultural Revolution and was subjected to reform when China began the marketization process in order to establish a socialist market economy.

Another goal of this thesis has been to examine the 1994 World Bank pension model in the context of China. I compared the World Bank model with the ILO model in order to determine where, and to what extent, the two models converge and diverge. I applied the lessons that I learned through this comparison in the context of China. I argued that the consequences of reforming the pension system based on the World Bank model are not good. I also asserted that the conditions for properly implementing such a model do not exist in China. I reached the conclusion that the World Bank model is not the ideal reform choice for China.

Suggesting a full comprehensive pension reform package is too large a task to be undertaken in this thesis; however, it is possible to suggest some reforms China could consider. Two reforms relate to the details of the design of a pension system, while the other two focus on the legal and social background to pension reform in China. The four proposals are: (1) setting up a national pension law; (2) encouraging public participation in pension reforms; (3) introducing a universal pension plan; and (4) increasing retirement age.

One proposal concerning the design of the pension plan is the introduction of a universal basic pension plan. Such a plan refers to a non-contributory universal retirement benefit paid at a flat rate to all who qualify by residence or citizenship once they reach a designated age.³⁴⁵ That is to say, beneficiaries would not directly participate in the financing of benefits, but, instead, benefits could be financed through general revenues. The standard of such a universal plan could vary across countries depending

³⁴⁵ L. Willmore, "Universal Pensions for Developing Countries" (2006) 35:1 World Development 1 at 24-51 [Willmore].

mostly on their financial capacities, but it would usually be set to the poverty line, either locally or internationally.³⁴⁶ The World Bank acknowledges that:

[The universal plan] is probably the best way to provide poverty relief to the elderly. Considering the difficulty of identifying who among the elderly is poor, the principal merit of the program is that its universality avoids the targeting issue.³⁴⁷

There are several advantages to a universal plan. The broad coverage it provides is the most significant one; all those excluded from the current system could be covered. Coverage would include China's large rural population, vulnerable groups such as those with disabilities and women, who may not be working for wages, as well as those low-income individuals who cannot afford to contribute. Since the universal plan would not link benefits with contributions, individuals with no or limited contributions would still have access to benefits. Thus, the solidarity component of the public pension plan would be reflected. In addition, the administrative cost would be low when compared to a means-tested plan, which would be very important for China, since its governance capacity is not optimal.

Another advantage that is often not recognized by many is that such a universal plan is not costly. As is estimated by the United Nations, the total cost for such a plan would be less than 1% of GDP in 2005 for most countries.³⁴⁸ In China, if all those people above 65 years of age had received a \$1 per day pension in 2006, it would have only accounted for 1.2% of the total GDP (258.6 billion RMB). Given that the Chinese government is ready to pay the implicit debt, which amounts to 800 billion RMB, it does not seem to be

³⁴⁶ One popular convention was US\$1 per day, which was proposed by the World Bank in 1990. However, many consider it is no longer appropriate today. See M. Ravallion, S. Chen & P Sangraula, "Dollar a Day Revisited" *The World Bank Policy Research Working Paper*, No. 4620 (2008).

³⁴⁷ World Bank, *Old Age Income Support*, *supra* note 222 at 32.

³⁴⁸ United Nations, *World Economic and Social Survey 2007-Development in An Aging World* (New York: United Nations, 2007).

an unbearable financial burden. However, if it is too expensive to move to a universal plan, the cost of such a plan could be lowered by increasing age eligibility or by reducing benefits. For instance, Mauritius provides age-differentiated benefits in order to lower costs by providing a modest pension for the “youngest old” and a larger pension for the “oldest old”.³⁴⁹

Another possible approach concerning the detail of the pension plan design is to increase the retirement age. It is well accepted that the aging crisis can be dealt with by increasing retirement age.³⁵⁰ In the context of China, the current normal retirement age is 60 for men and 50 for women (55 for women in managerial positions). These retirement ages are quite low compared to those in most of the OECD countries and in some Asian countries. The impact of a retirement age increase on budgetary savings would be substantial. It was estimated that increasing the retirement age by six months for every year, phased in over a 20-year period for men and over a 32-year period for women, would have reduced the implicit pension debt from 141% of GDP to 117% of GDP in 2001.³⁵¹ The required contribution rate would also have declined, from 35% of wages to 27% of wages.³⁵² Zhigang Yuan and Jin Feng have reached the same conclusion. They indicated that if the replacement rate is 60% when women retire at age 55 and men at age 60, the contribution rate is 36.43%, but if the retirement age were increased by five years (60 for women and 65 for men), the contribution rate would decrease to 25.16% (2005).

³⁴⁹ Willmore, *supra* note 345 at 25.

³⁵⁰ See Z. Yuan & J. Feng, “Rethinking Pension Reform in China” [in Chinese], (2005) 2:3 China and World Economy 40 [Yuan & Feng].

