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**Structural Changes in the Labor Market  
and Social Security System in China:**

**From the Viewpoint of Flexicurity**

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# **Structural Changes in the Labor Market and Social Security System in China: From the Viewpoint of Flexicurity**

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## **Abstract**

The global financial crisis triggered by the subprime mortgage crisis in the United States in 2008 revealed the unsustainability of China's export-led growth regime, which supported the country's rapid economic growth for over 20 years. Today, the Chinese economy has been forced to break away from export-led growth. Furthermore, the large financial investment made to compensate for the decreased export demand has helped China maintain high economic growth after the effects of the financial crisis started to wane in 2011. Thus, in recent years, the Chinese economy has had to transition from export- and investment-led growth to consumption-led growth.

In this paper, we analyze the most important factors promoting the change from export- and investment-led growth to consumption-led growth in China's economic growth regime. That is, we examine the correlation between the recent structural changes in the reproduction of labor force in the labor market and the social security system. Especially, we focus on the changes in the income-labor nexus due to labor market reforms and the present state of the Chinese social security system from the viewpoint of flexicurity, which increases flexibility and security simultaneously.

**Key words:** Growth regime, Export-led, Consumption-led, Flexicurity, Social security

**JEL Classification:** J21, J24, O43, P11, P36

## 1. Introduction

China's vast size and population caused Quesnay to believe that its domestic market would probably not be inferior to a market that combined all the countries of Europe. In addition, Smith said the size of the Chinese domestic market would equal a single unified European market (Giovanni, 2007). However, since these views were expressed, China's strong economic growth and industrial advancement from the 1990s has been based on the remarkable development of its export sector. In other words, export-led growth based on flows of foreign direct investment (FDI) from developed countries has been the driving force of China's economic growth (Yan, 2011). FDI has accumulated in the southeast of China, which imports capital-intensive and technology-intensive intermediate goods and exports assembled labor-intensive final goods using a domestic workforce that is paid low wages.

The 2008 global financial crisis triggered by a sub-prime mortgage crisis in the United States revealed the unsustainability of China's export-led growth, which had sustained China's rapid economic growth for more than 20 years. Currently, the Chinese economy has been forced to break away from export-led growth. Furthermore, China's large financial investments intended to compensate for the decline in export demand after the financial crisis began to slow down in 2012 (shown by a decrease in the growth rate from 8.1% in the first quarter to 7.6% in the second quarter). In this sense, the Chinese economy has to make the transition from export-led and investment-led growth to consumption-led growth in the years ahead.

In fact, the Chinese government has prioritized the expansion of consumption demand and maintained a mechanism that can promote sustainable consumption growth in the 12<sup>th</sup> Five-year Plan that started in 2011. Specifically, to reduce future work and life uncertainties and to increase domestic consumption, reform and expansion of the social security system is being accelerated. For example, at the 3<sup>rd</sup> session of the 11<sup>th</sup> National People's Congress, Prime Minister Wen Jiabao mentioned the importance of the social security system for economic growth and stated that for the transition to a domestic demand-based economy growth regime and maintenance of steady growth, the Chinese economy must depend on domestic consumption demand underpinned by security for income and health.

In this study, we examine the correlation between recent structural changes in the labor force and the change in the social security system. In particular, we focus on changes in the income–labor nexus within labor market reform and the present conditions of the Chinese social security system. Furthermore, we discuss the state-coordinated agenda for social security reform from the viewpoint of “flexicurity,” a term used to describe simultaneous increases in flexibility and security.

## 2. Obstacles to Transforming the Economic Growth Regime

### 2.1 New Trends in China’s Export-led Growth Regime

China’s export-led growth regime lacks sustainability due to productivity constraints in domestic flows overseas and accumulated trade deficits of its trading partners. Export-led growth in China has been deeply dependent on the state devaluating the exchange rate and low incomes. In other words, the devaluation of the exchange rate was under strong pressure from the United States and other trading partners in which trade deficits had accumulated<sup>1</sup>.

China’s one-child policy began in 1982<sup>2</sup> and as a result of more than 30 years of population control, its low-wage workforce in urban areas is moving from a state of oversupply to shortages. In particular, labor force shortages in the labor-intensive assembly process industries of the southwest region traditionally attracted inland domestic migrant workers but migration has slowed with China’s balanced development strategy that began in the 2000s and more occupation choices with the expansion of the services industry.

Furthermore, the wages of workers have risen alongside supply and demand changes<sup>3</sup> and state-initiated policies for income increases, such as adjusted wage

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<sup>1</sup> Actually, the Yuan rose 20% against the dollar from 2005, when China shifted from a fixed exchange rate system to a currency basket system, to 2008, when the global financial crisis struck.

<sup>2</sup> In some special cases, a second child is accepted by law. These include when a first child has a physical disability, when one partner of a remarried couple has no child, when neither partner has brothers, and when a second child is born during an overseas stay.

<sup>3</sup> Labor shortages in the export industry in southeast China after the mid-2000s led to a debate about whether China exceeded the Lewis turning point within and outside China. However, the shortages refer to only a specific age range and gender constitution (young migrant women workers with skillful hands); thus, it is incorrect that the surplus workforce from the traditional agricultural sector has dried up for the modern industrial sector. In addition, there are some views that supply–demand changes in the labor force as it approached the Lewis turning point brought about the wage increase. However, wage rises based on institutional changes and policies (including increases in the minimum wage

guidelines that consider inflation and increases in the social security burden of employers. These have raised the labor costs of exporters and gradually reduced the international competitiveness of China's labor-intensive exports<sup>4</sup>.

In China, limits to the sustainability of export-led growth were recognized and the government planned a transition from export-led growth to domestic demand-led growth based on the expansion of consumption demand from the middle of the 2000s. For example, the Central Economic Work Conference of 2008 emphasized the need to transform the growth regime to prevent serious consequences resulting from the decrease in export demand and a series of policies and measures were introduced to achieve this. In addition, after the 2<sup>nd</sup> and 3<sup>rd</sup> annual meetings of the 10<sup>th</sup> National People's Congress in March 2004, and the 11<sup>th</sup> 5-year Plan, which started in 2006, China announced a departure from export and investment dependency, thus facilitating the transition to consumption-led growth.

However, as Figure 1 shows, the export dependency of China's economic growth increased and the transition from export-led growth was difficult for China until the global financial crisis of 2008 spilled over into the Chinese economy. Therefore, given that export demand decreased as a result of the global financial crisis, the Chinese government aimed at endogenous development through a combination of the transition of the economic growth regime and a scientific outlook on development in order to break away from export dependence and promote domestic demand through a policy of large-scale financial expansion.

