

## PENSION REFORM IN CHINA: A QUESTION OF PROPERTY RIGHTS

*James A. Dorn*

China's aging population will sharply increase the number of retirees who have to be supported by each worker in the next several decades. That demographic problem combined with the inability of state-owned enterprises (SOEs) to cover even the pensions of current retirees makes reform of the pay-as-you-go (PAYG) system a top priority. The State Council has issued a number of decrees calling for moving to a multi-pillar system, incorporating both a defined benefit PAYG plan and a defined contribution plan with fully funded individual accounts, but little progress has been made (Wang et al. 2004).

Today China has a highly fragmented social security "system" confined primarily to workers in urban SOEs and some collectives. The high payroll tax rates and precarious nature of the system have led to noncompliance and evasion, and workers in the nonstate sector have little incentive to join (Zhao and Xu 2002).

To solve China's pension crisis, one must also address the loss-ridden SOEs and the weak condition of the four large state-owned banks. Pension reform cannot be successful without a broad-based change in China's ownership structure. The lack of well-defined property rights to pensions, enterprise assets, and bank capital means that China's financial sector needs radical reform.

This article focuses on China's pension crisis from the perspective of property rights theory. The issue of pension reform is essentially a question of property rights: Should pension funds be fully funded and individually owned or should the state socialize assets by taking wealth from the younger working generation and redistributing it to

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James A. Dorn is Vice President for Academic Affairs at the Cato Institute and Professor of Economics at Towson University in Maryland. An earlier version of this study was presented at a conference on "China's Pension System: Crisis and Challenge," sponsored by the Cato Institute and Peking University's China Center for Economic Research. The author thanks Jacobo Rodríguez for his helpful comments in revising this article for publication.

the older retired generation? In the privatized system, individuals will have an incentive to act responsibly and to save and invest for the future. In the PAYG system, there is no saving and investment. Individuals look to the state for their future welfare, retirement becomes politicized, and property plundered.

I shall argue that the best way for China to put its pension system on a sound footing is by large-scale privatization. Implicit pension debt must be made explicit and the current hybrid system must be fully privatized along with SOEs and state-owned banks. Trying to “revitalize” SOEs and “recapitalize” state banks will not do the job as long as majority ownership remains in the hands of government officials. Investment decisions will be politicized and capital will not go to its highest valued uses. Corruption will continue and wealth will be squandered as special interests vie for political favors.

Although the pace of economic reform will depend to a large extent on political reform, a sound understanding of the importance of private property rights for the future of capital markets in China is an essential first step toward reform.

## China’s Pension Crisis

Table 1 summarizes the key data illustrating the problems confronting China’s PAYG pension system. The old-age dependency ratio (i.e., the number of people who are age 65 or older relative to those age 15 to 64) will increase from 11 percent in 2005 to 25 percent in 2030 and 39 percent by midcentury. Meanwhile, the system dependency ratio (that is, the number of pensioners supported by each worker paying into the system) will increase from 35 percent in 2005 to 53 percent in 2030 and 69 percent by 2050 (Figure 1). In other words, less than 3 workers will be supporting each retiree in 2005, less than 2 by 2030, and less than 1.5 by midcentury.

The more immediate problem is that there is a negative cash flow in the pension system that will increase significantly over the next several decades (Figure 2). In 2005 the deficit is expected to be nearly RMB 50 billion (in constant 2000 yuan) or nearly \$6 billion (\$1 = RMB 8.28). By 2030 the deficit will reach RMB 630 billion (\$76 billion), and by 2050 nearly RMB 1.5 trillion (\$181 billion). Without reform the accumulated reserves in the current pension system will be – RMB 123 billion in 2005 (in constant 2000 yuan), increasing to – RMB 8.6 trillion in 2030 and – RMB 41 trillion in 2050. To balance the system, payroll tax rates would have to rise dramatically from 27 percent in 2005 to 45 percent in 2030 and nearly 60 percent in 2050

