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Social Welfare in China in the Context Of Three Transitions

by

Athar Hussain*

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Stanford University
John A. and Cynthia Fry Gunn Building
366 Galvez Street | Stanford, CA | 94305-6015

* Deputy Director, Asia Research Centre, London School of Economics
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Athar Hussain
Z224
Asia Research Centre
London School of Economics
Houghton Street, London WC2A 2AE
Fax: (44-171) 955 7591
E-mail: a.hussain@lse.ac.uk

Abstract

This paper conducts a comprehensive review and evaluation of China’s social welfare development in the context of socio-economic changes characterized by three transitions. The analysis first focuses on the urban and rural social security systems by examining the arrangements for income maintenance in old age and unemployment, as well as the effectiveness of such provisions. This paper goes on to describe the current status of healthcare provision in urban and rural areas, and explore ways to finance adequate medical care and eradicate preventable illnesses. Finally, the paper identifies the major impediments in the implementation of social security reforms aimed at replacing the inherited system.
1. Introduction

Social welfare is taken here in its broad meaning covering the protection of the population from deprivation and the development of that population’s capabilities. A few simple questions underlie the discussion here:

- How free is the Chinese population from the threat of destitution?
- What are the arrangements for income maintenance in contingencies such as old age and unemployment and how effective are they?
- Does the population have access to adequate medical care in cases of illness and how far has China succeeded in abolishing the incidence of preventable illnesses?
- What are the major impediments in the implementation of social security reforms aimed at replacing the inherited system?

In terms of the current level of human development indicators, China stands out among low-income economies (those with an annual per capita income of less than $760). China is a low-income economy in terms of per capita GNP if not PPP statistics; but it resembles middle-income economies in welfare indicators. Its population enjoys a comparatively high life expectancy of 69 years and low infant mortality rate of 38 per 1,000 live births; and its adult illiteracy rate (including semi-literate) of 15.8% is among the lowest among low-income economies (World Bank WDR 1999). Compared to other populous developing economies, the percentage of the population living in poverty is low (World Bank 1992).

Further, China's outstanding record in human development is losing its lustre. Over the reform period since 1978, improvements in indicators of human development have not been as sustained and dramatic as growth in per capita income, which underscores the point that rapid economic growth alone is not sufficient for a sustained reduction in deprivation. A concerted policy is also needed. Following a sharp drop in the population in absolute poverty from 33% to 12% between 1978 and 1985, progress in reducing poverty has since been slow (World Bank 1992b). Urban poverty, previously rare, has been rising (discussed below). The downward trend in the "under-five mortality rate" (the preferred indicator of child health), in evidence until the early 1980s, seems to have slowed down to a halt or even risen in some of the poorer provinces (World Bank 1996b).

Looking ahead two decades to 2020, the appropriate comparators for China are no longer low- but middle-income economies whose ranks it would be joining over the next ten years. In health indicators and educational attainment, China lags behind a number of Asian countries. Its under-five mortality rate of 47 per 1,000 live births is higher than those in Malaysia, Thailand and Sri Lanka and several times those in Hong Kong, South Korea and Singapore (UNDP HDR 1999). The incidence of preventable diseases such as viral hepatitis is high. The average length of schooling is significantly shorter and the drop out rates before the completion of basic nine-year schooling is higher than in Malaysia, Thailand or Sri Lanka, let alone South
Korea. The percentage of secondary (including vocational) school graduates going into higher education is a mere 20% (SSB 19991: 643 & 645), which is very low even compared to low-income Asian countries. What these gaps suggest is that, without a concerted effort in improving child and maternal health and raising the educational level of its population, China would in the near future begin look like a laggard amongst East and Southeast Asian economies.

The purpose of this paper is to provide an overview of various social welfare programs in urban and rural areas in a wider context of socio-economic changes. It is structured as follows. Section 2 discusses the three transitions China has been undergoing over the last two decades or so. Section 3 analyses the arrangements for income maintenance in urban areas, including old-age pensions, unemployment insurance and poverty relief in rural areas. Section 4 presents a brief outline of the rural social security system. Section 5 focuses on health-care and health insurance and Section 5 concludes with some observations. The emphasis here is on the current situation and the likely trend of changes in the near future, which is taken to be the period from 1998 to 2020.

2. Three Transitions
Issues concerning social welfare in present-day China are shaped by three transitions it has been undergoing over the last twenty or so years:

- the demographic transition;
- the process of economic development;
- the transition from a command to a market economy.

The first refers to the transition from a demographic regime of high fertility and low life expectancy to one of low fertility and high life expectancy with a non-rising population. From the point of view of social welfare, its most important feature is the changing age structure not a deceleration in population growth. The second transition (termed economic development) consists in an outflow of labour from farming and, associated with it, a shift from self- to wage-employment and population migration. For the present purposes, the salient features of the third transition are, first, a change in the terms of employment in the state sector and its falling employment share, and, second, the hiatus between the erosion of enterprise-based social welfare and the establishment of a government-managed "socialised system”.

2.1. Demographic transition
The Chinese population is around 1.25 billion (1998 figure and around 20% of the world total) and growing by around 1% per year (SSB 1999c). This is similar to the rate in the US, half of that in India and a third lower than the average rate of 1.5% in middle-income economies (World Bank WDR 1999). By international
standards, the process of the demographic transition in China has been exceptionally rapid, with associated changes in the age structure of the population crowded in a much shorter period than elsewhere (Feeney, 1996). The fertility rate is already down to 1.5 children per woman (SSB 1999c). At the current trends, the population is expected to stabilise around a grand total of 1.5 billion by the year 2040, 252 million more than the 1998 total (see SSB 1998d). Given the asymptotic growth pattern, most of this increase will take place between the next 20 to 25 years and will be accompanied by a radical change in the age-structure of the population, which is brought out by a comparison of the population profile in 1998 and 2020 (Table 1).