As a result, China's economy in 2009 was restored suddenly, helped by increases in domestic demand and a report from the 11<sup>th</sup> meeting of the Chinese People's Political Consultative Conference in 2010, which mentioned that the Chinese economy had achieved the transition from export-led growth to domestic demand-led growth. However, the decrease in export demand was connected directly with a fall in economic growth, as mentioned. On the other hand, the expansion of domestic demand based on increases in construction demand through the expansion of government spending resulted in

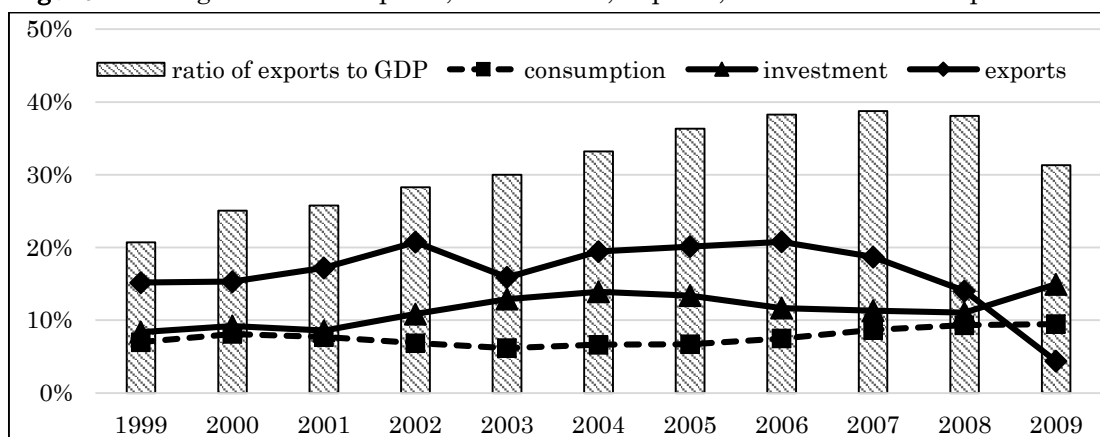
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guideline index to inflation, increases in social insurance payments as a proportion of total wage payments, and changes in growth strategy for expanding domestic demand) are large, while changes based on market factors are not so large. For detailed summaries of the debate on whether China has exceeded the Lewis turning point, see Yan (2008) and Minami and Ma (2009).

<sup>4</sup> In Japan, there have been many arguments since the early 2000s of the "China plus one" variety, namely, that a production base in a country other than China should be constructed to act as a counter-measure to risk from China. However, FDI from Japan to China expanded throughout the 2000s because the Chinese economy shifted to a market base from a production base, with economic growth and income increases during the period.

inflation and overinvestment in China, and the economic growth rate decreased as a result of the financial restraint policy.

**Figure 1** Changes in consumption, investment, exports, and the ratio of exports to GDP



Notes: Real values in 2005 prices. Values are a three-year average.

Source: United Nations database.

## 2.2 Main Obstacles to Changes from Export- to Consumption-led Growth

China advocated a transition from export-led growth to consumption-based growth led by domestic demand from the mid-2000s. However, why has the result been so poor in China, where state-led coordination is the driver of economic adjustment? We discuss the following four background factors.

First, we investigate the rigor of the annual economic growth target of 8%, which is strongly related to maintaining the three compromises for state-led coordination in China. The three compromise are: the basic compromise between world nations and the Communist Party of China on its monopoly of political power in exchange for the benefit of high economic growth to all nations (Boyer, 2011); the market compromise between the Chinese government and all market actors to participate in market competition in exchange for tolerating the levels of government intervention and economic profit; and the power compromise between China's central and local governments for the central government to hold rights to personnel management and financial decisions for evaluating political stability and the economic development results of local bureaucrats (Yan, 2012). Because the growth rate of 8% is based on these three compromises, decreases in the economic growth rate may be connected directly with China's socioeconomic crises. Therefore, to reduce the role of exports as the main driving force of

the Chinese economy brings a large risk in China's political and economic management.

Second, we discuss the influence of the slow path of industrial structure advancement. As mentioned in the Introduction, FDI from developed countries in the southeast of China promoted productivity growth and an advanced industrial structure of the Chinese economy. However, imports of capital-intensive and technology-intensive intermediate goods suggest a limited ability to supply these goods domestically. Furthermore, the existence of a huge low-wage workforce is an important condition for export-led growth but, on the other hand, it disrupts innovation efforts and productivity gains. In other words, industrial structure, the state of technology achievements, and the status of the labor force obstruct reduced reliance on China's labor-intensive export industry.

Third, we consider the existence of a dual structure of urban and rural areas, which are divided by institutional factors, especially the household registration system. The urban-rural divide disturbs the transition from export-led growth to domestic demand-led growth in China mainly through the supply of a low-wage work force and disparities between urban and rural areas. This suggests that the low-wage labor force movement from underdeveloped and low-income rural areas to the southeast was a significant factor in supporting the comparative advantage of China's exports.

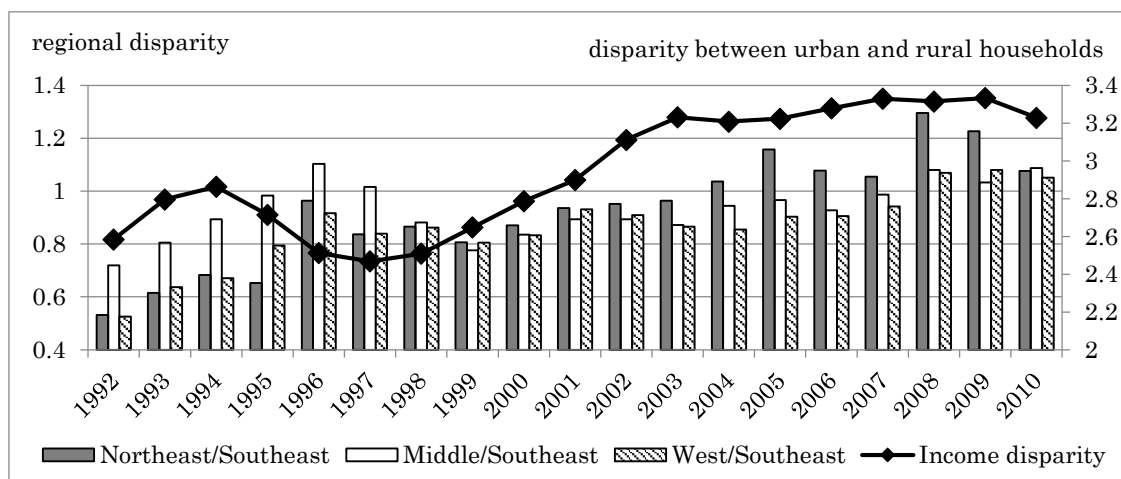
While a part of migrant workers' wage income is sent to their hometowns, contributing to the central and western rural areas' income improvement, the wages of migrant workers are very low and have limited influence on correcting regional disparities and the household income gap between these areas and southeast China, as Figure 2 shows.

Increasing regional disparities represented by the urban-rural divide and disparities between industry and employment status have increased the instability of China's socioeconomic system. Furthermore, growing regional disparities and instability of employment and income have resulted in delayed consumption demand of workers, in spite of higher employment and wage increases, as Figure 3 shows.

Fourth, China's underdeveloped social security system is one of the reasons for its economic growth transition. In China, the government pushed forward a shift from company (Danwei) social security systems to national social security systems from the 1990s. However, the urban-rural divide, China's historic path dependency, and

institutional complementarity between social security, employment, and training systems have disturbed the shift, resulting in the movement to the national social security system being slow.

