



# SEEKING BALANCE

China strives to adapt social protection to the needs of a market economy

**Ken Wills**

**T**here was bound to come a time in China's modern development—starting in 1949 with the founding of the cradle-to-grave welfare state—when the demands of the people for a better life outgrew the ability of the People's Republic to deliver.

That time could be now.

China thrived during decades of near double-digit growth since Deng Xiaoping first experimented with local markets and untethered parts of the economy from state control in the 1980s and 1990s. The country's rapid advance from developing nation to claim the No. 2 spot among the world's largest economies spawned a massive middle class and hundreds of billionaires.

But growth was uneven, leaving yawning gaps between rich and poor, between prosperous coastal cities and neglected, largely rural, inland regions.

Along the way, China sought, with mixed results, to adapt services such as pensions and health care to the demands of an increasingly market-driven economy. Today, as the government of Xi Jinping struggles to reconcile the aspirations of the rising middle class with the needs of the millions who remain in poverty, it must also contend with the challenges of slowing growth.

In an October 2017 address at the Communist Party's National Congress ahead of his second five-year term, Xi acknowledged that the government had essentially fallen short of people's expectations. He set out to redefine how the Communist Party would provide for its citizens for decades to come.

"As socialism with Chinese characteristics has entered a new era, the principal contradiction facing Chinese society has evolved," Xi told thousands of party delegates gathered in the Great Hall of

the People in Beijing, while hundreds of millions watched the national broadcast on television. “What we now face is the contradiction between unbalanced and inadequate development and the people’s ever-growing needs for a better life.”

These needs, he said, “are increasingly broad.”

Cataloging his government’s achievements, Xi boasted that China had lifted some 60 million people out of poverty in the previous five years, but he also noted that more needed to be done. He called for an end to rural poverty by 2020, a herculean task for sure, by “drawing on the joint efforts of government, society, and the market.”

Whereas other presidents who followed Deng sought to unleash the power of market forces to fuel growth and reduce poverty, Xi is reversing the trend and reasserting the role of the party and the state, some academics and political observers say.

“He is favoring the public sphere—and extending its social, political and economic reach,” China scholar Evan Feigenbaum wrote in a November 2017 paper for the Carnegie Endowment for International Peace in Washington. “The party has, quite simply, not adapted well in recent decades to the changed conditions of an aging society and growing economic inequality.”

When stock markets plunged in 2015, the government reimposed a rash of controls on capital movement out of the country and on free market trading. Xi has also increased the role of party members on private as well as public company boards.

At the same time, his government has reopened credit taps for state-owned enterprises—favoring them over the burgeoning private sector—to spur economic growth. In an effort to clamp down on financial risks from runaway debt, one of the three main “battles” cited by Xi, restrictions on corporate lending disproportionately affected private companies. The government has been stepping on the accelerator for state-owned enterprises, meanwhile, which benefit from loans freed up by recent cuts in banks’ reserve requirements. Still, experience suggests that lending to the public sector is a less efficient way of stimulating the economy and could actually add to the pile of nonperforming loans.

Under Mao Zedong, who led the Communist Party until his death in 1976, China emphasized building national strength through investment in heavy industry, and workers labored side by side for generally similar, but low, incomes. The vast

majority of people living in the countryside were organized along agricultural collectives or communes. Government enterprises and agencies together provided an “iron rice bowl” of benefits, including housing, education, health care, pensions, basic incomes, and even help with funeral costs.

As the country looked beyond its borders after Mao’s death, it began to embark on economic reforms that mirrored market mechanisms but were later dubbed “socialism with Chinese characteristics.” While Deng used incentive systems to stoke the economy—rolling out a nationwide plan in the early 1980s to let farmers reap the profits of excess production, for instance—he also started to reshape the welfare state to meet the needs of those who worked in the private sector.