³⁵¹ Sin, *supra* note 290 at vi.

³⁵² *Ibid.*, at 44.

It is worth noting that the retirement age was set in 1951 when average life expectancy was merely 40 years, while average life expectancy had increased to 71.4 by 2000.³⁵³

The third suggestion relates to building a foundation for pension reform in China, i.e. establishing a national pension law. The legal climate in China, as discussed above, is not a favourable one. China has not yet achieved the rule of law. In recognition of the problematic legal environment, Mark Frazier claims that the need for nationwide pension legislation is largely academic and that the fundamental social concern should be detached from the financial problem.³⁵⁴ However, a national pension law, in my view, will at least benefit pension reform in the following respects. First, a national pension law could clarify the powers and responsibilities of different administrations, both on the national level and on the local level. Once the responsibility for pensions is clear, there would be fewer administrations involved in the decision-making process, and the harm to pension reform caused by the clashing interests of various bureaus could largely be eliminated. A national pension law is also essential in order to identify the divisions of managerial and financial responsibility between the central and local governments, which is very important for a highly fragmented pension system such as the one that exists in China. Local governments have too heavily relied upon the central government. In fact, local governments' financial dependency will soon be beyond the financial capacity of the central government and will harm its financial sustainability. As well, dependence on the central government reduces the incentive of local governments to collect contributions, while local governments may issue policies that are in favour of local

³⁵³ Yuan & Feng, *supra* note 350 at 49.

³⁵⁴ M. Frazier, "China's Pension Reform and Its Discontents" (2004) 51 *The China Journal* 97 at 114 [Frazier].

interests (as in the example of the Shanghai government keeping the 11% individual accounts unchanged). Ironically, this damages the central government in the end.

Second, a national pension law would increase the government's credibility and public confidence in the system. The frequent changes in pension regulations over the past 30 years have weakened the public's confidence in the government's capacity to provide pension benefits.³⁵⁵ The National People's Congress has promulgated close to 200 laws, regulations and policies on old age issues over the last 20 years.³⁵⁶ Once the national pension law provided the framework for a pension system, there would be relatively less uncertainty and ambiguity from the point of view of employers and employees. Last but not least, a national pension law could reduce political intervention and arbitrariness. According to a survey conducted by Mark Frazier in China, local government and officials tend to exercise arbitrary discretion as a result of vague national policies and fragmented systems.³⁵⁷ For example, there are many enterprises that delay contributions, and social security officials sometimes pick the enterprises they want to target instead of strictly enforcing compliance for all.³⁵⁸ Therefore, it is not surprising that corruption scandals involving the misuse of retirement funds by officials occur from time to time. In particular, the Shanghai pension fund scandal was very serious. In August 2006, investigators discovered that the Shanghai Social Security Fund had invested approximately one third of the fund in highly speculative real estate projects, which was obviously against the pension investment regulations. Shanghai's Communist

³⁵⁵ Hu, *supra* note 262 at 33.

³⁵⁶ State Council Information Office, "The Development of the Old Age Provision in China", online: <<http://www.scio.gov.cn/gzdt/ldhd/200612/t103912.htm>> (accessed 12 April 2009).

³⁵⁷ Frazier, *supra* note 354 at 110.

³⁵⁸ *Ibid.*

Party chief, Chen Liangyu, as well as the head of the Social Security Bureau, Zhu Junyi, were jailed for corruption since it was established that they, together with many other officials, personally benefitted from these transfers. A national pension law that clarifies the responsibilities of different levels of administration could reduce arbitrariness and prevent corruption, which would in turn increase the credibility of the government and the trust of citizens. According to a survey conducted by Frazier in Shanghai and Beijing in 2005, 94.8% of the correspondents in Beijing and 93.5% in Shanghai believed that their pension benefits would be more secure if China passed a national pension law.³⁵⁹

My last proposal is to expand public involvement during the pension reform process. The pension system is, in fact, an implicit social contract between individuals and the state.³⁶⁰ As described by John Myles and Paul Pierson, “pension systems are essentially a code of laws stipulating who may make claims on the state and under what conditions”.³⁶¹ However, when the state tries to break the implicit contract by launching unilateral pension reforms, it is natural that individuals should at least be informed of the changes before they accept the new “contract”. Regretfully, this is not the case in China. While there are pension experts and social security bureau staff members who participate in the process of pension reform, individuals do not have a chance to get involved. Jia Daming, a pension scholar in China, said,

It is really strange to see that in today’s China, when the rise of the rate for electricity, water and even taxi fees was decided on the basis of hearing and public

³⁵⁹ M. Frazier, “Pensions, Public Opinion, and the Graying of China” (2006) 1 Asia Policy 43 at 59.

³⁶⁰ Frazier, *supra* note 354 at 97.