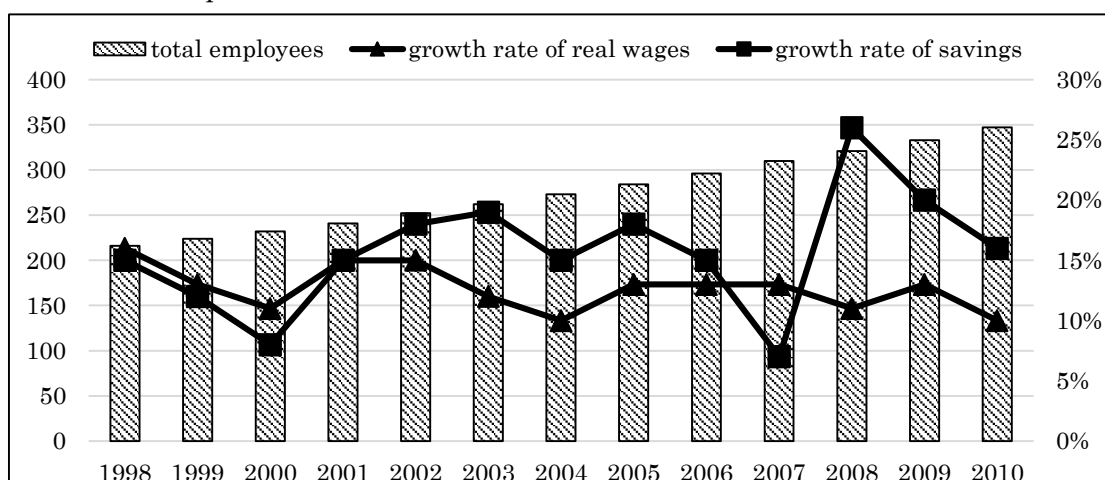
**Figure 2** Regional disparities between growth rate and households income



Note: Regional disparity is estimated by the growth rate of the real value of GDP, and household disparity is estimated by disposable income.

Source: National Bureau of Statistics of China, China Statistical Yearbook 2011.

**Figure 3** Employment and growth rates of wages and household savings in urban areas (Units: million persons; %)



Note: Since data for real wages in 2003 are missing in the China Labor Statistical Yearbook, we subtract inflation from the nominal wage rate increase. Savings data of households in urban areas are used.

Source: National Bureau of Statistics of China, China Statistical Yearbook 2011, and China Labor Statistical Yearbook 2011.



One of the important roles of the social security system is to enable the creation of a middle class, but the delay in China's social security system reform has inhibited the sustained expansion of the middle class and may disturb the construction of a domestic demand-led growth regime based on increasing consumer demand. According to the research of the Chinese Academy of Social Sciences, increases in economic growth, employment, and household income have resulted in China's middle class<sup>5</sup> growing at an annual rate of approximately 1%, with the total middle class increasing to about 23% in 2010 from 15% in 2000 (Lu, 2010).

Since the middle class generally comprises people with robust consumption desires and neutral political viewpoints, it is said that their existence or expansion will contribute to economic development and social stability. In particular, the transition of China's economic growth regime depends on the expansion of the middle class and an increase in consumption demand supported by the social security system. On the other hand, there are many viewpoints that ongoing increases in house prices and expenditure on medical care and education have constrained the household budgets of the middle class and the further expansion of the middle class in China. Furthermore, middle class expansion is constrained by the slow speed of social security reforms, which would otherwise correct the disparities between regions, industries, and households.

On the one hand, employment flexibility has increased with institutional reform of the labor market, including the lifetime employment system, the seniority wage system, and the internal company training system. On the other hand, delayed reform of the social security system, which has institutional complementarity with these systems, has decreased the security of employment and income<sup>6</sup>, resulting in increased instability of the labor market. In this sense, the Chinese social security system could be a factor that promotes the transition of the growth regime alongside the further expansion of the

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<sup>5</sup> Generally, the social middle class refers to people in the middle of social resource allocation. Based on this definition, university graduates in urban areas with annual income of 35,000–100,000 yuan form the social middle class in China. The middle class comprises mainly employees of new knowledge-intensive industries, such as the IT, finance, and insurance sectors; white collar employees and managers of foreign companies; public sector employees; and middle managers of state-owned enterprises (Lu, 2002).

<sup>6</sup> Here, security, an important element of flexicurity, refers to the lifetime employment of a worker. In other words, when employment adjustment expands flexibility in order to measure for changes in the management environment, employment and income stability have to decrease but security can be maintained or expanded with the social security system (especially unemployment insurance) and active labor market policies (especially vocational training and job outplacement).

middle class, but the effect in reality remains small for the moment. In addition, the social security system has few ways of correcting the difference between income hierarchies though raising income levels of low-income classes because the income redistribution function of the social security system is weak.

The Chinese government has pushed forward reform of the social security system for 30 years, and improvements include continuing correspondence with social changes and expansion of cover. However, as Wang (2010) mentions, payments have been reduced and security weakened, making it difficult to state definitively whether the nature of the security system is sufficient to promote domestic consumption growth and social stability.

### **3. Interrelations between Flexicurity Changes in the Employment and Social Security Systems**

#### **3.1 Changes in Industrial Relations and the Social Security System**

In this section, we first summarize the interrelations between industrial relations and the social security system, then we examine changes in flexibility and security in the labor market from a viewpoint of flexicurity<sup>7</sup>, and finally, we explain the limited role of social security system reform in China.

The influence of the social security system combined with industrial relations on the reproduction of workforce appears to play a role in improving welfare from the micro perspective of the lives and education of workers and families and in decreasing the risk of losing jobs and income. In addition, it is strongly related to growth regime changes and disparity corrections through redistribution and social stability from a macro perspective.

According to Régulation Theory, the reproduction of workforce has been regarded as a matter of consumption habits and consumption norms of workers and a regime of social formation of individuals (Hirano and Hanada, 1999). In particular, the economic act of

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<sup>7</sup> Flexicurity is a new word connecting flexibility and security. It can be understood as an integrated policy strategy, which is not the mere aggregation of flexibility and security elements, but their suitable or harmonious combination; it simultaneously increases labor market flexibility and security, which are normally opposed (Auer and Casez, 2003; Wilthagen and Tros, 2004; Madsen, 2006). Flexibility in this context means the adjustment of employment (external numerical flexibility), work hours (internal numerical flexibility), wages (wage flexibility), job and work units in companies (functional flexibility); on the other hand, security refers to job, employment, income, and work–life balance. For more detailed explanations and characteristics of flexicurity, see Yan (2010).

the reproduction of workforce can appear as the acquisition of income and expenditure; however, income, including the direct wage, represents the value of work while indirect income is based on the welfare of mainly national policy. In addition, the existence of this kind of indirect income provided by the state is an important condition to decrease various kinds of risks associated with employment and life in modern economic societies; it also promotes domestic consumption demand by supporting by the stability of the macro economy and correcting social disparities<sup>8</sup>.