Initially, the number of those venturing out to start their own businesses was limited by the uncertainty of having to forfeit benefits that went with

Once some people started getting rich, others took the leap and dove into the sea of small-scale entrepreneurship.

state employment. A few measures helped encourage individuals to become more independent, including reforms of labor contracts and prices and alternatives to collectives that shifted responsibility for profit and loss to managers. Once some people started getting rich, others took the leap and dove into the sea of small-scale entrepreneurship.

In the late 1970s, there were budding moves to shift social services from state enterprises to local governments. A thin social security system was established, though it wasn’t until 1994 that guidelines were drafted for a multitiered system of social insurance, social welfare, and an individual savings program, among other benefits. But those steps weren’t enough to provide relief to state-owned enterprises, which found it increasingly difficult to bear the costs of social welfare benefits.

“Without the support of a proper social security system, state sector enterprises bearing all the welfare burdens would find it difficult to compete in the market,” Bingqin Li, director of the Chinese Social Policy Program at the University of New South Wales in Sydney, wrote in a paper titled “Welfare State Changes in China Since 1949.”

Measures, such as the removal of employer housing provisions, were introduced to improve competitiveness. Enterprises got additional relief in the late 1990s. Unemployment insurance, living allowances, and minimum income guarantees replaced lifetime employment, while a basic pension system was introduced, and some health-care coverage was instituted, though the coverage rate was initially low.

Change accelerated as China prepared to join the World Trade Organization, a milestone in late 2001 that drew in massive amounts of foreign investment and focused Chinese companies on export markets. To compete with neighboring “tigers” Hong Kong SAR, Singapore, and South Korea, China’s state-owned enterprises had to streamline further, and government policies resulted in dismissals of tens of millions of workers.

Even for those remaining in the state sector, the reforms significantly changed the employees’ relationships with the enterprises. As part of the effort to improve efficiency, workers were turned into contractual employees, and the company’s obligations to provide a host of lifelong welfare programs were greatly reduced. Pension reforms aimed to provide a safety net for workers independent of the state firms.

By 2005, a typical retired urban worker received two distinct pensions, according to Huoyun Zhu and Alan Walker in their paper “Pension System Reform in China: Who Gets What Pensions?” published this year. One was from an account containing accumulated employer contributions, with benefits that depended on the average wage of workers, the worker’s salary before retiring, and the number of years contributions were made. The second was from an account containing individual contributions.

To complicate matters for Chinese planners, thriving new industries in China’s major cities attracted masses of rural workers seeking better-paying jobs. These migrants often found themselves in need of food, shelter, and social services, and rural areas were left denuded of working-age people.

A seismic shift in social benefits occurred in the late 2000s in response to the global financial crisis. Because China’s economy had not fully opened to the outside world, it was partially insulated from the worst of the downturn. Its stronger fiscal position also allowed it to embark on a massive stimulus program that spurred domestic and global economic growth and led to new social welfare coverage.

Investments were boosted to increase affordable housing, and taxes were reformed to be

more progressive; health care, education, and cultural spending was targeted to rural areas, which also benefited from spending on roads, rail, and power systems.

Still, the income gap between urban and rural and coastal and inland regions persisted or even continued to grow, and the Gini coefficient remained stubbornly above 0.4 (zero being full equality of income distribution and 1 showing complete concentration of income).

Big pieces of the social safety net were still missing. Many rural residents, unemployed urban residents, and jobless migrants were not covered by pension programs until 2009. Further revisions in 2015 broadened the umbrella of coverage in a transition from a state-enterprise to a state-society model, Zhu and Walker note.

As a result, most of China’s 1.4 billion people are now covered, but the uneven system exacerbates inequalities, note Zhu and Walker. “First, an important aspect of social stratification has been reshaped into five distinct pension scheme classes,” they write. “Second, the new pension model has strengthened the link between benefits and contributions, which privileges the better off.”

Meanwhile, China has substantially improved health insurance coverage. Starting in 1998, urban workers at state and private companies were covered. By late 2009, students, children, the urban jobless, and rural residents were added.

“Ten years ago, most people in China did not have access to health insurance; today 96 percent or so are covered in one way or another,” Dali Yang, a political science professor at the University of Chicago, says in an interview. “You can always say, ‘Well maybe the co-pay is too high or coverage is spotty, but in fact it’s very substantial.’”