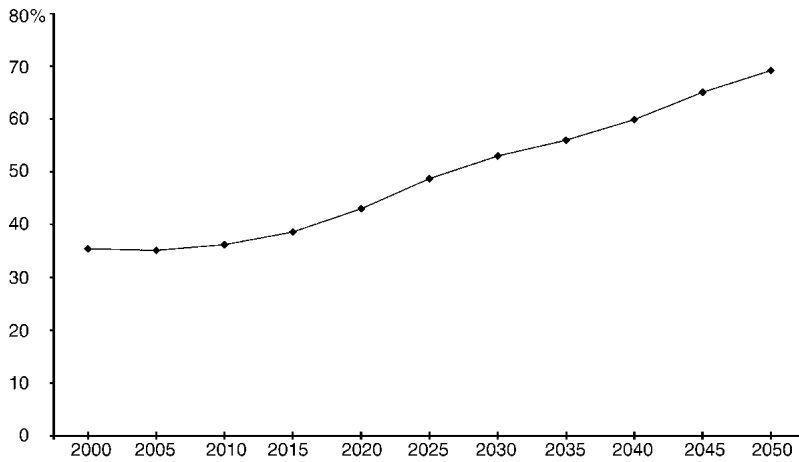
TABLE 1  
CHINA'S PENSION CRISIS

Year	2000	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
Dependency Ratios (%)											
Old-age dependency ratio (65+/15-64)	10.6	11.4	12.4	14.5	18.2	21.0	25.3	31.5	36.6	38.1	39.2
System dependency ratio	35.4	35.1	36.2	38.6	43.0	48.7	53.0	56.0	59.9	65.1	69.2
Financial Conditions (RMB 10 billion, in 2000 yuan)											
Revenue	17.2	25.8	36.3	43.5	50.3	56.9	63.9	71.3	78.5	84.3	90.1
Expenditure	21.2	30.6	42.9	58.7	78.3	102.5	126.9	149.4	174.0	203.1	235.3
Annual balance	-4.0	-4.8	-6.6	-15.1	-28.0	-45.6	-63.0	-78.1	-95.5	-118.8	-145.2
Accumulated res.	9.7	-12.3	-45.9	-111.7	-245.9	-484.2	-860.1	-1,384.0	-2,070.2	-2,966.1	-4,126.3
Bal. Contrib. Rate (%)	28.0	27.0	27.0	30.7	35.5	41.1	45.3	47.8	50.5	54.9	59.5

NOTE: RMB 8.28 = \$1.

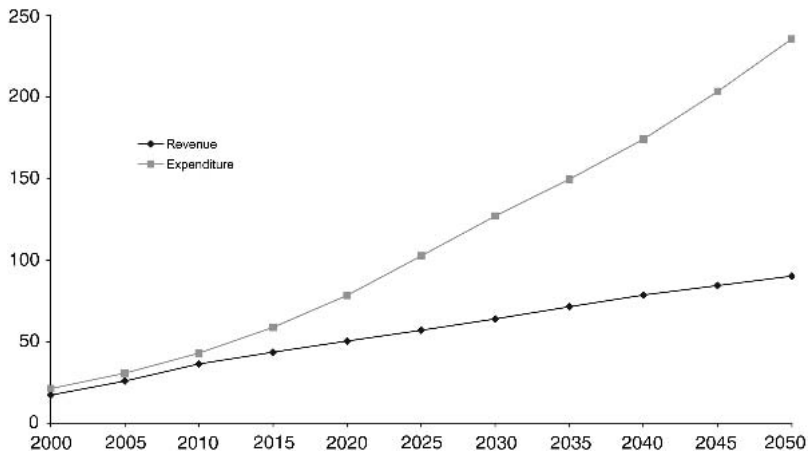
SOURCE: Wang et al. (2004: Table 5).

FIGURE 1  
A RISING DEPENDENCY RATIO IN CHINA'S PENSION SYSTEM  
(RETIREES PER WORKER, %)



SOURCE: Wang et al. (2004: Table 5).

FIGURE 2  
PROJECTED DEFICITS IN CHINA'S PENSION SYSTEM  
(RMB 10 BILLION, IN 2000 YUAN)



SOURCE: Wang et al. (2004: Table 5).

(Wang et al. 2004: Table 5). Such increases would cripple economic growth.

Another useful measure of the system's financial condition is the implicit pension debt (IPD)—that is, the present value of all future benefits promised to current retirees and to those still in the work force who have paid into the system, *assuming the PAYG system is immediately terminated* (World Bank 1997: 33).<sup>1</sup> Wang et al. (2004: Table 6) estimate that China's IPD is about RMB 4.4 trillion (in constant 2000 yuan) or 48 percent of gross domestic product (GDP). They assume that the old system ended in 2000, public institutions and government workers are excluded, and the discount rate is 4.5 percent. They also assume that the old pension regime was a pure PAYG system because most of the individual accounts set up as part of the multi-pillar system announced in 1997 were not funded. Indeed, they are notional and contain no real assets. Finally, the authors assume that the payroll tax rate is 24 percent and that the replacement rate is 60 percent. When public institutions and government workers are included, the IPD increases to nearly 64 percent of GDP.