In China, the export-led growth regime characterized by “mass production–mass export” was based on the following three characteristics of industrial relations. First is the lack of labor unions, which represent the interests of the labor class in negotiations with the managerial class; second is the undeveloped social security system, which would ordinarily accommodate increases in unemployed and retired people; and third is the absence of vocational training and skills formation systems that are based on discussion, agreement, and collaboration between the government, workers, and employers.

In China, industrial relations concerned with the proliferation of the labor force are based on state-led coordination and differ widely from industrial relations of developed countries, which are based mainly on institutional coordination arising from discussion and agreement among the government, workers, and employers. In other words, state-led coordination has promoted job creation through economic growth, wage rises linked to increasing macro labor productivity, labor force movement between industries and areas, and the expansion of the social security system as a precondition for the abovementioned institutional changes in the labor market.

It is well known that there is a strong institutional complementarity among the wage system, the skills formation system, and the social security system (Uni, 2009). However, in China, the advancement of its industrial structure and the expansion of the role of the market system in the labor market have changed the employment, wage, and

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<sup>8</sup> In Organization for Economic Cooperation and Development (OECD) countries, social security systems have been established and enlarged as institutional compromises between labor and management, known as Fordism, which supported the golden age of capitalism. In addition, secure social welfare benefits for all (including the unemployed and aged) contributed to mass consumption after World War II and were linked with efficient workforce composition and mass production processes to guarantee rapid economic growth (Hirano and Hanada, 1999). Mass production and mass consumption accumulated due to productivity and wage increases that were the result of negotiation and compromise between labor and management, and the reception of the Taylorism (scientific management); thus, the incomes and standards of living of workers improved (Yamada, 1999). However, the Taylorism caused a decline in the motivation of companies and workers to invest in skills formation, which disrupted productivity growth. Therefore, Fordism collapsed in the early 1970s.

skills formation systems; yet, the transition from company welfare and vocational training systems to a national social security system and skills formation system has been delayed. In this sense, in a labor market with increasing flexibility, there is demand for a system that guarantees the income of job losers and a system that provides an opportunity to participate in vocational training.

### **3.2 Increasing Flexibility and Decreasing Security with Institutional Reforms of the Labor Market**

In general, labor market flexibility increases with expansion of the fluctuation range of corporate earnings with intensified global competition, the advancement of industrial structure, and increases in service industry employment to total employment (Auer and Casez, 2003).

China's industrial structure advanced with its sustained and rapid economic growth from the 1990s (due to export growth), while its labor force moved to the services industry from the primary and secondary industries. In the process, the flexibility of both its employment system and wage determination rose significantly in quantitative terms, but security of both employment and income gains decreased remarkably.

Essentially, if security is not provided, expanded flexibility in the labor market will increase instability in employment, income, and life, as well as expand societal disparities and poverty. Therefore, employment system reforms toward flexibility need measures to increase security. In this regard, flexicurity strategies of Denmark (the Golden Triangle) and the Netherlands (the Polder Model) are successful examples. They are a package of policies for labor markets that include flexible employment systems, generous social security systems, and active labor market policies underpinned by the collaboration of government, workers, and employers. In addition, flexicurity has come to guide strategic labor market reform among members of the European Union<sup>9</sup>.

However, in China, employment system reform has expanded external quantitative flexibility only and wage system reform has increased wage flexibility only. In addition, enterprise ownership reform and the transition to a floating labor market promoted by the government form a macro environment for flexible expansion of the labor market. Furthermore, enterprise and individual investments in skills formation have changed to

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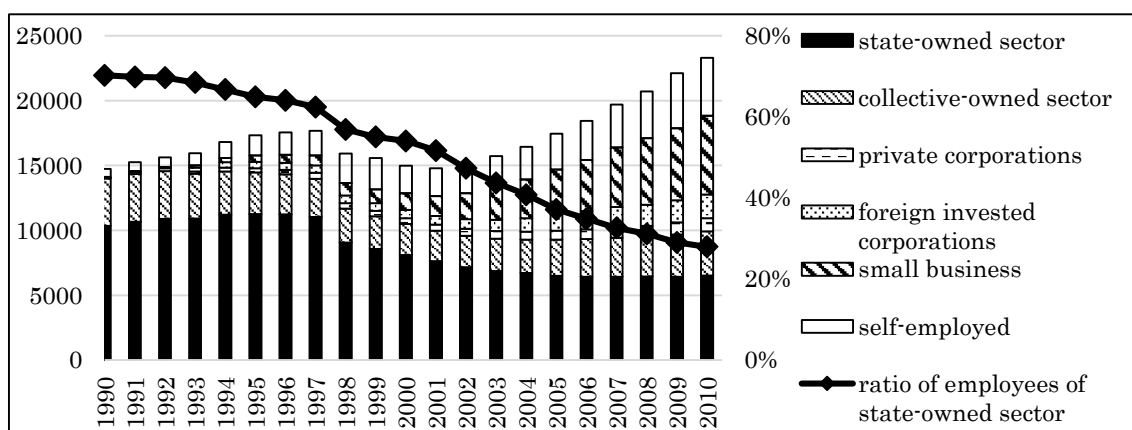
<sup>9</sup> See European Commission (2007).

general skills from specialized company or industrial skills with an increasing role for market mechanisms in employment (Yan, 2011).

In this sense, we can say that the expansion of external quantitative flexibility and wage flexibility in the Chinese labor market after 1990 is a result of state-promoted policy and the adaptive behavior of enterprises and individuals. In other words, a reduction of the public ownership sector based on national structural changes reduced the ratio of workers in lifetime employment while the expansion of the private sector based on the market competition mechanism increased new employment through the labor market.

As a result of increased employment flexibility, enterprises are easily able to respond to changes in demand for workforces alongside changes in the management environment and workers can move freely between companies and industries by applying for employment contracts based on labor supply and demand.

**Figure 4** Ratio of employees by ownership in urban areas (unit: 10,000 people; %)



Source: National Bureau of Statistics of China, China Statistical Yearbook for each applicable year.

Therefore, as Figure 4 shows, the ratio of employment in state-owned enterprises as a proportion of total employment has reduced gradually, non-regular employment has increased with the expansion of the ratio of employment in the private sector, and labor market instability has increased. The calculation of the number of non-regular employees in the Chinese labor market varies according to the different definitions and scope of the estimation<sup>10</sup>; however, China’s Ministry of Human Resources and Social

<sup>10</sup> Although there is no official definition of non-regular workers in China, from the calculation range of the “Labor White Paper” (Ministry of Human Resources and Social Security), we can see that non-

Security estimates that about 105 million non-regular employees work in irregular sectors, such as small private companies and personal management businesses in urban areas.

While it is difficult to calculate the number of non-regular employees in regular sectors at present, if the estimated 100 million migrant workers in the regular sector are taken into account, the scale of non-regular employees in China will be more than 60% of the total number of urban area employees (347 million people). Most of these non-regular employees do not receive social security for their period of employment, rendering employment and income instability extremely high.

