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Social Protection, Labor Market Rigidity, and
Enterprise Restructuring in China

by

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Abstract

A major obstacle for enterprise restructuring in economies in transition is labor market rigidity, closely associated with the social protection arrangements put in place in the central planning era. This paper reviews the interaction between social protection and labor market flexibility in China, and evaluates China's experiments with social security reform, labor market reform, and enterprise reform.

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I. Introduction

An unpleasant trade-off facing policy makers in economies in transition is how to reconcile market efficiency and social protection. These economies have inherited from the central planning era a large, inefficient state-owned sector, which employed a large bulk of the total labor force. During the process to transform these state-owned enterprises into competitive, efficient, profit-oriented firms, many of the existing workers, who have been taking lifetime employment for granted, may suddenly confront the risk of losing their jobs. In the absence of an adequate social safety net, high unemployment would cause enormous economic hardship to those vulnerable and even strong backlash against market-oriented reforms.

China started its economic reform as early as in the late 1970s. ^{1/} The initial phase of the reform, which abolished collective agriculture--the People's Communes-- and re-established the family farming system, was remarkably successful. When proceeding to start the urban industrial reform, however, China realized that it was a far more difficult task than rural reform. A key, nevertheless often neglected, difference between rural and urban areas was the difference in the labor market structure. The family farming system granted farmers complete freedom in job choice, labor supply, and decisions concerning saving for old age. Responding to market signals, farmers could move freely from traditional farming to rural township and village industries, or to construction and other tertiary

^{1/} For reviews on China's experience with economic reforms, see Perkins (1988), Blejer, et al (1991), and Bell, et al (1993).

sectors in cities. They were outside China's formal social safety nets even before they were liberalized from the collective farming, so they were unbound by the from-cradle-to-grave socialist welfare system that applied to urban, state-owned sector. By contrast, there was no such labor market flexibility in China's state-owned sector. China's state-owned sector played a dominant role prior to reforms, especially in China's highly centralized urban economy, accounting for 77 percent of China's gross industrial output and employing 78 percent of total urban labor force in 1978 (Tables 1 to 3). If the government had imposed the same kind of market discipline and hard budget constraint to state-owned enterprises, some enterprises would have been closed down and their employees would have been out of work. The government, while committed to market-oriented reforms, was by no means prepared to accept massive unemployment and the associated social and political risk. In the end, China took a cautious and gradual approach to enterprise reforms. The objective was to strike a right balance between improving enterprise efficiency and minimizing the social cost of restructuring. Over the 1980s, China introduced, in a piece-meal fashion, measures to reform its labor market and social security system. It is only by the early 1990s, however, with an appropriate market and social infrastructure already having been put in place, and with the accumulated experience through more than a decade of trial and error with urban reform, that China began to launch full-scale enterprise reforms. While these initiatives have yet to demonstrate their full impact and effectiveness, some of the initial results seem encouraging.

Table 1. China: Role of the State Sector in Urban Employment

(In Tens of Thousands of Workers)

Year	Total Urban Labor Force	State Sector	Collectives	Individual Businesses
1978	9,514	7,451	2,048	15
1982	11,428	8,630	2,651	147
1986	13,292	9,333	3,421	538
1990	14,894	10,346	3,549	835
1992	15,630	10,889	3,621	1,120

Source: Ministry of Labor and State Statistical Bureau, Beijing.

Table 2. China: The Evolving Role of State and Non-State Sectors in Industrial Production

(Percentage Share of Total Industrial Output)

Year	State-Owned Sector	Non-state Sector
1978	77.6	22.4
1979	78.5	21.5
1980	76.0	24.0
1981	74.8	25.2
1982	74.4	25.6
1983	73.3	26.7
1984	69.1	30.9
1985	64.9	35.1
1986	62.3	37.7
1987	59.7	40.3
1988	56.8	43.2
1989	56.1	43.9
1990	54.6	45.4
1991	52.9	47.1
1992	48.1	51.9

Source: State Statistical Yearbook of China, 1993, Beijing.

Table 3. China: The Changing Distribution of Industrial Labor Force
in the State and Non-State Sectors

(Percentage Share of Total Industrial Workers)

Year	State-Owned Sector	Non-state Sector
1978	51.5	48.5
1979	50.9	49.1
1980	49.7	50.3
1981	50.0	50.0
1982	49.7	50.3
1983	49.1	50.9
1984	46.3	53.7
1985	45.2	54.8
1986	44.0	56.0
1987	43.7	56.3
1988	43.8	56.2
1989	44.7	55.3
1990	45.0	55.0
1991	44.9	55.1
1992	44.2	55.8

Source: State Statistical Yearbook of China, 1993, Beijing.