The above data paint a very bleak picture of the present system. As Wang et al. (2004: 120) conclude, "Our baseline calibration confirms that the current PAYG system is not financially sustainable and that its high annual deficit threatens China's fiscal stability." Even if benefits were reduced and the retirement age increased, the system would still not be viable because payroll taxes would have to be increased dramatically. Fundamental, not piecemeal, reform is necessary.

### Empowering Workers

Before leaving office, Premier Zhu Rongji argued that pension reform is "the lifeline of our workers . . . and we absolutely can't allow any payment delays or embezzlement of the funds" (Hutzler and Leggett 2001: A10). For that reason he recommended that retirement funds be professionally managed and workers be given a wider range of investment options. Moving from a PAYG system to a fully funded system in which workers have property rights in their retirement accounts is clearly consistent with the socialist ideal of empowering workers (Piñera 1998).

Zhao and Xu (2002) calculate what it would cost to end the old system and move to a fully funded system that would achieve the

<sup>1</sup>If the PAYG system were terminated immediately and individuals were all on the new fully funded system, no payroll contributions would go to the old system; all contributions would be invested in the private retirement accounts. Hence, with no contributions to the old system from payroll, all promised benefits under the old system would be unfunded liabilities.

same replacement rate as the current PAYG regime.<sup>2</sup> They estimate that the annual cost of paying off the IPD over a 50-year period would be 1 percent of GDP or 5.6 percent of payroll, assuming the economy grows by 4 percent per year. Thus, *if the old system were terminated*, the cost of funding benefits promised to *current and future* retirees would only be 5.6 percent of payroll compared with the 24 percent tax rate needed to fund *current* retirees under the PAYG system. In addition, if one assumes that (1) the real rate of return on investment under the fully funded system is 6 percent (a reasonable assumption given the high rates of growth in the nonstate sector), (2) wages grow by 4 percent per year, and (3) workers contribute to their individual accounts for 40 years, retire at age 60, and live to age 75, then the new system could achieve a 60 percent replacement rate with an annual contribution equal to 10.2 percent of payroll—compared with the current rate of 24 percent. China could therefore pay off its pension debt *and* fund a private system with a total contribution rate of only 15.8 percent of payroll (Zhao and Xu 2002: 406–12).

It is important to recognize that the above calculation for the fully funded system holds if and only if workers' contributions to their individual accounts remain invested and if workers can earn competitive rates of return. Consequently, to be successful, pension reform must be accompanied by capital freedom—workers must be free to choose among an array of investment options, including investing in the private sector and in foreign markets. Moreover, private pension fund management is essential if the retirement accounts are to be free of political interference. With those conditions satisfied, workers should be able to earn at least 6 percent on their investments, according to Zhao and Xu (2002: 407).

If all the above assumptions hold, then workers in the nonstate sector who have no incentive to enter the PAYG system (or the multitier system with notional accounts) will find the new system attractive. Their broad participation would make the lower contribution rates possible (Zhao and Xu 2002: 411). Moreover, if SOEs and state-owned banks were privatized, the proceeds could be used to fund the transition and give workers new investment opportunities.

<sup>2</sup>The present system can be characterized as a multi-pillar pension system, similar to that proposed by the World Bank (1997), with a public PAYG pillar funded by a 13 percent payroll tax levied on enterprises; a fully funded pillar with individual accounts financed by a combined worker-employer payroll tax of 11 percent; and a voluntary pillar similar to an Individual Retirement Account. However, since the mandatory individual accounts are notional, Zhao and Xu (2002: 399–400), like Wang et al. (2004), treat the current system as a PAYG system financed by a payroll tax of 24 percent and having a replacement rate of 60 percent.