### Table 1
Population Profile 1998 and 2020

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total (1,000)</td>
<td>1,248,100</td>
<td>1,441,980</td>
</tr>
<tr>
<td>Population Ratio of Children(^1) (Dependency Ratio)(^2)</td>
<td>24.2% (35.2%)</td>
<td>19.3% (27.9%)</td>
</tr>
<tr>
<td>Population Ratio of the Elderly(^3) (Dependency Ratio)</td>
<td>7.2% (10.5%)</td>
<td>11.4% (16.5%)</td>
</tr>
<tr>
<td>Total Dependency Ratio(^3)</td>
<td>45.7%</td>
<td>44.3%</td>
</tr>
</tbody>
</table>

Notes: The age division here follows the convention in demographic literature. 1. Aged (0-14). 2. Following the convention in demography the denominator of the dependency ratios is the population aged 15-64. 3. Aged 65+. Source: SSB 1999c and SSB 1998d.

Compared with the 1998 population composition, in 2020 there will be 23 million fewer children, 106 million more elderly people and 111 million more working-age adults. The rise in the ratio of the elderly to the total population and working-age adults, on which much of the discussion in China tends to be focused, will be accompanied by a fall in the ratio of children. The net result will be a fall in the crude dependency ratio (i.e. not adjusted for the labour participation rate of working-age adults and the differing needs of various age groups).

An exclusive focus on the ratio of the elderly as the index of the burden of old-age support is misleading for two reasons. First, it concentrates on the adverse side and neglects the huge economic bonus provided by a declining ratio of children. Accruing first, the benefit will continue to outweigh the cost until
2020, if not later (for a similar argument in relation to the US see Cutler et al, 1990). Moreover, the cost associated with the rise in the ratio of the elderly relative to working-age adults is mitigated by the fact that China is, and would for sometime remain, a surplus labour economy. Following Sen (1984), this is taken to mean that the withdrawal of a substantial percentage of working age adults from the labour force, which is what the rise in the ratio of the elderly means, would have no or little effect on the burden of supporting the dependent population. The implication is that China has more time to adjust to the ageing population than is generally believed. China's old-age pensions system is beset with major problems, but these are due far more to internal design faults of the system than to the process of ageing associated with the demographic transition. Second, the ratio of the elderly gives a distorted picture of the geographical distribution of the burden of supporting the elderly population. In terms of the ratio of the elderly alone, compared to the interior provinces, the coastal provinces carry a higher burden of supporting the elderly population. But most of these tend to have a lower ratio of children to the population because of their lower fertility rates. As a result, the total dependency ratio, including both children and the elderly, is generally lower in richer coastal than in the poorer interior provinces. To give two examples: Shanghai, the (city) province with the highest per capita income, has the highest ratio of the elderly of all provinces. Guizhou, the poorest province in terms of per capita income, has a low ratio of the elderly but a higher total dependency ratio than that of Shanghai, 39 compared to 38.3 (SSB 1998c). To explore the full ramifications of the demographic transition for social welfare, it is necessary to go beyond the crude dependency ratio and examine changes in the composition of various age groups. These are divided here into the "dependent" (or non-active) population (children and the elderly) and working-age adults, which we discuss in turn.

Composition of the Dependent Population

The composition of the dependent population matters for two reasons. First, the respective needs of children and the elderly differ, a feature that is captured by equivalence scales (see for example, Cutler et al, 1990; Deaton, 1997). Second and more important for the present purpose, the pattern of financial support of children is different from that of the elderly. Thus, with the dependency ratio held constant, a shift in the composition of the dependent population away from children towards the elderly, as has been happening in China, has significant distributive implications. Much of the financial cost and personal care of children falls on households. But a large part of their cost of education is met from public resources, though over the reform period the cost borne by parents has steadily risen. Currently financial support for the elderly population is split between households and the "society" (which in China means the government and work units), with the former carrying the main burden. Taking 60 as the benchmark retirement age, only 35.9

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1 The current official retirement age in China is low by international standards, ranging between 50 and 60. The actual retirement age is a distribution rather than a number and the choice of 60 as the benchmark retirement age
million (20%) of the 178.1 million aged over 60 receive pensions and all but a small percentage of these are in urban areas. The remaining 80% are mostly rural residents dependent on their children, predominantly sons, for financial support. There are now collective (community) pension schemes in rural areas, but these are still in the development stage and cover only part subsistence.

Taking the current arrangements for old-age support as givens, the government, enterprises and families will all feel the financial impact of the rising elderly population. In urban areas the cost will fall mainly on work units (including their employees) and the government. For the latter, with all else held constant, it will be offset by the declining ratio of children, though not necessarily completely. State-owned units (including government and public organizations), which already carry a heavy burden of old-age pensions, will be most adversely affected by the trend as they will receive none of the dividends from the falling ratio of children. Currently, around 77% of retirees are ex-state sector employees (SSB 1999b: 541) and this percentage will rise over the next two decades because of the higher median age of the state-sector labour force compared to that of the non-state sector. Given the high percentage of the urban elderly population receiving old-age pensions, urban households would feel the financial impact of the rising elderly population largely in the form of higher taxes (including social security contributions) rather than in the form of providing direct financial support for elderly parents. In contrast, rural households would feel the economic impact of the changing age structure largely through expenditure on children and elderly relatives. With the development and extension of rural collective pension schemes a part of the cost will be shifted the community or the local government and show up as contributions to the pension schemes or local taxes.