China's experience, consistent with those of other reforming socialist economies, suggests that, without removing rigidity in labor market, the social and economic costs of necessary enterprise restructuring in terms of unemployment would be too high to be politically sustainable. Reforming social safety nets is crucial to increase labor market flexibility and to pave the way for transforming the state-owned sector.

II. Barriers to Enterprise Reform

The literature on economies in transition tends to emphasize that the main problem with state-owned enterprises in economies in transition lies in their public ownership and the associated inefficiency, and thus advocates rapid privatization as the panacea. While ownership, competition and efficiency are closely related to firms' efficiency in both developed market economies and reforming socialist economies, a closer examination of China's pre-reform conditions and experience suggests that the traditional labor market structure and social security system may also constitute very important barriers to enterprise reform. ^{1/}

1. Wage setting and employment in the state-owned sector

Under traditional employment system in China, the state simply assigned workers to enterprises. Since state-owned enterprises were obligated to provide jobs, new hiring decisions had no relations to firms' labor demand. The result was over-staffing in most enterprises. Similarly, potential job market entrants had no need to do job hunting. Though the state attempted to match a worker's skill with his job assignment, this administrative matching, like the rest of the central planning, did not work well. Wages, like commodity prices and interest rates, were set by the state and usually fixed for a long period of time. There was little cross-section variation in compensation between industries and professions. Base wages were entirely determined by seniority, and the total reward had no

^{1/} For a survey on China's evolving social security system, see Ahmad and Hussain (1990).

correspondence with work efforts. Since their pay was not linked to their job performance, workers had little incentive to increase productivity.

2. Enterprise as provider of social protection

Moreover, the state-owned enterprises were obligated to provide a range of social services to their workers, including housing, pensions, and medical insurance. Unlike in the developed market economies, social security system in China was based on individual enterprises and three pillars:

a. Guaranteed job security. Once a worker was assigned to an enterprise, from day one he was guaranteed a lifetime employment. The system of lifetime tenure may have achieved an important social objective, but it may also have had adverse consequences on enterprise efficiency. Instead of inducing corporate loyalty, synergy, and greater work efforts, as it would have been the case in Japan, the system of lifetime employment in China may have actually distorted working incentives and decreased work efforts, due to the so-called "iron rice bowl" effect. What lacked were a competitive external environment and a rational wage structure. In China, the fixed, uniform wage-setting policy severed the link between reward and job performance, and extreme egalitarianism failed to motivate workers.

b. Housing. Enterprises were responsible for providing low-cost accommodation, usually at subsidized rent, to employees. Since housing was constructed and owned by his firm, it was impossible for a worker to keep it if he should, in the unlikely event, switch job to a different firm. A study by the author based on survey data shows that in China's big cities housing was the single most important determinant for a worker to accept one

job over another if given the choice. ^{1/} Since housing constituted such an important part of a worker's remuneration package, he had an extreme aversion to losing it. Therefore, the non-portable housing benefits offered to a worker may also have forced him to stay with a particular firm. It is estimated that job turnover in Chinese cities is less than 1 percent, and mobility for nonagricultural households is estimated to be less than 4 percent, compared with annual mobility rate of 10-20 percent in Korea.

c. Pensions. Enterprises were also responsible for income maintenance for their own retirees. The expenditure on retirement benefits was financed by firm's current revenue. The funding of pensions bore no relations with broadly-based pooling and sharing of resources across firms and/or across worker cohorts. Older industrial firms - those established in Northeastern China during the First Five-Year Planning period, for example - had heavier burden of retirement outlays than the newly-founded companies in the nonstate sector because these older, state-owned enterprises had substantially more retired workers to support. Similar to housing benefits, pensions in China were based on individual firms and were therefore nontransferable.

Other social benefits provided by China's state-owned enterprises include:

- free medical benefits;
- liberal sick and maternity leave policy;
- day care and schools;

^{1/} See Hu, Z. L. (1989), "Housing Benefits and Occupational Choices in Urban China," Unpublished manuscript, Harvard University.