The sale of state assets would also allow authorities to lower the payroll tax needed to finance the new system and fund the IPD.<sup>3</sup> If a broad-based tax were substituted for the payroll tax, rates could be even lower with further gains in efficiency. Finally, the transition period of 50 years could be reduced if workers were given recognition bonds representing their promised benefits under the old system and payable at retirement (Zhao and Xu 2002: 408–9).<sup>4</sup>

The longer China waits to move toward a fully funded system, the more costly that transition will be (World Bank 1997: 33). In 2001, the State Council sanctioned the Liaoning experiment intended to increase the use of “social pooling” and to create a firewall between the PAYG pillar and individual accounts. A National Social Security Fund was also established. But little progress has been made. Assets allocated to the individual accounts have been used to pay current retirees, and the plan to fund the NSSF through the sale of SOE shares never materialized.<sup>5</sup>

Workers will not become empowered until they have full rights to their pension funds. Privatizing the pension system would create new wealth that stays with the workers and could be left to family members or others. Workers would no longer be tied to their firms or be wards of the state upon retirement. The private sector would grow as SOE holdings were reduced and new savings and investment poured into the productive sector of the economy. To achieve those results, China will have to honor its commitment to the World Trade Organization to allow foreign banks to compete fully with state-owned banks by 2007, liberalize interest rates, open capital markets, respect private property rights, and depoliticize banking and commerce.

In December 2003, the Standing Committee of the National People’s Congress approved a constitutional amendment to give greater

<sup>3</sup>If the sale of state assets reduced the IPD to 40 percent of GDP, a tax rate of 0.8 percent of GDP would be sufficient to pay off the IPD over a 50-year period (Zhao and Xu 2002: 410).

<sup>4</sup>The transition time could be reduced to 40 years by giving all workers in the old system recognition bonds—with the last bonds coming due exactly 40 years after the PAYG system was ended—compared with a 50-year transition period when the IPD is financed by taxes. If the IPD were financed with long-term government bonds (debt), the transition period would increase. Zhao and Xu (2002: 405, 409) believe that debt financing is not politically feasible because of the decentralized nature of China’s fiscal system. Li and Li (2003), however, favor debt financing.

<sup>5</sup>In June 2001, a plan was introduced whereby 10 percent of the proceeds from the sale of SOEs’ nontradable shares and from IPOs (initial public offerings) would be earmarked for the NSSF, but that plan was discontinued (Kynge and McGregor 2001: 14; Zhao and Xu 2002: 412).

security to private property. The NPC formally adopted that amendment in March 2004, making a “citizen’s lawful private property. . . inviolable.” Premier Wen Jiabao has pledged to “unswervingly encourage, support and guide the development of the nonpublic sector.” He told the *Washington Post* in November 2003 that protecting private property will “give greater scope to the creativity and enterprising spirit of the Chinese population and will in the end help us achieve the goal of common prosperity” (Goodman 2003: A1).

The great Chinese sage Lao Tzu reached a similar conclusion long ago when he said that when the ruler takes “no action,” “the people of themselves become prosperous” (Chan 1963: 167). The principle of nonintervention or *wu wei* does not mean that government should do nothing but rather that it should take “no action that is contrary to Nature” (Chan 1963: 136). *Wu wei*, therefore, is “the embodiment of suppleness, simplicity, and freedom” (Smith 1991: 208). Although Lao Tzu had no vision of a liberal constitutional order of freedom based on private property, his vision of a spontaneous social order is consistent with classical liberalism (Dorn 1998, 2003).

## Private Property, Freedom, and Prosperity

Establishing a fully funded pension system in China giving workers private property rights to their pension funds would increase economic freedom and prosperity, just as it did in Chile (Piñera 1998). As Jacobo Rodríguez (1999: 2) writes, “Chile has created a retirement system that, by giving workers clearly defined property rights in their pension contributions, offers proper work and investment incentives; acts as an engine of, not an impediment to, economic growth; and enhances personal freedom and dignity.”

Peking University economist Yaohui Zhao (2001: 1) argues:

The best alternative in solving the financial crisis is to give individuals incentives to participate. The best way to give incentives to individuals is to put all pension contributions (from both employer and employee) into individual accounts and make sure that the investment earns competitive returns. This gives individuals the property rights to these accounts.

Once workers’ rights to their pensions are privatized and secure, they will have greater freedom and a brighter future than under the present politicized pension system. Moreover, under a private, fully funded system, demographic issues become irrelevant. The performance



of the pension funds depends solely on the strength of the economy and the investment portfolio, not on the aging of the population. Retirees are no longer supported by workers; there is no intergenerational redistribution of income. A new culture emerges in which the overriding aim of economic policy must be to safeguard property rights and “do no harm”—that is, a policy devoted to enhancing economic freedom and prosperity.