Focusing on the elderly, the distributive implications of old-age financial support through pensions (on a pay-as-you-go basis) and by families are very different. Leaving aside the cost borne by work units, support through pensions distributes the burden across all households regardless of their age composition. In contrast, old-age support by families concentrates the burden on a proportion of households, those with dependent elderly relatives. As increasingly realised in China, the current heavy reliance on the family for old-age support goes against the grain of the demographic trend and socio-economic changes. Because of the birth control policy, which in many localities means one child per couple, the future cohorts of the elderly will have fewer children to depend on than does the present cohort. An extreme example, which is often cited in China, is a future hypothetical family comprising 2 earners and 5 dependants, consisting of working couple (both single children themselves), their single child and their four elderly parents. Thus a crucial issue facing China is the progressive replacement of family financial support with old-age pensions.
Age-Structure of Working-Age adults

The age structure of working-age adults matters because age, either on its own or as a correlate of features such as educational attainment and experience, is a central consideration in hiring decisions. Having started in the late 1960s, the demographic transition has begun to have a significant impact on the age structure of China's working-age population with significant implications for social welfare. To show this, Table 2 compares the age structure of working age adults in 1982, when the effect of fertility decline from the late 1960s had yet to feed through to the population of working-age adults, and in 1998. The latter includes birth cohorts (aged 15-29) affected by the fertility transition and which received most, if not all, of their education in the reform period since 1979, benefiting from the revival of the educational system after the Cultural Revolution.

Table 2
Age Structure of Working-Age Adults: 1982 and 1998

<table>
<thead>
<tr>
<th>Age Group</th>
<th>1982</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aged 15-29</td>
<td>47.3%</td>
<td>36.3%</td>
</tr>
<tr>
<td>(Number in Millions)</td>
<td>(292)</td>
<td>(311)</td>
</tr>
<tr>
<td>Aged 30-64</td>
<td>52.7%</td>
<td>63.7%</td>
</tr>
<tr>
<td>(Number in Millions)</td>
<td>(325)</td>
<td>(546)</td>
</tr>
</tbody>
</table>

The change in the age structure over the 16 years is striking. The percentage of younger working-age adults (aged 15-29) has dropped by 11 percentage points. In absolute terms, only 19 million (7.9%) of the 240 million increase in the numbers of working-age adults is in the 15-29 age group and the remaining 221 million (92.1%) is in the 30-64 age group. One straightforward implication of the change in the age structure of the labour force is a reduction in the problem of finding jobs for school leavers, which would diminish still further as the effect of fertility decline feeds through to the labour force. Added to this, the change has implications for the age structure of the unemployed who have risen sharply in numbers in recent years. As a benchmark, if all unemployed persons have an identical chance of finding a job then the unemployment spell will be the same of all age groups. But, as in other economies, in China the spell of unemployment tends to be longer for older than younger workers. The available evidence strongly suggests that older workers (above-40 among men and above-35 among women) face lower chances of finding another job than younger workers do. The problem of unemployment among older workers in China is compounded further by their much lower educational attainment than that of younger workers. Because of the adverse impact of the Cultural Revolution (1966-78) on secondary and higher education, a large proportion of birth cohorts from 1953 to 1963 (aged between 35 to 45) missed out entirely on post-
basic education and occupational training. In contrast, the post-1970 birth cohorts (aged 28 or less in 1998) have largely escaped the deleterious effect of the Cultural Revolution. The implication is that China faces a serious problem of long-term unemployment due to the combination of the deleterious effects of the Cultural Revolution on education and training and of the impact of the demographic transition on the age structure. Further the problem of unemployment among older workers is likely to get worse over the next ten to 15 years because of a rising trend in the median age of the labour force driven by the falling size of cohorts entering the labour force.

2.2. Process of Development

The salient features of economic development with implications for social welfare are the following:

- the shift of labour out of farming into industry and services;
- change-over from self- to wage employment;
- labour and associated population migration.

Part and parcel of economic development, these are not particular to China but take on particular forms and have special consequences in the Chinese context. The three are correlated but not perfectly. To run through their broad social welfare implications, the division of the labour force between farming and non-farming activities determines the relative impact of weather fluctuations on personal incomes and assets. With 46.6% of the labour force still engaged in farming (SSB 1999f), natural disasters loom large in China as a major cause of deprivation. In the past few years, much of social protection in rural areas has been concerned with the alleviation of devastation caused by summer floods. The division between wage- and self-employment is of special relevance for social security because two of its principal components, old-age pensions and unemployment benefit, have traditionally been tied closely to wage employment (Atkinson, 1991) and they are in China as well. Compared to income from self-employment, especially when in kind, wages provide an easily verifiable standard for defining benefits and a convenient tax handle for financing social security schemes. The implication is that a shift from self- to wage employment widens the scope for the application of a mandatory social insurance scheme with entitlement to benefits tied to the contribution record. Labour and population migration is pertinent to social welfare because, first, it is associated with a change in the composition of households, thus the pattern of sharing of incomes. Second, migrants often do not have the same access to employment, housing, public services and social security schemes as locals do. The second has a special resonance in the Chinese context because of restrictions on migration and the associated disadvantageous status of migrants.

Compared with populous developing economies, China presents two anomalies in respect to the distribution of the population and labour force, which have knock-on effects on the social security system.
The most striking of these is the wide discrepancy between the percentage of the population with the official designation "non-agricultural" (fei nongye) and the percentage of the labour force engaged in non-farming activities. According to the household registration system, a mere 32.2% of the population is classified as "non-agricultural", and the corresponding percentage of the labour force designated as urban is 29.6% (SSB 1999b; SSB 1998e). This falls well short of the percentage of the labour force actually employed in services and industry, which is 53.4% (SSB 1999b; SSB 1999f). Reckoned in terms of the household registration designation "non-agricultural", the urbanization rate in China is not only, as widely noted, exceptionally low by international standards but also at odds with its GDP share of agriculture of only 18.4%. But reckoned in terms of the percentage of the labour force and correlatively the population actually dependent on farming as the principal income source, the Chinese urbanization rate of 50 plus percent is neither low by international standards nor at odds with its GDP composition. This estimate of the urban population also fits in with the spatial definition of “urban” in terms of the population in high density settlements with a preponderant share of non-farming activities in local GDP, say at least 85%. In terms of this definition, urban population comes to around 51% of the total (for details see Hussain 1999). This estimate still errs on the low side because it excludes most of the migrant population, defined as those resident and working in cities and towns for more than 6 months - the threshold used in the 1990 population census to distinguish migrants from short-term visitors. Including them would add another 4 to 5% to the total.