- library, sports and entertainment facilities; and
- subsidized food and other consumer goods.

The traditional system of social protection, therefore, tied workers together with the firms that employed them. The enterprise-based, non-transferable social security benefits, working together with fixed wage setting and a system of permanent employment that relied on administrative job assignment, formed labor market rigidity in China. These characteristics of China's employment system and social security discouraged labor mobility by adding fixed adjustment costs, and led to substantial efficiency loss in the state-owned sector.

China's unique "city residence registration" (Hu-Kou) system effectively eliminated labor mobility between rural and urban areas. Millions of well-educated rural youths were denied opportunities to work in the modern industrial sector, leading to under-utilization of a sizable stock of China's human capital. Within the state-owned sector, the lack of labor mobility may also have caused further efficiency costs due to widespread mismatching between workers and jobs.

Although the social benefits offered by state-owned enterprises to their workers were both extensive and generous, a critical program was missing from the old system--there was no unemployment insurance. While it was not needed with China's old system of guaranteed job security, the absence of it has become the major obstacle to enterprise restructuring. Without this important social protection measure, market-oriented reforms would inflict poverty and human suffering on the jobless, and could lose the

general support of the people who after all are supposed to be the beneficiaries of these reforms.

III. Connection between Labor Immobility, Social Protection, and Enterprise Reform

The surge of rural industry and private business in China during the last decade has put strong competitive pressures on the state-owned sector. In recent years, a third of SOEs have been loss-making. Financially-troubled SOEs have suddenly found themselves facing the threat of bankruptcy and reorganization. They are struggling to shoulder the social responsibility for their workers and at the same time to survive the competition from a fledgling and dynamic private sector.

Why does labor market matter for enterprise restructuring? The answer hinges on the significant costs associated with the traditional labor market rigidity. Clearly, in China's new competitive environment, a leading cause for SOEs to lose ground is that they have higher costs. With gradual price decontrol, and increased autonomy in making production and investment decisions, SOEs' profitability becomes increasingly dependent on their cost structure.

While the slow development in both debt and equity markets makes it difficult to precisely measure the cost of capital for Chinese firms, available information suggests that China's SOEs very likely enjoy some competitive advantage over its rural township and village enterprises (TVEs) in that the cost of capital is lower in the state sector than in the

nonstate sector. 1/ A leading cause for the difference in the cost of capital is that, much of the old capital in the state sector was financed by "free" budgetary grants or bank credits. While the reform in investment planning has transformed the method of financing for new capital projects from free budgetary allocations to interest-charging bank loans, the SOEs still have lower cost of capital compared to the TVEs because SOEs continue enjoying subsidized interest rates and easier access to investment credit. 2/

SOEs, however, have substantially higher labor costs, caused by overstaffing and the heavy burden of providing social benefits to their workers. To improve the economic performance of China's state-owned sector, a first step will then be to relieve SOEs' burden of social services and increase labor market flexibility.

A comparison of SOEs and rural enterprises (TVEs) can illustrate the importance of labor market reform. Like SOEs, and contrary to the misunderstanding held by some Western economists, China's TVEs are not strictly privately owned; rather, most TVEs are owned and controlled by local governments or collectives. While there exist a host of factors that can help to explain the success of TVEs, a chief advantage enjoyed by TVEs is the flexibility of rural labor market. Almost all workers are short-term contractors or seasonal laborers, who receive no permanent job guarantee. Wages are flexible and market determined. There is a close link between pay

1/ SOEs in China do face higher nominal tax rates than TVEs. The effective tax burden on them, however, unlikely differs substantially from that on TVEs, considering SOEs' easy access to government soft "policy loans" and to budgetary subsidies.

2/ I am indebted to Eduardo Borenstein for this observation.

and performance, so workers are well motivated and productivity growth is fast. Firms' hiring decisions depend entirely on their demand for labor. They can readily adjust the size of the workforce in response to changing market conditions. Unlike SOEs, these TVEs provide few social services directly to their employees. In particular, the provision of housing is optional because workers of TVEs are previously farmers and already have their private homes.

By contrast, the traditional social security system inhibits enterprise restructuring because it effectively prevents labor mobility. The most undesirable aspect of it is that the enterprise-provided social protection produces a lock-in effect on employment.