Depoliticizing pensions means that workers will no longer have to depend on government for their retirement income. Individuals, as private owners of their pensions, will be responsible for their future. A culture of freedom will replace the old parasitic culture of dependency; a new constituency will be created in support of limited government and economic freedom. José Piñera, the architect of the Chilean privatization program, is correct when he says, “The world would be a better place if every worker were also an owner of capital” (Piñera 2001: 1).

Opponents of privatization often argue that it increases risk and that a government PAYG system reduces risk. But it is important to recognize that a PAYG system is not risk free. Demographic changes and political pressures to increase benefits run the risk of creating large deficits in the system. Privatization eliminates those risks but introduces market-risk factors. However, if individuals have access to competitive domestic and international capital markets, they can diversify their portfolios and limit their risk exposure. Some people will select higher risk exposure to try to obtain higher returns, but if they know that there will be no government bailout if they fail to achieve the high returns, they are more likely to be conservative than reckless. After all, they are risking their own, not taxpayer, money.

To overcome the fear of markets, people need to appreciate their significance. The market is a network of trust relationships cemented by private property rights and freedom of contract. To the extent those institutions are weakened, the market price system will be distorted and resources will be allocated more by political than by market forces. The value of property rights depends on the scope and enforcement of those rights, especially on the ease of selling property rights and on the rewards one expects to capture from exercising those rights. Any attenuation of private property rights reduces trust and liquidity as reflected in lower market prices. As Ricardo Guajardo, CEO of Bancomer-BBVA, noted at a recent Cato Institute conference in Mexico City (October 24, 2001), investors are “looking for trust and certainty,” which means “property rights should be bulletproof.”

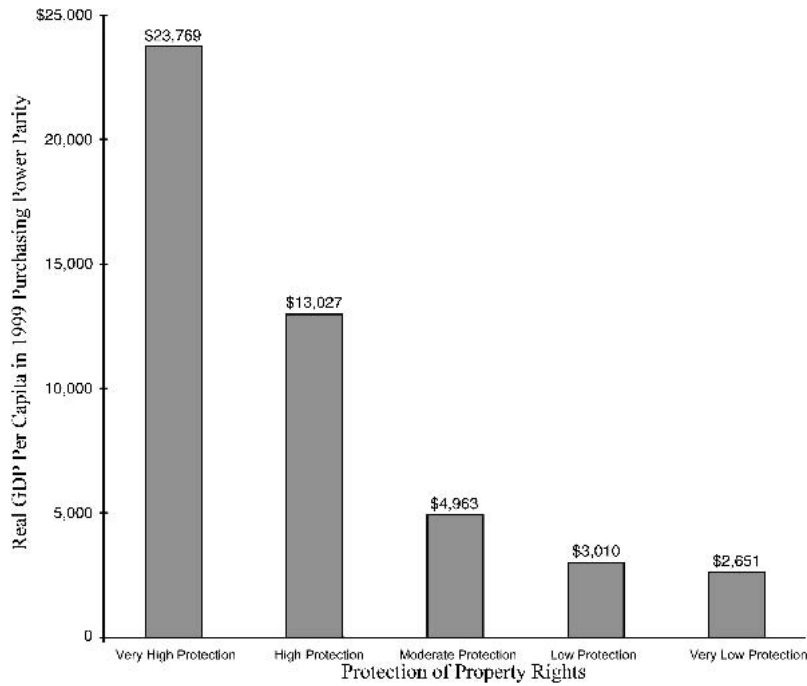
By failing to establish the institutional infrastructure necessary for creating a vibrant private capital market, China is denying itself the chance to create new liquidity and wealth. It is a mistake to think that imposing capital controls and limiting investment opportunities is in China's long-run interest. A key lesson of the Asian financial crisis, according to Federal Reserve Board Chairman Alan Greenspan (1999: 10), is that

where a domestic financial system is not sufficiently robust, the consequences for a real economy of participating in this new, complex global system can be most unwelcome. Improving deficiencies in domestic banking systems in emerging markets will help to limit the toll of the next financial disturbance on their real economies. But if, as I presume, diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress, then steps to foster the development of capital markets in those economies should also have an especial urgency. And the difficult groundwork for building the necessary financial infrastructure—improved accounting standards, bankruptcy procedures, legal frameworks [to protect property rights] and disclosure—will pay dividends of their own.

Assets have little value if people do not have clear title and are not free to put them to their highest valued uses—that is, if there are no private property rights protected by law. As Hernando de Soto, author of *The Mystery of Capital*, notes, “Capital is that value, that additional value, that comes from things that are duly titled”; “capital is also law” (Fettig 2001: 23, 26). Countries are poor when their leaders prevent privatization and fail to abide by the rule of law. Hong Kong is rich not because it has abundant natural resources but because it has market-supporting institutions.