What implications follow from the observation that the actual urbanization rate exceeds the official rate of 32.2% by 20 percentage points or more? One implication is that social welfare issues correlated with urbanization, such as housing and unemployment, affect a majority rather than, as official statistics would suggest, less than a third of the Chinese population. Second and more important for present purposes, given that the official rural poverty line of Y620 per year is around a third of the commonly used urban poverty line of Y1,800 per year, the incidence of poverty is substantially higher than that implied by the commonly used estimate of the urbanization rate. This observation is especially pertinent to rural counties in the immediate vicinity of the urban districts of large cities that are often comparatively rich by rural standards but relatively poor by urban standards.

The other anomaly is presented by the sectoral distribution of the labour force in China, which was even more marked at the outset of economic reforms. The employment share of 49.8% in the primary sector (of which farming accounts for 46.6 percentage points) is similar to that in low-income or low middle-income economies. But the employment share of the secondary sector in China (23.5%) is comparatively high, and that of the tertiary sector (services) is comparatively low (26.7%). The period since 1978 marks a break from the pre-reform period in two respects: first, a marked acceleration in the transfer of labour out of farming, and, second, a steady shift of labour towards services in the non-farming sector. In the 20 years (1978-1998),
the share of labour in farming (more accurately that in the primary sector) has dropped by 21 percentage points, more than twice as rapidly as the mere 13 percentage drop in the 26 years from 1952 to 1978 (SSB 1999b). A side effect of the single-minded emphasis on industrialisation and bias against services in the pre-reform period was to put brakes on the transfer of labour out of farming, thus dampening the rise in per capita income. The period since 1978 has also seen a steady shift of non-farm employment towards services: its share in total employment has more than doubled from 12.2 to 26.7%. Contrasted with this, in the pre-reform period, the share of services fluctuated and was in 1978 less than 3 percentage points higher than that 1952. In those 26 years all but a small proportion of the labour outflow from agriculture was towards industry.

Looking forward to 2020, what would the sectoral labour distribution look like and what would be its social welfare implications? Assuming that the sectoral distribution of employment up to 2020 follows the same pattern of change as it has done since 1990, the share of the labour force in agriculture would fall at an annual rate of around 1.4 percentage points and the shares of industry and services would rise by 0.3 and 1.1 percentage points per year respectively. The result would be services with the largest share followed by industry and agriculture, an exact reversal of the ordering in 1978 (Table 3).

<table>
<thead>
<tr>
<th>Sectoral Distribution of Labour Force (%)s</th>
<th>1998</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary: (almost all farming)</td>
<td>49.8</td>
<td>16.7</td>
</tr>
<tr>
<td>Secondary (industry except for mining)</td>
<td>23.5</td>
<td>31.5</td>
</tr>
<tr>
<td>Tertiary: (services)</td>
<td>26.7</td>
<td>51.8</td>
</tr>
</tbody>
</table>

Source: SSB 1998b

By 2020 the sectoral distribution of the labour force in China would be very similar to that in present-day South Korea. Relevant to the discussion here, in what particular respects would the working lives of the population in 2020 and contingencies facing them be different from those of the present-day population? Given the long shadow of the rural-urban distinction on the life trajectory of individuals and contingencies facing them, the answer is that they will be different for the rural and for the urban populations. At present, 70.1% of the rural labour force is self-employed in farming combined with some side-line activity and, for the most part, resident in the place of birth (SSB 1998f). The remaining 29.9% employed in town and village enterprises retains strong links with agriculture. Their households have each a plot of land, which is worked on by some of their family members. Unlike their urban counterparts, they neither have old-age pensions, unemployment benefits nor, in most cases, health insurance. The land allotted to them is supposed
to be the substitute for these. Most members of the present-day urban labour force have worked for the same unit (predominantly the state sector) since entering the labour market and have until the past few years no or little experience of unemployment.

By 2020, most likely earlier, an overwhelming majority of the labour force would be wage-employed on a terminable contract in either industry or services with (likely) little or no direct family link to farming. A middle-aged member of the labour force would have experienced several job changes, including adapting to different occupations, interspersed with spells of unemployment and also a change in the place of residence since entering the labour force, most likely from a village to a town or a city. He/she would also face the prospect of retirement at some age and may have only one child. The purpose of this contrast is to bring into relief the changes with ramifications for social security. These are:

- the shift from self to wage employment;
- the prospect of unemployment;
- migration and increased labour mobility;
- retirement at a particular age.

The current legal and administrative framework and the social security system implicitly assume life trajectories and contingencies facing individuals that are increasingly at variance with reality. The designation "formally employed" (zhigong ren) is reserved for the urban labour force and does not apply to the rural labour force despite the fact that 30% (91.6 million) of them are wage-employed in town and village enterprises (SSB 1998f). Neither labour insurance (discussed below) nor many of the labour laws apply to wage-employees in rural areas who are regarded as "self employed", nor are they counted as unemployed when laid off or entitled to a retirement pension. Moreover, though migrant labour ("floating population") currently totals between 50 to 70 million (depending on the estimate) - between 7 to 10% of the labour force, labour migration is still largely treated as a temporary episode rather than as a permanent phenomenon. As elsewhere, migration in China is driven by the gap between urban and rural incomes, which since the mid-1980s has been widening. Rural migrants are allowed to take up temporary or casual employment in cities but not allowed to settle permanently without permission, which is hard to obtain in large cities, though not any longer for towns and medium-size cities. Migration, although it contributes to an increase in income in rural areas, has implications for social security. Not being allowed to settle permanently, a large percentage of migrants do not have permanent housing, lack full access to public amenities and are largely excluded from urban social security. Provision for portability of the old-age pensions and unemployment insurance either do not exist or are rudimentary.