The external factors faced by China's SOEs and TVEs--taxes, regulations, and macroeconomic conditions, etc.--have gradually become converging over time since the economic reforms began. One area that remains strikingly different, however, is the labor market structure. The differences in employment, wages, and social security system may be one of the factors that help explain the contrasting economic performance of the state-owned sector and township and village enterprises.

The enterprise-based, nontransferable social security benefits, the guaranteed lifetime employment, and the absence of a public unemployment insurance program have presented substantial risk and large opportunity costs associated with adjustments in labor market. The system has led to

overstaffing, ^{1/} and high labor costs in most state-owned enterprises, and adversely affected their profitability. While a change of ownership and control, say, through privatization, may be eventually required to revitalize China's ailing state sector, the labor market inflexibility and the continued absence of an adequate social safety net have hindered China's progress in transforming its state-owned industry. If excess labor in the state-owned sector can not be released and absorbed into the private sector, then, China's strategy of marketization without privatization for reforming SOEs will stand little chance to succeed.

IV. Chinese Experiments with Social Security and Labor Market Reforms

1. Overview

In contrast to the sweeping rural reforms introduced and implemented in 1978 and 1979, and the dramatic foreign trade and investment reforms in 1983 and 1984, China's enterprise reforms have been delayed. Although the Government may have been reluctant to give up its commitment to the dominance of public ownership in China's economy, a more important reason for the delay has been a deep concern about massive unemployment and social instability likely to be caused by drastic enterprise reform measures. Apparently, the Government has concluded that the social and political costs were too high to attempt a "shock therapy" to China's state-owned sector.

^{1/} It is estimated that in 1993 about 21 million workers were redundant in China's state-owned sector. In other words, the state-owned sector could have cut its combined workforce by 15 percent without reducing output. The figure might have considerably underestimated the true size of surplus labor in the state-owned sector.

This cautious, gradual approach to enterprise reform may have brought about some unexpected benefits. For one thing, China has had ample time to experiment with, and carefully evaluate, various reform proposals in a few selected enterprises or in several designated cities. Through slow-paced trial and error, valuable lessons have been learned and experience gradually accumulated. Without guidance of any formal theory, a practical strategy has nevertheless emerged--to start with labor market reform and social security reform so that necessary conditions, including legal and institutional requirements, can be created to support full-fledged enterprise reforms. 1/

2. Reform of the wage and employment system

An area identified as the one of the first targets of reforms was the irrational wage system in the state sector. The Chinese authorities were convinced that some changes in the rigid, egalitarian wage policies were long overdue, and making these changes could generate immediate efficiency gains without incurring any big social risk. The reform measures emphasized improving work incentives within state-owned enterprises. Wage policies were allowed to be more flexible, and bonuses, once condemned as capitalist, were introduced in 1978 as a component of workers' total compensation. SOEs were granted discretion in determining the amount of bonus to be paid to

1/ Most of the enterprise reform initiatives to date have aimed at improving the incentive structure for both SOE managers and workers and removing labor market rigidity. These reform measures in China are vividly characterized as smashing three "irons"--(i) "iron rice bowls" (guaranteed job assignment, pay, housing, pension, medical and a host of other benefits for SOE workers; (ii) "iron chairs" (permanent job position in permanent state enterprises, with no layoff or bankruptcy risk); and (iii) "iron wages" (uniformly distributed, fixed wage payments that are unlinked with job performance and productivity).

individual workers, and were encouraged to link pay to workers' performance. Wage gaps were permitted to widen, reflecting job performance differential as well as workers' seniority. Concerned about general wage inflation under the more flexible wage system, and the weak relation between firm's wage growth and its productivity growth, the government introduced in 1984 a system of aggregate wage control, which linked the total sum of wages and bonuses an enterprise entitled to distribute to its employees to certain performance indicators such as its gross profits or sales volume. Recently, the Chinese authorities have attempted to further liberalize its direct control over total wages. It is intended that the government will play only a supervisory role in the future. ^{1/} Trade unions, which traditionally have been inactive in wage-setting process, will be given a role as workers' representatives in negotiations with SOE management for remunerations and work conditions.