In a study of 150 countries, Lee Hoskins and Ana Eiras (2002) find that countries with stronger private property rights have created more wealth (as measured by real GDP per capita) than countries in which private property rights are attenuated and corruption is high (Figure 3). Likewise, James Gwartney and Robert Lawson (2002: 20) find a strong correlation between economic freedom (as measured by the economic freedom of the world index) and human welfare (as measured by per capita income, economic growth, and life expectancy). They also find that individuals with low incomes fare much better in countries with higher levels of economic freedom. Making private property rights bulletproof does matter. If China wants to revitalize its firms and banks—and solve the pension crisis—it must change ownership, not simply inject more funds into dying institutions.

FIGURE 3  
STRONGER PROPERTY RIGHTS CREATE GREATER WEALTH



SOURCE: Hoskins and Eiras (2002: 40).

### The Inseparability of Pension Reform and Ownership Reform

Creating fully funded pensions should go hand-in-hand with privatizing state-owned enterprises and banks. China's socialist sector is bankrupt and should be allowed to wither away so that the dynamic private sector can grow to its full potential. If China wants real capital markets, then private property rights and freedom of contract must be safeguarded by the rule of law. Firms must be allowed to offer shares and those shares must be fully transferable.<sup>6</sup> Likewise, banks must be put on a sound commercial basis so that they will have the flexibility to adjust quickly to market forces without prior political approval.

<sup>6</sup>Of course, firms must also adopt generally accepted accounting practices and meet certain financial standards in order to list their shares.

Trying to make socialist firms and banks act like private joint-stock companies without changing effective ownership is futile. Indeed, capital markets without widespread private ownership and fully transferable shares are an illusion (Nutter 1968). To be credible, asset (stock) prices must accurately reflect the capitalized values of companies—that is, the discounted value of expected future profits. Product and factor prices must be freely determined to give an accurate profit picture, and interest rates must reflect consumers' time preferences and the productivity of capital to correctly calculate present values.

By failing to create real capital markets, China is failing to take advantage of the gains to be had from specializing in ownership and risk taking.<sup>7</sup> The socialization of risk reduces incentives to innovate and to create wealth. The value of Chinese firms is below what it could be if capital were free to flow to its highest valued uses and if workers were free to own their pensions and to move their funds to where risk-adjusted returns were maximized. It is time for China to put its vast pool of private savings to better use than to bail out state enterprises and prop up state banks that continue to make loans to bankrupt firms.

## China's Challenge

China has been willing to experiment with different ownership forms since 1978 but is still wedded to state ownership. Amending the PRC Constitution to make private property inviolable is an important step toward creating a culture of enterprise. With further liberalization, assuming China honors its commitments under the WTO, there will be an opportunity to spontaneously develop the institutions necessary for real capital markets. Foreign investors can play an important role in that development.

After a decade of reform, China's paramount leader Deng Xiaoping said, "The reform of the political structure and the reform of the economic structure are interdependent and should be coordinated. Without political reform, economic reform cannot succeed" (Deng 1987: 147–48). The challenge for China's new leaders will be to accommodate economic reform by relaxing the Communist Party's monopoly on power and to respect the natural rights of all individuals to life, liberty, and property. The first step is to recognize the importance

<sup>7</sup>For a discussion of the benefits from specialization in ownership and risk taking, see Alchian (1977: chap. 5).

of property rights for China's future prosperity. Shanghai will never match New York or London or Hong Kong without allowing capital freedom.

China's leaders could learn much from the wisdom of Lao Tzu. Nonintervention worked well for Hong Kong, and it can work for China. Indeed, economic liberalization has more than quadrupled real per capita income in China since 1978. Further liberalization will yield additional gains in the battle to alleviate poverty. In particular, China needs to

- Remove restrictions on private ownership and protect property rights;
- Establish a fully funded pension system that empowers workers;
- Liberalize the financial sector and privatize SOEs and state banks;
- Allow full convertibility of the renminbi.

Once property rights are more secure and China's capital markets are liberalized, domestic and foreign investors will have more options and the private sector will have greater opportunities to grow. Moreover, if Greenspan is right, China's financial markets should be better able to weather a crisis.

Privatizing China's pension system would be a giant step in the right direction. A larger privatization program, however, must accompany that step if China is to realize its full potential.

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