Both the growth in wage employment in rural areas and rural out-migration, though massive, remain yet to be incorporated in the Chinese social security system, which is still based on the anachronistic
assumptions that rural labour is self-employed in farming and is immobile. Government policy is only slowly beginning to recognise labour migration as an irreversible feature of economic development. A tangible policy change is the emphasis on the proliferation and development of medium and small towns and a loosening of restrictions on immigration into them.

2.3. Transition to a market economy

Economic reforms have in their train brought a rapid and sustained growth rate and an unprecedented rise in living standards, but they have also have had a profound impact on the working life history of individuals and on the contingencies they face. Even though the Chinese economy has managed to skip the downward part of the J-curve of the transition from a command to a market economy, in the fields of employment and social welfare it is undergoing changes similar to those in transitional economies of Eastern Europe. In the present context, of special importance are the following:

- growing incompatibility between the traditional social welfare responsibilities of enterprises and their economic role;
- the increasing replacement of permanent employment with terminable employment and rising numbers of lay-offs;
- the rapid growth of non-state enterprises (particularly private ones) with a sparse social security coverage;
- widening inequality in the distribution of personal incomes.

Taking the above in turn, historically, Chinese state enterprises have operated as semi-enclosed communities, more akin to the army than to firms in market economies (Walder, 1986). As well as producing goods or services for sale they have also provided either free or at low prices a wide range of services to their current and retired employees and often their families as well. Prominent amongst these have been housing, outpatient and, in large enterprises, also in-patient medical care, schooling for children and in some cases even public utilities. The cash wage has traditionally been just one component of a package with an array of benefits in kind (see Hu, 1996). The extended social role of Chinese state enterprises has traditionally bound much of the urban labour force to their respective work units (danwei) for not merely their working lives but also retirement. This bond is increasingly perceived as a major barrier in the restructuring of state enterprises, including the closure of the ones with no or little chance of survival in a market economy. Confronted with a dramatic worsening of financial position in recent years, many state enterprises are forced to default on their social obligations, such as pensions to their retirees, and to lay-off their employees in large numbers. As a result, the urban labour force no longer perceives employment in a state enterprise as a secure guarantee of income for life complemented with generous benefits in kind. It offers, in Chinese parlance, neither an "iron
 Dating from the pre-reform period, the social role of state enterprises was originally embedded in an economic and political structure with three salient features:

- the integration of the government budget with enterprise budgets and the profitability of the state sector as a whole;
- a combination of low wages with over-employment and lifetime employment;
- the work unit as the primary locus of political organization and social control.

The integration of enterprise and government budgets spread the financing of social responsibilities across all enterprises, and insulated employment and wages in cash and kind in an enterprise from its financial performance. Labour recruitment in state and urban collective enterprises and government organizations was geared less to meeting the labour demand and more to preventing the emergence of unemployment in urban areas. As it were, the labour supply created its own demand, and this had two consequences. First, the work-unit based social provision covered a large majority of the urban population. In 1978, 78.3% of the urban labour force was employed in the state enterprises and government organizations, and the rest was employed in collective enterprises, which tended to emulate the state sector.

Second, because of the large excess of job seekers relative to vacancies in urban areas most work units had more employees than they needed. State enterprises have been the mainstay of the urban social welfare system. Pre-empted by the extensive social role of work units, government provision of social services has tended to be sparse. Thus, a paradoxical feature of the Chinese urban economy has been the combination of extensive social security benefits with a rudimentary capacity of the government to manage and administer social security schemes. If government agencies have performed many of the managerial functions, such as making output and investment decisions, enterprises, in turn, have provided what in developed market economies governments or civil organizations do. Thus whereas economic decision-making was centralised in government departments, decisions concerning social services and collective goods were dispersed across a large number of enterprises. Broadly, economic reforms are reversing this pattern by decentralising economic decision-making to enterprises and centralising (termed socialising in China) the social security system in the newly established Ministry of Labour and Social Security and its territorial counterparts. The first type of reform preceded the second which began only a few years ago and, as we shall see below, is far from completed.

The economic reforms and ensuing fall-out have gradually cut the ground from underneath the social role of the state sector and call into question its rationale. Three aspects are particularly relevant in this regard:

- the separation of enterprise budgets from the government budget;
the weakening of centralised wage determination and the granting to the enterprise management of discretion over wage determination;

- the introduction of employment on terminable contracts and, in the past few years, a sharp rise in the numbers of lay-offs (xiagang, literally standing-down).

Each of the above has been necessary to raise the efficiency of state enterprises and each in a particular way raises problems for continuing with their social role. The separation of enterprise budgets from those of territorial governments, amongst the first measures of economic reforms, converted social provision by enterprises from a joint financial liability of the state sector into individual enterprise liabilities, akin to "mandated employer benefits" (for a discussion of such benefits see Kingson and Schulz, 1997). Such benefits create a special problem in a transitional economy such as the Chinese, given that state enterprises were not established with reference to their future financial viability and are not selected for survival in a market economy. The change introduced a tension between the extended social role of enterprises and their transformation into market-oriented organizations. Strict adherence to financial autonomy threatened to cut the ground from underneath the urban social welfare system and many social services. Conversely, subsidies to non-solvent enterprises blunted, if not negated, the main aim of reforms. Since 1978, the Chinese government has tried to deal with this dilemma through ad hoc compromises. Insolvent enterprises have been kept afloat, though disadvantaged in various ways. A major effect of these compromises has been to widen variation in the range and level of welfare and social provision by enterprises depending on their financial position. The marked deterioration in the financial position of the state sector in recent years due to competition (both internal and from imports) and a shift in the share of value added going to wages (see Hussain and Zhuang, 1998) has made subsidisation of loss-making increasingly untenable, pushing the enterprise-based social welfare system to the brink of collapse.