Since the mid-1980s, SOEs have been gradually given more hiring autonomy. An important step leading to greater labor market flexibility was taken in 1986, when the "labor contracting system" was introduced, under which all new employees in state-owned enterprises would be hired on a contractual basis for a period of usually three-to-five years. The introduction of labor contracts marked a shift from permanent job offering to more flexible "contracting," breaking away from the tradition of lifetime

^{1/} In July 1992, China published the "Regulations on Transforming the Operating Mechanism of State-Owned Enterprises," with the intention to give effect to the "Enterprise Law," enacted in 1988. These regulations specify 14 management rights which would henceforth be exercised by the state enterprises. Three of these clearly defined rights pertain to labor market, which are the right to assign labor, the right to have personal management, and the right to set wages and bonuses.

tenure. In contrast to the obligated permanent job offers in the past, these hiring contracts do not guarantee for automatic contract renewal or job extension when they expire. With a finite duration of employment contracts, workers face the risk of joblessness and tend to work harder in order to stay on the job. Managers find it easier to monitor workers' performance, and appropriately reward or punish workers according to their performance. SOEs are, therefore, given considerable discretion in selecting employees and in making retaining decisions upon expiration of labor contracts.

By 1992, the number of contract workers (He Tong Gong) in the state-owned sector had risen to 21 millions, accounting for 19 percent of the total work force in the state-owned sector (Table 4). The proportion was larger for state-owned industrial enterprises, with contract workers accounting for 27 percent of their total workers in 1992. In Shanghai, contract workers accounted for 33 percent of total workers in the city's combined state-owned sector. As a complement to the labor contracting system, a labor arbitration system is being developed to resolve labor disputes. To gradually replace the old system of administrative job assignment by the government bureaucracy, numerous employment agencies such as labor service companies are being established in Chinese towns and cities to help place the first-time job seekers in the labor force.

Table 4. China: Percentage Share of Contract Workers
(In Total Workers)

Year	In Total Urban Labor Force	State Sector	Collectives	Individual and Foreign Businesses
1983	0.6	0.6	0.3	...
1984	1.8	2.0	1.0	8.1
1985	3.3	3.7	2.2	11.4
1986	4.9	5.6	2.7	14.5
1987	6.6	7.6	3.6	18.1
1988	9.1	10.1	5.8	20.7
1989	10.7	11.8	7.0	25.1
1990	12.1	13.3	8.1	26.3
1991	13.6	14.9	8.9	28.0
1992	17.2	18.9	11.0	29.8

Source: Ministry of Labor and State Statistical Bureau, Beijing.

Even more significantly, managers of SOEs have been granted the legal authority to layoff redundant or incompetent workers. In practice, however, it is rare for managers to exercise their power to dismiss workers. Rather, they tend to feel morally obligated to keep unsatisfactory workers employed, by making efforts to reassign workers with poor performance to less important or less paid positions. Instead of laying off all redundant workers, manufacturing enterprises have sought to create service-oriented

subsidiaries to re-employ those workers. 1/ In general, SOEs still have the social responsibility for maintaining jobs. Laying off workers are considered only as a last resort to improve efficiency and profitability. It remains to be seen how far China is willing to go to accept more unemployment, as market forces may dictate.

3. Introduction of a bankruptcy law

In 1986 China enacted a bankruptcy law, the first ever in the history of the People's Republic, which came into effect in 1988. 2/ The bankruptcy law has just begun to play a significant role in providing a set of incentives to managers to improve enterprise performance and allocating business risks among interested parties. In the immediate ensuing years, however, few actions were taken to apply the bankruptcy law to financially troubled state enterprises. Mainly because of concern for the implication for unemployment, the government was reluctant to allow the bankruptcy law to be fully implemented. Instead, the government intervened to bail out troubled firms by injecting them with cheap credit and subsidies, writing off or assuming their debt liability, if the losses were caused by policy factors such as price control. 3/ For those unprofitable firms whose financial losses were mainly due to poor management, the government would

1/ China Daily (July 12, 1993) reported that China's giant state-owned metal company--China National Nonferrous Metals Industry Corporation--planned to slash 330,000 jobs over the next sever years. However, few of the workers to be laid off will actually end up jobless, because the workers will simply be transferred from the company's core business--metalworking--to other newly established, job-creating service subsidiaries.

2/ For an excellent summary of the evolving legal framework for enterprise reform in China, see Liechtenstein (1993).