Next, we discuss changes in China's wage flexibility. The transition from a lifetime employment contract system to a flexible employment contract system resulted in the collapse of the conventional seniority wage system (*Dengji gongzi zhidu*). Various new payment systems were established, but the most common is the duty and skills-based wage system (*Gangwei jineng gongzi zhidu*). In addition, the wage level in China is still strongly dependent on state adjustment and is, thus, representative of wage guidelines based on industry or area. However, in recent years, the wage level has influenced the supply and demand of the workforce and there have been new kinds of wage decisions that are based on labor–management negotiations.

Furthermore, the ratio of the performance-based pay system (*Jixiao Gongzi zhidu*) has grown, leading to income disparity between employees in companies, regions, and industries. The principle of performance-based pay has been introduced in companies as well as government agencies. This payment system was introduced to schools and hospitals in 2009 and expanded to all public sector employees in 2010.

Denmark, as the world's most successful example of flexicurity, has expanded the flexibility of its labor market alongside simultaneous increases in employment security. Denmark's flexicurity is based on active labor market policies and income security based on the social security system, including an unemployment insurance scheme. In the Netherlands' flexicurity model, the expansion of flexibility has supplemented increases in employment and combination security, which recognizes work–life balance and income security based on a generous social security system, such as that of Denmark.

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regular workers in China include employees who have not entered into regular work contracts in regular sectors (public, state-owned, corporate, and foreign investor sectors) and employees in non-regular sectors (small private enterprises or the self-employed) in urban areas (Mizoguchi, 2012).

However, in China, income security has not been guaranteed due to low levels of unemployment benefits and an undeveloped social security system, which is still in the process of reform. An unemployment insurance scheme introduced in 1999 expanded the coverage range to all employees in urban area from only employees in the public sector. In addition, the payment of insurance premiums changed from enterprise only to the government, enterprise, and workers, while the amount of unemployment benefits was set between the local minimum wage and the minimum welfare allowance.

In this regard, the unemployment insurance scheme in China has formally come close to international standards set by the International Labor Organization. China's insured members increased to 134 million people in 2010, nearly double the 69 million members in 1990. This number covers 9 million unemployed and 128 million employees in the formal sector of urban areas almost; however, the participation rate for total numbers of workers, including the informal sector in urban areas, is less than 40%.

Furthermore, the income replacement rate of insurance benefits is low (less than half of income just before unemployment) and cannot provide security for unemployed workers to participate in vocational training and lifetime education. In other words, China's unemployment insurance scheme does not play a role in guaranteeing income security to supplement the expansion of flexibility in the labor and wage determination systems.

Next, we examine the current status of vocational training and skills formation schemes based on China's active labor market policies.

The Chinese government promotes the workforce's active movement between companies, industries, and areas by the creation of employment through economic growth; the construction of a floating labor market; and reform and expansion of higher and lifetime education to provide opportunities for workers to acquire general skills. In addition, the government creates opportunities for vocational training under state-coordinated expansion of employability through skills improvement.

These policies have relieved the pressures of decreasing job security with the expansion of flexibility and increased employment security throughout working life. The government and private enterprises have since 1997 established a significant number of educational training and occupation mediation organizations, specifically reemployment service centers (approximately 37,000 institutes with 58 million registered jobseekers

and 60 million registered job offers in 2009). In addition, a revival of occupation professional training education occurred after 2005, while lifetime education at university is promoted as an important national policy.

Furthermore, the government has relocated 13 million migrant workers in urban areas from 2009. In other words, the Chinese government promotes the skills improvement of workers through state-led expansion of education and vocational training schemes to correspond with the advancement of the industrial structure. However, the reform is currently underway and is not yet complete. Thus, institutional reform in labor markets has not been accompanied by organic combination of three domains of flexicurity (flexible employment systems in which layoffs are easy, a generous and widespread social security system, and an active labor market policy).

In this sense, the systemic institutional reform of the Chinese labor market after the 1990s increased the flexibility of the labor market largely, but employment and income security have not improved because of undeveloped social security, vocational training, and skills formation. As a result, instability in the labor market has increased. This adversely affects social stability and workers are uneasy about their employment and income gains in future. Therefore, the household budget does not use the income for consumption and saves it for future risk. This is an obstacle to the transition of the growth regime.

At the same time, some new institutions and policies related to labor markets have been proposed. We omit a detailed explanation due to space constraints, but mention the new “Employment Contract Law” enforced in 2008, which aims to correct excessive employment flexibility in the current labor market. In addition, the emergence of collective wage bargaining in the southeast area, where foreign companies are concentrated, provides the possibility of introducing the flexicurity strategy in the Chinese labor market.

However, it is not possible to transplant immediately a European model of flexicurity that depends on the cooperation and collaboration of the government, workers, and management because of restrictive conditions for labor unions in China. On the other hand, with state-led coordination playing the main role in China’s socioeconomic adjustment, the country can create conditions to enlarge flexibility and security simultaneously through the expansion of the social security system. In addition, the



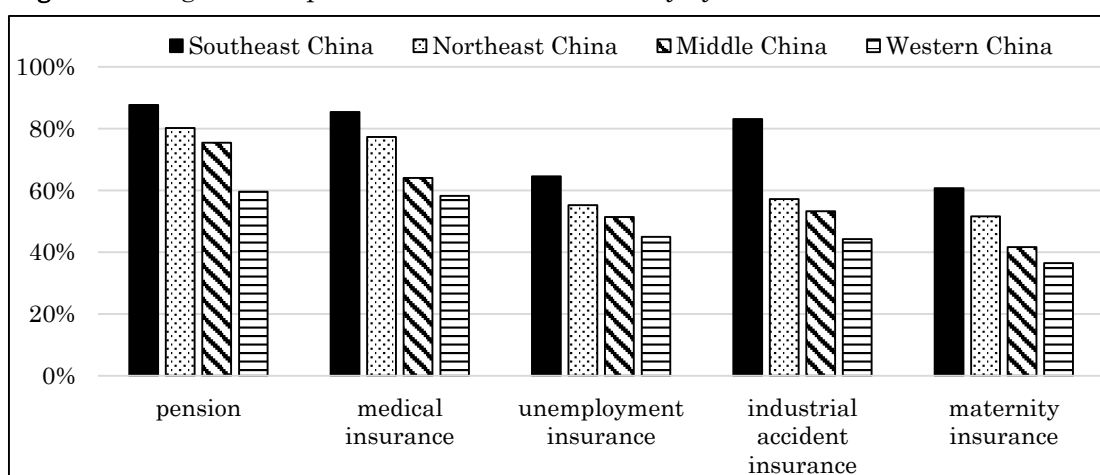
construction of a social security system that corresponds to flexibility and security changes would have a significant influence on the construction of domestic consumption-led growth through the formation of a larger middle class, as we explain in Section 4.

## 4. Reform of the Social Security System and China's Middle Class

### 4.1 Social Security Reforms: Expanding the Coverage Rate

In China, social security reform would support changes in industrial relations and work-life conditions of the socialist market economy.

**Figure 5** Regional disparities in the social security system (2010)



Note: Medical insurance data are calculated based on annual data of regular employees in state-owned enterprises because there are no series data on all employees in urban areas.

Source: National Bureau of Statistics of China, China Statistical Yearbook 2011.