Although the social safety net has been expanded under Xi, the government says some 30 million people—almost 2 percent of the population—linger below the poverty line, defined as earning the equivalent of about 95 cents a day. The official numbers gloss over the nearly 500 million people who live just above the poverty line, on less than \$5.50 a day, according to World Bank estimates.

One solution has been to move poor rural residents to cities, where job opportunities might be greater. In 2014, Xi’s government embarked on an unprecedented plan to shift some 250 million people to cities by 2026. That has meant redrawing municipal boundaries to encompass surrounding rural areas,

relocating rural residents, and even building entirely new cities. The plan simultaneously serves various national objectives: to increase China's percentage of urban residents in line with global developed economy standards, boost domestic consumption to rebalance the economy away from exports, and improve delivery of social services.

Poverty-reduction funds allocated by the central government budget in Xi's first term were more than double the total spending of the previous five years. That money is used primarily for infrastructure, agricultural subsidies, and discounted loans. But spending for another significant poverty-reduction program—a minimum living standard provision called *dibao*—has been declining as a percentage of GDP, according to Ministry of Finance figures.

Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order. The slowdown has led to a pause, even a reversal, in plans to further streamline state-owned enterprises.

"Xi is having none of this business about empowering private interests and 'broadening' the makeup of the Party," Feigenbaum writes. "His team views the unwinding of some of these prior policies as a necessary step toward a new and, from their standpoint, more satisfactory division of roles between the public and private spheres."

Efforts to strengthen the social safety net have also flagged as local officials focus more on restoring growth than goals such as expanding pensions, improving education, or relaxing the *hukou* system, which ties people and their benefits to a particular locale, says Mary Gallagher, a professor of political science at the University of Michigan in Ann Arbor.

"Those things I don't think have been effectively integrated into ... the system of performance evaluation for local officials," Gallagher says in an interview.

Other challenges loom. The adoption of new technologies—another national priority for Xi—has put China in a globally competitive position but has also exacerbated its social welfare needs. For instance, China's drive to invest in robotics threatens to cause large-scale unemployment in industries, from logistics to manufacturing, that provided life-long jobs in the past. Displacement of many more workers could sow discontent should China renew efforts to streamline state enterprises, throwing workers into national benefit plans that are often less generous than those provided by employers.

"A lot of times, when they do close down these firms, they'll say you'll still have a job, but it might

be as a street sweeper," Elizabeth Economy, director for Asia Studies at the New York-based Council on Foreign Relations, says in an interview. "There's a huge difference in the type of work they are getting and the type of benefits."

Xi's acknowledgment of economic shortcomings and his blueprint for solutions raise the stakes for his government when priorities fall short of expectations, Economy says.

"Economic reform, poverty alleviation, addressing environmental issues—all of those things are policy initiatives that he thinks are essential to maintaining the legitimacy of the Communist Party and moving the country forward," she says.

But the biggest test facing Xi's government may be an unavoidable demographic trend—the widening gap between pension contributions and payouts as China's population grows older.

## Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order.

The State Council, or cabinet, predicts about a quarter of the population will be over 60 by 2030. Estimates of the country's pension funding shortfall within the next few years range from \$130 billion to \$175 billion, a gap the government must fill. While Xi has vowed to improve the system, his administration has offered few specifics. Last year, the government directed a handful of large state-owned companies to transfer 10 percent of their stock to pension funds to ease the funds' asset shortfall. And the government took steps this year to remove regional disparities in benefits. One option could be to tap into the government's healthy coffers, making contributions from general revenues.

Other options—none of them easy—would focus on investing funds more effectively to boost returns; cutting benefits, which would risk alienating pensioners; or raising contribution rates for companies and individuals, which are high compared with other countries. Already running behind the rising expectations of ordinary Chinese people, the government must race just to catch up. **FD**

Formerly Beijing bureau chief for Bloomberg News, **KEN WILLS** is a freelance writer based in Evanston, Illinois.