3/ The remaining price controls for electricity, railway and highway transport services, for example, have caused losses to many transport and public utility enterprises.

reshuffle management and force a reorganization by arranging a merger with another better-performing state enterprise. ^{1/} As more SOEs became unprofitable, and debt-ridden, which demanded huge increases in government subsidies and widened the government fiscal deficit, the Chinese authorities have become more willing to let loss-making state-owned enterprises go bankrupt. In 1992, the People's Courts handled 2,685 bankruptcy cases nationwide, a 365 percent increase since 1991. Quite a few number of failed firms were state-owned. In the coming several years, the Chinese government plans to lift subsidies and all special protection measures for SOEs so that SOEs become fully answerable to market forces. At the same time, measures will be taken to ensure management autonomy and rights of state-owned enterprises. While some SOEs may eventually succeed in adapting to China's increasingly competitive, market-oriented economy, other SOEs are expected to fail the test and more bankruptcies are likely to follow.

A constraining factor in China for applying the bankruptcy law, protecting enterprises' autonomy in both hiring and firing decisions, and imposing hard budget constraints on SOEs was the lack of an adequate social safety net for displaced workers. As noted above, the traditional social protection system in China was enterprise-based, which locked workers into their workplaces. Over time, this constraining factor has become a severe obstacle to restructuring China's state-owned enterprises. Increasing labor market flexibility, a necessary condition to transform the state-owned

^{1/} Leasing and privatization have also played an increasingly important role in the recent years. Many state-owned department stores and other stores, for example, have been leased out to private individuals. In many cities, foreign investors are allowed to bid and restructure existing unprofitable state-owned enterprises.

sector, has called for overhauling China's social security system. With the introduction of labor contracting system, provisions had to be made for the transfer of retirement benefits, because a worker could no longer rely on being attached to one enterprise throughout his or her working life. Provision had also to be made for the income support of those workers whose contracts were denied renewal and unable to find new jobs quickly.

4. Establishment of unemployment insurance

To facilitate needed trimming of redundant working force in the state sector and implementation of the bankruptcy law, the role of social unemployment insurance is critical. The package of labor market reforms introduced in 1986 included the establishment of an unemployment insurance (UI) scheme as a natural complement to the labor contracting system. The main elements of the unemployment insurance legislation are closely linked with the proposed labor market reform measures. The legislation addresses eligibility criteria, benefit levels, funding, and administration. Those eligible for unemployment benefits include: (a) workers of bankrupt enterprises; (b) workers made redundant by near-bankrupt enterprises during a process of reorganization; (c) contract workers on expiration or cancellation of contracts; and (d) workers dismissed for disciplinary reasons. The eligibility criteria are thus compatible with the structural changes in China's labor market and overall economy. The UI legislation sets a two-year duration for benefits and a nominal replacement ratio of up to 75 percent of standard earnings. ^{1/} Enterprises are required to

^{1/} Standard earnings are defined as the claimant's average monthly standard wage over two years before his or her unemployment.

contribute 1 percent of their payroll to UI funds. The UI scheme has the feature that the funds may be used to finance job training and job creation programs administered by local Labor Bureaus and their affiliated labor service companies, which have the mandate to assist new entrants, and more recently, job losers, in identifying employment opportunities.

Since the unemployment insurance is established as a social insurance rather than an employer-liability program, it is mainly administered at the city and county government level, not at the enterprise level. There have been several attempts in China to establish pooled unemployment insurance programs at the provincial level, further moving away from the enterprise-based social protection. The Regulations on Unemployment Insurance for State Enterprises Employees were enacted in April 1993, which provide for the establishment, management, and operation of unemployment insurance funds. The UI program as contained in the existing regulations covers only the state-owned enterprise sector. In some cities, such as Shenzhen and Qingdao, which have moved furthest on the front of reforms, however, UI has been extended to cover temporary and self-employed workers and workers in joint ventures and foreign-funded enterprises. It is the goal of the government to expand the coverage of the unemployment insurance system in the near future. In particular, unemployment benefits will be provided to all involuntary unemployment regardless of cause, and the coverage will be extended to employees in collectively owned and foreign enterprises nationwide. It will be most desirable for China to extend the UI coverage to employees of TVEs and private businesses as well, whose share in total workforce has surged over the last decade.

The timely introduction of unemployment insurance has put a critical program into China's social safety net, facilitated the release of "excess workers" from the over-staffed state sector, and helped to contain the social and economic costs associated with transformation to a market economy. During the first three years since the inception of the UI programs, an average of 30,000 workers each year have claimed UI benefits. This number more than tripled in 1990 and 1991, with the deepening of labor market and enterprise reforms. About 200,000 SOE workers in 1992 benefitted from UI programs. The number of UI recipients have been so far quite small relative to the total work force in China's state sector. But this number may start to rise in the next decade, depending on the current extent of "surplus labor" in the state sector, the proposed extension of UI coverage, and the growth prospect of the Chinese economy.