Under the Chinese social security system, pensions and medical insurance are now formally applied to rural areas, and migrant workers in urban areas can participate in unemployment insurance. Nevertheless, the Chinese social security system maintains an urban-rural divide, as mentioned in Section 1. For example, maternity insurance, which is very popular in urban areas, is not provided in rural areas, while land tenure security in rural areas of China, which provides only the right of use land rather than property rights, is seen as lifetime social security in these parts. As Figure 5 shows, in middle areas where the ratio of farmers to total workers is higher than that of other areas, the participation rate in the social security system is low and there is a large

difference between the southeast and western areas.

In addition to urban–rural disparities and those between industries, companies, and employment forms, the redistribution effect of the social security system is weak and plays no role in correcting differences. Table 1 compares China’s redistribution effect with those of developed countries. In developed countries, about 20–50% of the difference is revised through the adjustment of tax and welfare benefits. However, the ratio of redistribution in China is very small or even negative after the adjustment by income tax and pension benefits. In addition, the negative value means that the welfare benefit is distributed to high income brackets and that total income disparity will expand further.

**Table 1** Redistribution effect of the tax and social security system in developed countries and China

OECD countries (middle 2000s)	Japan	US	UK	France	Germ any	Swed en	OECD average
Gini Coefficient before the tax and social security benefit	0.44	0.46	0.46	0.48	0.51	0.43	0.45
Gini Coefficient after the tax and social security benefit	0.32	0.38	0.34	0.28	0.3	0.23	0.31
Redistribution effect	27%	17%	26%	42%	41%	47%	31%
China (2006)	Bei jing	Hai nan	Heilong jiang	Jiang xi	An hui	Shan xi	Guang xi
Gini Coefficient before the tax and social security benefit	0.26	0.37	0.34	0.27	0.25	0.27	0.35
Gini Coefficient after the tax and social security benefit	0.23	0.35	0.33	0.26	0.26	0.26	0.32
Redistribution effect	12%	4%	4%	4%	-5%	2%	10%

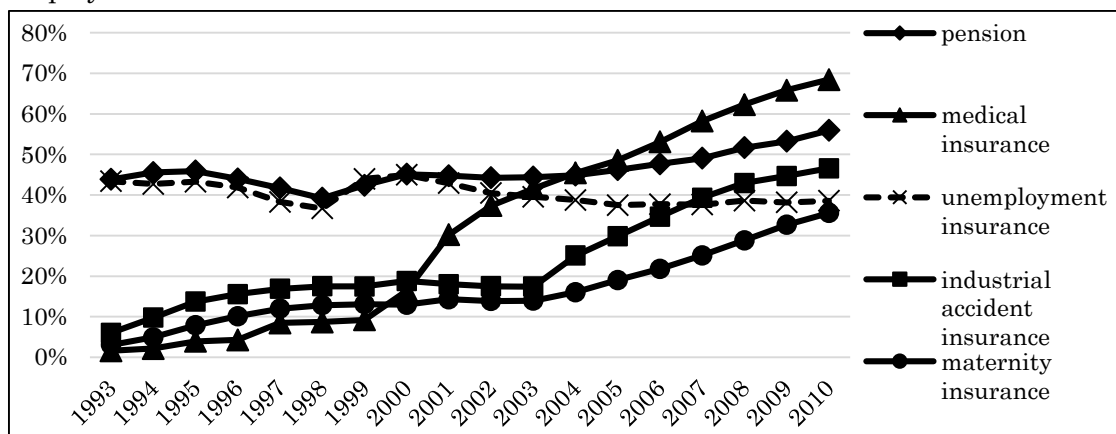
Note: Due to limitations of published data, tax is calculated from income tax only and the benefit from social security is calculated from pensions only.

Source: Based on METI (2011b), Yong and Kaneko (2010), and Yong (2011).

On the other hand, the participation rate in the four main types of social insurance, except for unemployment insurance, has grown rapidly after 2000; thus, the coverage range of the Chinese social security system has increased gradually. The failure of the participation rate in unemployment insurance to increase, despite year-by-year growth

of total employees in urban areas, is attributed to an increase in small private enterprises that, in breach of the law, do not join unemployment insurance as well as to an increase in employment of administrative management in recent years, as Figure 6 shows.

**Figure 6** Changes in the social security system participation rate of China's urban area employment



Note: See Figure 5.

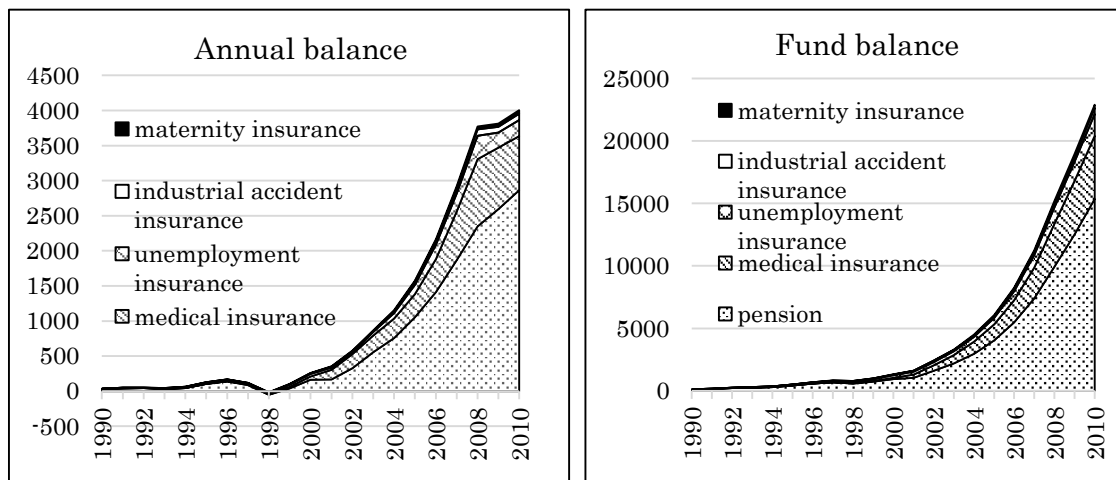
Source: See Figure 5.

In particular, medical insurance has increased significantly. Medical expenses were raised suddenly alongside the expansion of independence and self-management of medical institutions as part of reforms of the state-owned sector after the 1990s, which introduced a market mechanism to medical fields. In addition, the contents and coverage of worker's accident compensation insurance and maternity insurance expanded in order to reduce the burden of households and workers, resulting in a remarkable rise in medical expenses as China's social security system was brought closer to international welfare standards. However, the participation rate in medical insurance remains under 50% and the expansion of the coverage rate has become an urgent consideration.

As for industrial accident insurance, emergency expenditure on employees' work-related accidents and life events were covered by the corporate welfare system previously, specifically a combination of company corporate welfare and long-term steady employment (lifetime employment). However, in the process of transitioning to a national social security system, workers who do not participate in the social insurance system face difficulties in managing risk.

As Figure 7 shows, the finances of social insurance in Chinese urban areas show an increased surplus due to increased participation, with fund balances increasing constantly. On the other hand, the increases of each fund balance, including pensions, have tended to reduce (from a 49% increase in 2002 to a 21% increase in 2010); thus, there is a possibility that finances will become strained alongside the progression of the low birthrate and aging population.