Besides, two developments in the state sector have diminished the large overlap that previously existed between enterprise-based and urban social welfare and provision. First, the percentage of state sector employees on short-term terminable contracts has risen from a mere 7.0% in 1986, when it was generalised to all new recruits, to 51.6% in 1997 (SSB 1998a: 148). Second, a significant percentage of those who are formally “permanently employed” or have yet to come to the end of their employment contracts are “laid-off” (xiagang). These receive a living allowance in lieu of wages conditional on signing a contract that fixes a time limit to links with the work unit (usually three years). The number of “laid-off” employees from the state sector at the end of 1998 totalled around 8.8 million, 9.8% of the employees in the state sector (SSB, 1999b: 229 & 231). The spread of contract employment and the increasing frequency of separations from work units in various forms imply that the long-term attachment to work units that has underpinned their social welfare role no longer holds for a majority of the urban labour force. The share of the state sector in urban
employment has declined, not just relatively but since 1995 also absolutely. The percentage of urban employees in the sector has dropped from 78.4% in 1978 to 43.8% in 1998 (SSB 1999b: 13).

3. Social Security System

The Chinese social security system has two central features (for detailed discussion see Hussain, 1993). First, it consists of two separate sub-systems, urban and rural (discussed in Section 4), with different organizations and benefits - a common feature. Second, until the reform over the past few years (discussed below), the urban system was segmented according to the ownership status of the work unit (state/non-state), which it still is in practice. Both features are anomalous carry-overs from the pre-reform period. Employees of the government and state-owned enterprises (SOEs), almost all in urban areas, have traditionally benefited from subsidised housing and comprehensive labour insurance, providing disability and old-age pensions, maternity and sickness benefits, medical care and, since 1986, unemployment benefits as well. Traditionally, there has also been a parallel, but less generous, labour insurance for urban collective enterprises.

3.1. Recent Reforms in Urban Social Security

As generally recognised in China, work-unit-based social welfare comprising subsidised housing and labour insurance is no longer sustainable. After a period of piecemeal reforms to stop the system from collapsing and localized experiments, the State Council has over the past few years promulgated a number of regulations to institute an urban social security system to replace the inherited work-unit-based system. The salient changes can be summarised in the following five items:

1. Extending social security schemes, previously confined to state and urban collective sector employees, to all urban wage-employed workers regardless of the ownership status of the work unit, but not to wage-employees in rural counties.

2. Centralizing the oversight and administration of social security schemes in the Ministry of Labour (renamed Ministry of Labour and Social Security) and its territorial subsidiaries, provincial and municipal Labour and Social Security Bureaux (LSSBs). Gradually transferring the management and administration of social security schemes from work units to LSSBs.

3. Replacing the financing of social security by work units alone with joint financing by employers, employees and the government. The introduction of employee contributions is accompanied by the introduction of individual accounts for old-age pensions and, yet to be implemented, health insurance. Further, at some future date the financing of social security schemes is to be upgraded from the municipal to the provincial level so as to ensure adequate risk pooling.

4. A reappraisal of entitlements and their formalisation.

5. Introduction of the social relief scheme for urban households falling below the poverty line.
What are the implications of the above reforms and are these sufficient to institute a social security system that protects the urban population from various risks and is viable? To answer this question we examine each of the above in turn. Item 1 has been long overdue, necessitated by a steady decline in the share of the state and urban collective sector in urban employment. Some cities, such as Shanghai, have had a unified scheme covering all urban wage-employees for some years. Item 2 lays the foundations for the administration of an integrated social security system. It ends the split responsibility within the government. Previously, labour insurance for government employees came under the Central Ministry of Personnel and that for enterprise employees was the responsibility of the Ministry of Labour. Health insurance was supervised by the Ministry of Public Health. The centralization of oversight in one government agency opens up the scope for the integration of hitherto disparate social security schemes. In principle, the reform also relieves work units of the burden of administering social security schemes, which has risen sharply in recent with the rise in the number of pensioners. However, it would take some years before work units are fully divested of their social welfare responsibilities. Because of a heavy reliance on work-unit-based social welfare in the past, municipal governments have a limited capacity to administer social security schemes, an impediment that is often overlooked by the central government and observers. Fieldwork by the author in Liaoning and Sichuan in 1999 suggests that it would take municipal governments a number of years before they are in a position to administer social security schemes.

Items 3 and 4 are complementary, both aimed at putting urban social security on a sound financial footing. In terms of economic theory, it should make no difference whether the employer or the employee pays social security contribution. But, assuming imperfect omniscience, in practice employee contributions serve to make the costs visible to the covered labour force and thus facilitates a revision of benefits so as to contain rising costs, which is one of the main problems facing the Chinese urban social security system. Further, given rising urban unemployment and the pressure on enterprises to contain costs, employee contributions are either only partially compensated by a rise in wages or not compensated at all. The introduction of individual accounts for old-age pensions and in future for health insurance, which is inspired by the Singapore example, serves two purposes. The first, and immediately more important, is to lower the resistance to the introduction of employee contributions against the historical background of the financing of labour insurance by work units alone. Second, compared to the usual practice in pooled systems, individual accounts institute a tighter link between the contribution record and benefits, and thus limit the extent of redistribution between the covered population and also facilitate a reappraisal of benefits. But it has to be pointed out that individual accounts make huge demands on administrative capacity, which is of special importance in the Chinese context. In particular, the introduction of individual accounts for health insurance, as envisaged in China, raises formidable operational problems because in such an account pay-ins and pay-
outs run concurrently rather than being separated in time, as they are in an old-age pension account. The evidence on the ground suggests that the health insurance scheme as now conceived is non-viable and would need design changes.

The introduction of a government contribution towards urban social security, rather than being a novelty, simply formalises what has implicitly been the case. Municipal governments have long subsidised old-age pensions and health care expenditure of loss-making enterprises in their charge. There is also a fiscal justification for a government contribution in that it partially spreads the cost of urban social security across the whole of the tax base rather than concentrating it all on the payroll tax, which is a tax and is already high in China. The principal problem in the government financing of urban social security is that it takes place at the level of municipal governments. The fiscal capacity of municipal governments in China varies very widely and there is at present no regular system of fiscal transfers across municipal governments within a province, let alone across provinces. As a result, municipal governments caught in the pincers of an eroding tax base due to the poor financial performance of local enterprises, on the one hand, and a rising expenditure on social security benefits, on the other, find it very difficult to meet their statutory obligations. As a result, although urban social security schemes are supposed to be fairly uniform, the coverage of the schemes and the level of benefits vary widely across cities. The pooling of social security contributions and expenditure at the provincial level is the professed policy aim but most provinces do not have a road map for the province-wide integration of social security schemes.