5. Housing reform

Transforming state-owned enterprises into autonomous operating economic entities also requires development of alternative means of providing for the housing of their employees. The obligated provision of employee housing by SOEs has not only created labor market rigidity, but also added a heavy social burden to SOEs in comparison to their private sector counterparts such as township and village enterprises, and foreign-funded enterprises. Since the late 1980s, China has made some limited progress in housing reform. Consensus has been reached that the provision of housing is not an essential function of state enterprises or government and that it could be better carried out by the private markets.

The initial reform measures were mainly making incremental upward rent adjustments aimed at reducing housing subsidy in the state sector. More recently, the focus of reform has shifted to privatizing the public housing stock by selling housing units to state employees. Several legal developments, including the 1988 amendment of the Chinese Constitution, the subsequent revision of the 1986 Land Law, and the national regulations concerning urban land use, land transfer, and property rights have had positive impact on the development of real estate market in China.

As widely recognized, these legal developments are necessary to replace enterprise provision of housing to workers with market-based delivery of housing. Many real estate development companies have been rapidly formed in the past several years, which construct and sell residential property to Hong Kong residents and Taiwanese investors. Although the number of domestic customers who purchase residential housing has been growing, these buyers tend to be China's nouveau riches -- the prosperous private businessmen. Selling housing units at market prices to SOE employees has proven more difficult, because of their low wage income 1/ and the lack of housing financing. In some cities, municipal housing funds have been set up--to be funded from the issuance of savings bonds and the proceeds from selling existing state-owned housing stock -- to construct affordable housing for urban residents in general and SOE employees in particular. Mortgage financing companies are also being established with primary source of funding from pension funds.

1/ The low monetary income of SOE workers reflects the payment of many subsidies in kind in China's state sector, including consumer goods and low rent accommodation.

6. Development of the service sector

China's rapidly expanding private sector has in fact presented opportunities for restructuring the state-owned enterprises through new job creation and development of a housing market. These factors help to mitigate the lock-in effect in China's labor market, as released surplus labor is quickly absorbed into the fast-growing private sector and housing becomes better available to new employees and transferred or relocated workers.

As part of the solution to the problem of excess workers in SOEs, the government has attached great importance to the development of the tertiary sector, which in 1992 employed less than 20 percent of China's total labor force and accounted for about 28 percent of GNP. This sector is generally more labor intensive than manufacturing and is viewed as having great potential for absorbing the surplus labor in the state sector. In July 1992, the government published its "Decisions on Expediting the Development of the Tertiary Industry," which spell out a set of policy measures to boost the service sector, including transforming state-owned tertiary enterprises into profit-oriented businesses, decontrolling prices and offering credit and tax incentives. A policy measure of special importance is to encourage civil servants in government organizations and workers in SOEs to resign and establish private businesses in the service sector. 1/ The government hopes that in the rest of the 1990s the service sector will generate a large number of new jobs, essentially playing a role similar to

1/ The Chinese press describe such voluntary exodus out of state sector to private sector by using a colorful phrase--" Xia Hai"--which means "plunging into the sea (of commerce)."

that played by the township and village enterprises in absorbing the surplus labor in the rural area during the last decade.

7. Relaxation of restrictions on migration

Other initiatives to increase labor market flexibility in China include relaxation of restrictions on migration of rural labor to cities. Temporary city residence permits are issued to allow rural labor to provide a wide range of services in urban areas. Restrictions on regional mobility are gradually lifted for university graduates and professionals. In recent years, the government has also emphasized the role of training. The Ministry of Labor and its local Labor Bureaus, as well as enterprises themselves, have established numerous training centers, retraining programs, and technical and vocational schools to improve workers' skills and adaptability to the changing labor market.

8. Pooling of pensions

A key objective of social security reform in China is to relieve individual enterprises of full direct responsibility for their workers' retirement pensions by establishing funds that pool resources and risks among enterprises and across regions. Experimentation with pension pooling began in 1986 in several cities including Shanghai and Shenzhen. In recent years, retirement funds have been established at the municipal level in most cities and some at the provincial level. Employers and employees are required to contribute a certain percentage of the payroll toward these funds. 1/ These mandatory retirement funds are generally modeled on the

1/ In Shanghai, for example, the contribution rates by both enterprises and workers are set at 5 percent of the wage bill.