**Figure 7** Changes in China's social security system finances (Unit: 100 million Yuan)



Note: Because rapid increases in unemployment start from 1997 with state-owned enterprise reform, the annual balance of unemployment insurance in 1997 is -5.3 billion yuan.

Source: See Figure 5.

The Chinese social insurance system is in the process<sup>11</sup> of transitioning to a national social security system from a company-based social security system by adopting a combination of a pay-as-you-go system and a funded system as the main scheme and a social insurance method for fund procurement. From the perspective of national solidarity for the social security system, there is weak solidarity for the funded system; thus, the social insurance system is weak in comparison with the tax-based social security system (Uni, 2012).

<sup>11</sup> Like economic reforms, China's social security system has reformed gradually. In other words, the reform has proceeded step by step, with old and new systems existing simultaneously and changes based on learning by doing. This kind of gradual reform matches actual conditions and displays the special characteristics of China. On the other hand, the institutional path dependency of the old system obstructs further reform and disrupts the institutional complementarity of the socioeconomic system in China (Zheng, 2007).

However, the funding of the social security system procured through the social insurance method is applied and distributed under the unified management of the nation (specifically, it is managed by local governments under state-led coordination), and from this perspective it can be viewed as a form of national consensus for the Chinese social security system. In addition, financial transfers from central and local government revenue to social security funds for reform and expansion can be viewed as a kind of national consensus, regardless of whether the transfers have the buy-in of the entire nation.

#### 4.2 Reform of Social Security as a Condition for Expanding the Middle Class

A social security system that is divided into several sub-systems by differences in burden and payment has a low income redistribution effect and will decrease growth in domestic consumption demand as consumers' desires decline. Furthermore, such a system will be an obstacle to the expansion of the middle class as well as increases in employment, wages, and economic growth.

**Table 2 Ratio of each income group to total population in China**

	2000 年	2005 年	2010 年	2015 年	2020 年
Wealthy (over 35,000 dollars)	0.3%	0.9%	2.8%	6.6%	13.0%
Upper middle income (15,000–35,000 dollars)	0.6%	1.9%	8.8%	18.1%	27.9%
Lower middle income (5,000–15,000 dollars)	4.5%	16.4%	39.0%	42.7%	38.0%
Low-income (5,000 dollars or less)	94.6%	80.8%	49.4%	32.6%	21.1%

Source: Based on METI (2011a), the data source is Euromonitor International 2011.

In China, about 300 million peoples comprise the middle class, although there are more optimistic estimations from abroad about the expansion of the Chinese consumption market from an expansion of the middle class. As Table 2 shows, according to the Japanese Ministry of Economy, Trade and Industry's "White Paper on International Economy and Trade 2011", China's social middle class (the combined upper and lower middle classes) already comprises about 48% (approximately 640 million people) of the total population; the ministry predicts the middle class will increase to

about 61% (approximately 910 million people) in 2015, and to about 66% (approximately 830 million people) in 2020.

Regarding the movement between hierarchies of China's middle classes, Bishida and Sonoda (2005) point out that China has unique characteristics. First, it is difficult for rural people to occupy the ranks of the middle class as movement between regions is strongly restricted by both the government and the expansion of a market economy based on socialism. Second, a hierarchical structure of politics predominates, making it easy for people with political power to move to the middle class. Thus, the reported scale of the social middle class in China versus the actual scale may arise from calculations using household budget income as a base, rather than personal income, as is the case with Japanese estimates (see Footnote 12).

In other words, some self-employed people and managers of small and medium enterprises in urban areas get richer under "the market compromise" and some central and local government bureaucrats (*Ganbu*) get richer under "the power compromise," became the middle class by using their positions in a transforming market.

The social middle classes comprise mostly people from urban areas with urban registration and most are recipients of the conventional social security system in China. Furthermore, alongside the transition to a national social security system based on state-led coordination from a company corporate welfare system, the range and contents of compensation for these social middle classes have expanded.

On the other hand, more than 100 million migrant workers who are hired by the non-regular sector and forced into cheap labor are not recipients of the social security system. However, some people from rural areas with higher education qualifications who are employed in the regular sector in urban areas are included in the social security system and are able to enter the social middle class under China's "increment reform."

In addition, the social security system, which is closely related to expanding the social middle class, has a large impact on urbanization, which can speed up the transition to a domestic demand-led growth regime in China. With the advancement of China's industrial structure and political promotion by the state, urbanization advanced rapidly after 1990; the ratio of urbanization increased from 27% in 1991 to 46% in 2008. Currently, the Chinese government is promoting inflows to about 400 small and medium-

size local cities while limiting inflows from rural areas to 41 large cities, whose population exceeded 2 million in 2008. This is in order to expand the middle class as agents of domestic demand-led economic growth.

However, the social security system of urban areas that are in the process of reform cannot cover China's increasing rural population who held land tenure security and were protected under the traditional rural protection system. As a result, there is an increase in the population ratio without access to social security. For these people, the government established "minimum welfare of the urban resident" in 1999, and expanded welfare service by the community (*Shequ*). However, due to financial shortages as welfare expenditures of local governments have increased, there have been cases in which local governments reduce the amount of payments or limit the number of recipients (Sawada, 2011). Those people who do not receive benefits under the social security system and who cannot become members of the middle class expose dissatisfaction with the existing socioeconomic system and, at times, they criticize the government through demonstrations.

## 5. Discussion and Conclusions

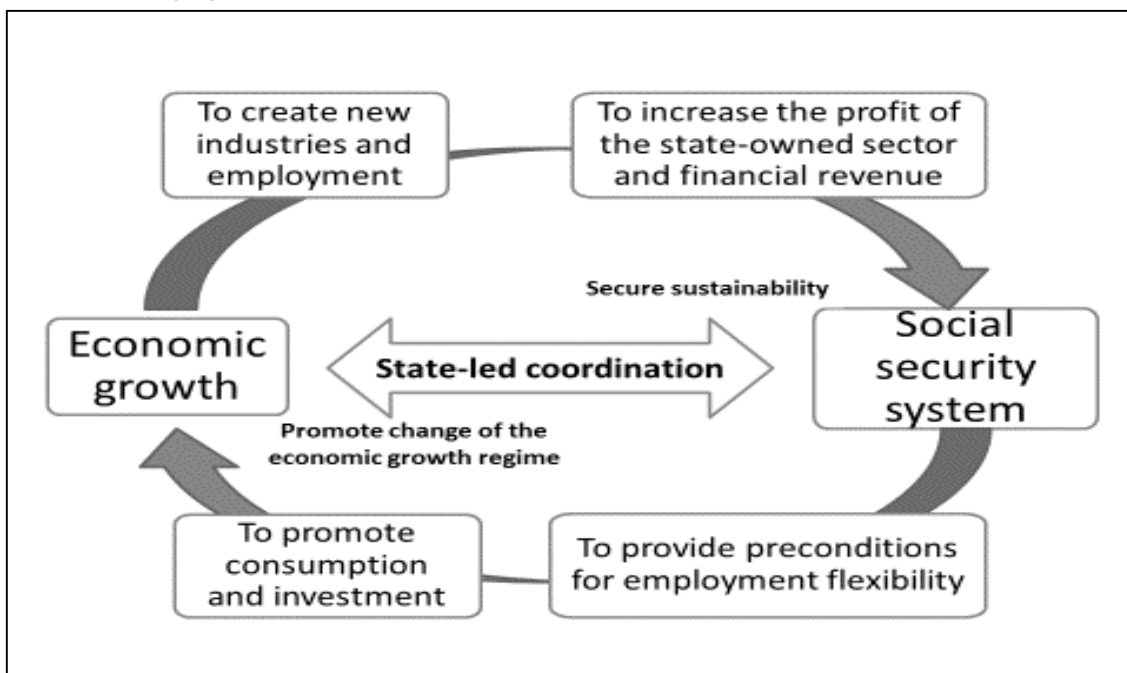
The debate about the influences on China's growth regime transition of significant changes to industrial relations and the social security system can be summarized as a cumulative causation structure of state-led coordination based on economic growth, employment system reform, and the social security system, as Figure 8 shows.