Item 5 is an innovation in response to the rising numbers of the urban poor which is currently estimated to be 13 million, 3.3% or 5.4% of the urban population, depending on its definition (see Hussain 1999b). The urban social relief covers all urban residents (excluding migrants) instead of employees only and is non-contributory. The scheme is financed from the municipal budget assisted by transfers from the Ministry of Finance for poor municipalities. It is means-tested on the basis of household income and is operated not by the Ministry of Labour and Social Security but by the Ministry of Civil Affairs, which traditionally have been responsible for poverty relief in urban areas. The national poverty line is Y1,800 per head per person per year for urban areas, compared to Y 620 for rural areas. But the national urban poverty line is notional, used for the head count of urban residents living in poverty but not for targeting relief to the urban poor. For the practical purposes of providing social relief or assistance to poor households each municipality determines its own poverty line, which varies widely as exemplified by the following:

- Shenzhen (Special Economic Zone): Y3,828 per year
- Xiamen, Beijing: Y3,120 per year
- Yinchuan (Ningxia): Y1,716 per year

The wide range of local poverty lines is due far more to variations in the fiscal capacity of cities than to that
in price levels. As recognized by the Ministry of civil affairs, poverty lines in poorer cities fall below the lowest acceptable subsistence level and are no more than the level needed to prevent severe hardship.

3.2. Labour Insurance

We turn now to a brief discussion of the three principal schemes of Labour Insurance, which are:

- old-age pensions;
- unemployment insurance;
- health care insurance.

The first and the third date from the 1950s, when labour insurance was introduced. The second dates from 1986. Its absence in the past reflected partly the ideological assumption that unemployment was a characteristic of capitalist economies and partly the employment and recruitment policies. Employment was for life and the government carried responsibility for finding employment for the urban labour force, features rendered obsolete by the economic reforms. In addition to the above three schemes, there are also disability and maternity benefit schemes, which are comparatively small.

The above three schemes differ in magnitude, organization and the problems they face. In terms of expenditure, the old-age pension scheme is by a wide margin the largest followed by health insurance, the cost of which has risen sharply in recent years. For the most part, its management still rests in the hands of work units, which are also responsible for its financing, in the first instance at least despite the recent reforms. Whilst pension costs of the employees of state-owned and of collective enterprises have been pooled for some years, health care insurance is in the midst of a major transition to a municipal system. Since its inception in 1986, unemployment insurance has been managed not by work units but by Provincial or Municipal Labour Bureaux and financed by a payroll tax. In terms of management and financing the scheme has served as the model for the reform of other schemes.

With recent reforms, all schemes are now financed by payroll taxes split between employers and employees, with the government acting as the residual source. But each scheme is still financed by a separate tax. A unified payroll tax covering all social security schemes is proposed but not promulgated. Further, default on social security contributions is reported to be substantial. As a result, the social security schemes do not cover all urban wage employees as they are supposed to do. In the aggregate, the social insurance contributions exceed current expenditures (SSB 199b). But the financial surplus on social insurance does not convey an accurate picture because "contributions" include payments into individual old-age pension accounts of current employees and "expenditures" on some major items, such as medical expenditure on non-catastrophic illnesses. Appropriately calculated, the social insurance account is in deficit. But the principal problem is not the deficit in the aggregate because government expenditure on social security remains comparatively small. Rather the main problem is the discrepancy between the deficit across cities and their
fiscal capacity.

**Old-Age Pensions**

We turn now to a brief discussion of the salient features of old-age pensions and unemployment insurance.

The old-age pension system is in the midst of a major transition from the inherited system to a new system, a transition that will take several decades to complete. The inherited system applies to the 35.9 million existing pensioners and would continue to apply to those retiring over the next thirty or so years. Under the system, pensions are a percentage of the last 'basic wage' (excluding bonuses) in employment, and pensioners have also their health care cost covered by their ex-work unit, though this will change with the shift-over to municipal health-care insurance. Pensions are based on a national schedule, ranging between 75 to 100% of the 'basic wage', and depend upon the years of employment and the date of recruitment. The ratio of average pensions to the average wage of urban employees is 79.8% 83.1% in the state sector (SSB 1999b: 32 & 552). The replacement rates in China, although they have fallen, are exceptionally high by international standards. But in assessing the replacement rate, it is important to keep two considerations in view. First, because of a low average wage, a significant proportion of pensioners receive pensions lower than the local poverty line. A significant percentage of recipients or urban poverty relief are pensioners. Second and more important, default by work units on pension payment has over the last few years been widespread. Thus pensions that are generous in principle can be niggardly in practice.

The management of old-age pensions still rests predominantly with work units. They keep records of the parameters relevant to determining pensions, disburse pensions of their ex-employees and are also responsible for their personal care. This highly decentralised system raises two sets of problems: first, its viability and efficiency and, second, the scope for abuse of the system. This system, which worked reasonably well when the number of pensioners was small, is under strain and will become increasingly cumbersome as the number of pensioners rises relative to the labour force. The disappearance of enterprises due to mergers, which are increasing, and bankruptcies, compounds the problem. Further, the keeping of records of employment and wages by enterprises makes it easier for them to abuse the system, and makes it more difficult for the authorities to prevent abuses.