³⁶¹ *Ibid.*, citing J. Myles & P. Pierson, “The Comparative Political Economy of Pension Reform” in P. Pierson, ed., *The New Politics of the Welfare State* (New York: Oxford University Press, 2001) at 321.

debate, the process of pension policy making was going on secretly and was enacted without any public involvement.³⁶²

Although individuals are not able to change the government through the ballot box, they can be a potentially large threat to social stability if the government forces them to accept a new pension plan without their having had real involvement in the reform process.³⁶³ According to Nauryzbayeva, there are three criteria for genuine public involvement in the policy-making process,

... interested parties occupying distinct position; their willingness and ability to articulate and promote their positions with a certain degree of proficiency (expert capacity) and political framework for the dialogue.³⁶⁴

Unfortunately, none of the three criteria was met through the social security reform process in China. Interest groups do exist; however, they have no distinct position, and no expert capacity – and there is no political framework for dialogue. The best illustration of the absence of real public involvement in China is the lack of trade union involvement in pension reform. While strong trade unions have played an important role in the process of pension reform in other countries, trade unions in China are not independent, and thus cannot really represent the interests of employees. A trade union official once admitted that unions have the dual roles “of supporting the foreign investors, but also monitoring whether the management is abiding by the labour laws”.³⁶⁵ Unfortunately, in an environment in which the reform process is strictly closed to the public and in which reform is not clearly explained and justified, there is a potential threat to social stability.

³⁶² D. Jia, “What Is Harsher Than the New Pension Policy?” [in Chinese], in (2006) 35 *Inside Information on Economic Reform*.

³⁶³ Frazier, *supra* note 354 at 66.

³⁶⁴ Z. Nauryzbayeva, “Bridging Research and Policy: The Role of Expertise in the Policy Process in Transition Society — The Case of Pension Reform in Kazakhstan”, online: <<http://www.policy.hu/nauryzbayeva/frp.doc>> (accessed 12 April 2009).

³⁶⁵ Lee, *supra* note 163 at 79.

Therefore, public hearings and public debate, as well as other possible means, should be encouraged in order to offset the political transition costs of pension reform. After all,

Pension reform and other social sector reforms are more complicated politically than “first generation” structural adjustment reforms ... Whereas structural adjustment reforms could be designed by insulated technicians, implemented through executive decree, and rarely target particular groups, social sector reforms directly affect the interests and eventually require the active participation of consumers and producers as well as approval by elected legislation.³⁶⁶

The four proposals I have suggested can contribute to the development of a pension system, but such reform should not be rushed into practice before further research is completed. One of my concerns relates to the implementation of a universal pension plan and increasing the retirement age. The pension system is not an isolated public program but a part of the entire public welfare system and should not be dealt with separately from other programs, such as health care and housing. A universal pension is more effective in alleviating poverty in old age if decent health care and housing systems exist. However, currently, the pension system and the health care system are fragmented among provinces and even cities. This fragmentation creates barriers to a unified social security system in China. China is a country with 31 provinces and four municipal cities. But economic development varies greatly across these jurisdictions and great disparities exist across the whole nation in nearly all important socioeconomic dimensions – demography, income, and growth.³⁶⁷ The health care and social assistance systems are very complex and have also experienced several reforms since the beginnings of economic reform. The absence of a national law has exacerbated such fragmentation. It would be interesting to study the

³⁶⁶ J. Estelle & S. Brooks, “The Political Economy of Structural Pension Reform” in R. Holzmann & J. Stiglitz, eds., *New Ideas About Old Age Security* (Washington DC: World Bank, 2001) 133 at 155.

³⁶⁷ World Bank, *Pension Reform*, *supra* note 192 at 28.

feasibility of reforming the pension system together with health care, and the social assistance system as a whole, rather than reforming each separately.

There is also the contradiction between increasing the retirement age, which may be satisfactory in dealing with the old age crisis, and exacerbating youth unemployment. It is true that the young adult population has been declining. However, economic reform has increased labour mobility, and many young people in rural areas are now moving to cities to seek jobs. As a result, the absolute number of young workers has increased sharply in urban areas. Creation of a balance between increasing the retirement age to deal with the old age crisis and preventing youth unemployment remains a challenge that must be addressed.

Another of my concerns relates to the effect of issuing a national pension law. There remains much additional research to be done. For example, although issuing a national pension law has several benefits, it is an open question as to the appropriate level for promulgating a national pension law affecting pension reform. As indicated above, the pension system in China remains fragmented. Pension funds are collected and managed at the provincial or even municipal levels. Will the creation of a national pension law fundamentally change this situation? This is not an easy question to answer. Law in China has some characteristics that are different from law in a western rule of law country. The ambiguous relationship between law and the policies of the Chinese Communist Party is a good example. It would be too much to anticipate the establishment of a unified national pension system simply by promulgating a national pension law. Thus, while I conclude that China has a long way to go before it develops a decent pension system, I hope that my thesis has been a step on that long journey.

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