In other words, along the path from social security to economic growth, the expansion of social security will reduce risks associated with employment and income under an increasingly flexible labor market, ease anxieties about the future, and expand domestic consumption demand. In addition, domestic demand growth and investment will be promoted by the expansion of the social security system to create preconditions for employment flexibility. That is, the expansion of domestic consumption and investment will promote the transition of the economic growth regime to domestic demand-led growth from export-led growth.

On the other hand, along the path from economic growth to social security, increasing business and employment demand and the expansion of profit and revenue

by the state-owned sector (including state-owned corporations and land) will enable the necessary funds to be secured for the expansion of social welfare, thus, improving the sustainability of the social security system.

**Figure 8** Cumulative causation structure of economic growth, employment, and the social security system under China's state-led coordination



Source: Based on METI (2011b, p. 23).

In the cumulative causation structure of Figure 8, an important point is how to finance the necessary funds for expansion of the social security system. As mentioned in Section 4, social insurance reserves have risen consistently under the pay-as-you-go system, but there remains a shortage of reserves, which cannot be rectified at present due to the decreasing birth rate and aging population. Regarding the scale of the shortages, at the annual balances of 2005, the Ministry of Human Resources and Social Security of China has estimated a shortfall of 1.8–2.9 trillion yuan while the World Bank has estimated a shortfall of about 2 trillion yuan.

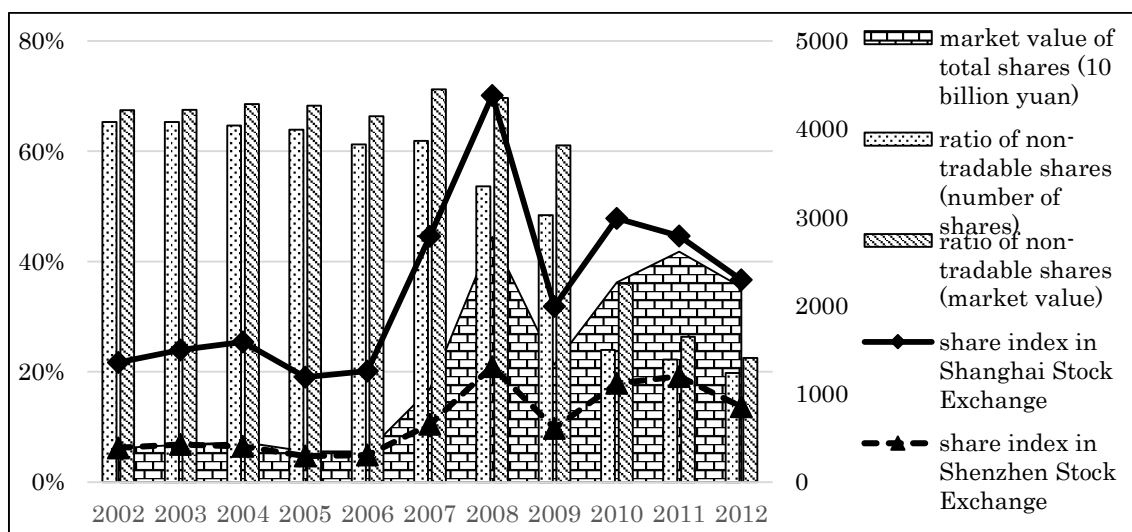
We now consider ways for using capital gains of state-owned stocks for the reform and expansion of the social security system as a mechanism of fairness and equal distribution of the dividends of state-owned stocks among people.



It is well known that the ratio of state-owned enterprises to total enterprises in China fell sharply with reform of the socialist market economy system after 1992; however, state-owned enterprises maintain a dominant position in key industries of the country. There is criticism that the state-owned sector, which is under the government's direct or indirect guidance, significantly disrupts the normal functioning of the country's market mechanisms and competition, thus, obstructing effective resource allocation and causing rent seeking and corruption (Wu, 2007; Nakakane, 2010).

On the other hand, there are positive views about the theoretical possibilities of China's state-owned economy in a socialist market economy. Specifically, it may provide a way to redistribute dividends of the public economy for people though increased management efficiency and productivity of the state-owned economy (Itoh, 2012).

**Figure 9** Changes of the share indexes of the Shanghai and Shenzhen stock exchanges and the ratio of non-tradable shares



Note: The left axis shows the ratio of non-tradable shares and the right axis the market prices of shares and the share index. Data are based on values at the last trading day of each year.

Source: China Securities Regulatory Commission, *Monthly Report of Stock Market*.

As Figure 9 shows, a considerable proportion of state-owned shares remained in Chinese securities markets after the non-tradable share reform of 2001. Although the ratio of non-tradable shares to total issued stocks has decreased significantly (from 65% in 2002 to 20% in 2012), their aggregate market value was more than 3 trillion yuan in

2010, which is more than the estimated Chinese social security fund balances (2.3 trillion yuan). This signifies a substantial possibility for promoting reform and expanding the social security system under state-led coordination in China.

There are two options. One method is to sell all state-owned shares, transfer the gains from the sales to the social security fund balance, and manage the fund via the stock market. The other method is to maintain ownership of the shares and transfer the annual dividends into the social security fund balance. We now summarize the methods of supplying revenue for social security reform and expansion through active and effective management of state-owned shares for the transition of the economic growth regime to domestic consumption-led growth from export-led growth in the Chinese economy.

First, gains from security sales or annual dividends can be transferred to the social security fund balance and used for the expansion of China's social security system; in so doing, this provides preconditions for labor market reform based on the flexicurity strategy, as mentioned in Section 2. In addition, the creation of a flexible and secure labor market increases domestic demand through the activation of investment and consumption in the macro economy.

Second, if a new management organization representing the various actors is formed and substitutes for the present government management agency, this would be a new and efficient way to promote shifts from state-led coordination to national institutional coordination in China.

Third, securing financial resources for the reform of the social security system through the management of state-owned funds could achieve collective ownership and fair distribution of management for all people. This would contribute to maintaining the legitimacy of the socialist market economy system in China.

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