Central Provident Fund of Singapore. Retirement pension pooling has eased many state enterprises' financial burden of supporting their growing number of retirees. Pension pooling has also helped maintain workers' retirement benefits from job to job and, hence, improved the conditions conducive to greater labor mobility.

Table 5 suggests that the transition to a market economy in China has not sparked high unemployment. The urban unemployment rate in 1992 stood at 2.3 percent, and the number of the unemployed in urban China actually declined from 5.3 million in 1978, when the reform was commenced, to 3.6 million in 1992. The first-time job seekers, consisting of mainly recent secondary school graduates, accounted for about 80 percent of the total urban unemployed. While a variety of factors, such as strong economic growth, and budgetary subsidies to keep loss-making SOEs afloat, have so far prevented massive urban unemployment in China, the increased labor market flexibility has also clearly played a positive role in keeping the unemployment rate low 1/.

As China's social security reform continues, it is important to establish a system of social protection for all employees regardless of the ownership structure of their employer, hence achieving greater social equity and a "level playing field" among enterprises of different ownership in China's socialist market economy.

1/ Paradoxically, in spite of the initial success of agricultural reforms and the rapid development of rural TVEs, the problem of rural unemployment may have become more acute. The growth in agricultural productivity and relaxed restriction on migration of peasants to cities, have produced a large pool of rural surplus labor.

Table 5. China: Economic Growth and Unemployment

Year	Total Urban Unemployed	In Which: First-Time Job Seekers	Share of First-Time Job Seekers	GNP Growth Rate	Urban Unemployment Rate
		(10,000 persons)			(In Percent)
1952	376.6				13.2
1957	200.4				5.9
1978	530.0	249.1	47.0	11.7	5.3
1980	541.5	382.5	70.6	7.9	4.9
1981	439.5	343.0	78.0	4.4	3.8
1982	379.4	293.8	77.4	8.8	3.2
1983	271.4	222.0	81.8	10.4	2.3
1984	235.7	195.9	83.1	14.7	1.9
1985	238.5	196.9	82.6	12.8	1.8
1986	264.4	209.3	79.2	8.1	2.0
1987	276.6	235.1	85.0	10.9	2.0
1988	296.2	245.3	82.8	11.3	2.0
1989	377.9	309.0	81.8	4.4	2.6
1990	383.2	312.7	81.6	4.1	2.5
1991	352.2	288.4	81.9	8.2	2.3
1992	360.3	299.8	83.2	13.0	2.3

Source: Ministry of Labor and State Statistical Bureau, Beijing.

The Chinese authorities have noted the necessity to transfer social responsibility from enterprises to government. The new fiscal reform measures, introduced at the beginning of 1994, aim at enhancing the role of government in a market economy in social protection and other social services such as education and health care. However, the lack of clear

assignment of fiscal responsibilities between different levels of government in China presents risk to transferring government functions from enterprises to appropriate level of government. ^{1/} Currently, for instance, it is the subnational governments--provincial and, most importantly, municipal--that are responsible for financing and administration of both retirement funds and unemployment funds. The stated goal, however, is to establish a unified national social security system encompassing old age pensions and unemployment insurance at the central government level.

V. Conclusions

Labor market rigidity induced by traditional social protection mechanism creates barriers for enterprise restructuring and privatization in economies in transition. Lessons from many of these countries' experience suggest that increasing labor market flexibility through social security reform is necessary to meet the challenge of making a smooth transition to a market economy.

In the past decade, China has made some important progresses in reforming its social security as well as the wage and employment system. These developments have substantially facilitated labor mobility and helped protect workers' well-being and helped sustain social support for economic reforms. China still faces formidable risks and challenges, however. Much more remains to be done to transform China's state-owned sector and to deal with the threat of potentially large unemployment in rural as well as in

^{1/} For a discussion on issues and options for reforming social expenditure assignment in China, see Hu (1993).

urban areas. Nevertheless, with the emergence of a strong, dynamic private sector, and the gradual creation of conditions favorable to reforms, China should be better poised now than ever before to launch full-fledged enterprise reforms.

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