Currently, pensions expenditure is financed on what is generally termed a 'pay-as-you-go' basis. Employee contributions towards pensions, which were rare, only a few years ago, have become a general norm, but their rates vary across cities. The current pension costs are pooled, and a recent government regulation has abolished separate pools for state and collective work units and for particular industries such as the railways and the electricity industry. But separate pools continue to exist by default because the administrative structure for the operation of a unified pool is not in place. Enterprises participating in a pooling scheme devote a set percentage of their wage bill to pensions, which varies across localities. But
since it is not the pool but the work unit that disburses pensions, the pooling arrangement works by an *ex post* redistribution that introduces a huge uncertainty in the payment of pensions. Enterprises spending more than the percentage claim the difference and, conversely, those spending less pay the difference into the pool. But the pooling arrangements work far from smoothly. Contributions to the pension pools are not based in law, and compliance rates have been significantly less than full 100% (World Bank 1996a) and in recent years have dropped sharply. Further, because of *ex post* redistribution, pools do not provide a solution to the non-payment of pensions by enterprises in the first place, which has been a serious problem for some years.

Under the new system that is being phased in, the one-tier system is replaced with a two-tier system. The first tier is supposed to provide a basic pension to ensure a minimum living standard regardless of earnings in employment but conditional on a certain number of years of contribution, which is usual in old-age pensions systems. The first tier is supposed to be financed entirely by employer and government contributions, with the government acting as the residual risk bearer. The second tier is supposed to be earnings-related and based on individual accounts. It is to be financed entirely from employer and employee contributions, with no government contribution except via tax expenditure. The new system is modelled on the system in use in a large number of economies and combines the “defined benefit” and “defined contribution” systems (for a discussion see Diamond 1994). It is important to distinguish between short- and long-term effects of the new system. The immediate effect is no more than to introduce employee contributions towards pensions. The process of establishing individual accounts has just begun and will take a number of years to complete. Unlike the old system, the operation of individual accounts is premised on information on earnings/contributions of each individual over the whole of his/her working life. The introduction of individual accounts also opens the issue of the setting up of notional accounts for those who are well into their working lives, and thus do not have a sufficient number of working years left before retirement to accumulate enough for an earnings-related second tier. As yet, there is no national framework for assigning notional credit to such accounts. Currently all accounts are largely notional in the sense that, in most cities, contributions by employers and employees are mostly used to finance current pension expenditure. The implication is that, until an alternative source for financing pension liabilities over the next three to four decades is found, the new system will remain inoperative.

The new scheme lays the foundations for a better system for the future. But, apart from introducing the employee contribution, it has no bearing on the following issues the Chinese old-age pensions system will be facing over the next two to three decades:

- the timely payment of pensions;
- the establishment of a government structure for the collection of contributions and disbursement of pensions;
the implementation of province-wide pooling of contributions and expenditure, which is the professed policy aim;

• a partial funding of future liabilities so as to smooth the impact of the rising number of pensioners;

• the financing of the health care expenditure of retirees under the municipal health care insurance scheme.

**Unemployment Insurance (UI)**

Initially restricted to employees in state enterprises, participation in unemployment insurance is now mandatory for wage-employees in urban districts, including those in small private enterprises. However, the actual coverage of the scheme falls well short of a full 100% because of problems in collecting contributions from smaller non-state enterprises. In 1998, UI covered 43.0% of all urban employees compared with 39.4% in 1997 (SSB 1998b: 14 & 462; SSB 1999b: 13 & 528). Despite the rise, the rate remains comparatively low, limiting the importance of UI as an income maintenance mechanism in the face of raising urban unemployment. A potentially serious problem is the rapidly falling employment share of the state and urban collective sector, with a high coverage rate of 76.8%, and the rising employment share of the remaining sector (dominated by private enterprises) with a derisory coverage rate of 4.6%. The implication is that, without a substantial extension of UI coverage in the private sector, the effectiveness of UI as an income maintenance scheme will steadily diminish. This leads to the related question of the percentage of the urban unemployed receiving UI benefits. The percentage of "registered unemployed" receiving UI benefits in 1998 was 27.7% (SSB 1999b: 83 & 528). The percentage with respect to the "actually unemployed" would be much lower. As in other economies, those not entitled to UI have little or no incentive to register.

Previously linked to wage in employment, the unemployment benefit (UB) is now set at a flat rate that ranges from 60 to 70% of the minimum wage, which is fixed by the local government and may vary between districts in the same city. The percentage varies with the locality and reflects its financial position. Workers dismissed for misconduct may receive a reduced benefit or none at all depending on the gravity of the offence. Coverage for health care costs varies. In some localities, recipients receive another 10% of the minimum wage for medical care, in others the incurred cost in excess of a fixed amount is split between the recipient and the insurance fund. Currently, there is no separate housing allowance, which may have to be introduced in future as rents rise with the commercialisation of housing. The maximum duration of benefit is two years, which is comparatively long by international standards. Each year's contribution yields entitlement to three months’ benefit. Unemployed workers with exhausted benefit entitlement can apply for means-tested, urban social relief.
UI is financed by a payroll tax of 3%, with employers paying 2% and employees 1%. Until June 1998, the rate was only 1% and paid entirely by employers. Until a few years ago, the UI fund tended to be in surplus and was used for a variety of purposes, some with no relation to unemployment. In response to reports of mismanagement and misuse, the Ministry of Finance has tightened control over the use of UI funds. Territorial governments are forbidden to charge any administration cost to social security funds. The rise in the contribution rate was prompted by a sharp increase in registered unemployment and layoffs, and reports of widespread default on UB and on living allowances to "laid-off" employees. As well as raising funds, this rise introduced two important principles that have implications for the financial sustainability of the system: first, a relation between total cost and the contribution rate and, second, of shifting a part of the cost to employees without compensation. The second has become a norm for all social security schemes, and is equivalent to a personal income tax because it is not shifted back to employers.

On the basis of evidence gleaned during fieldwork in the Northeast, the unemployment insurance account is now in deficit in most cities in the region. The deficit has to be covered from the municipal budget. The amount of deficit and its ratio to the municipal budget varies from city to city. Residual financing from the municipal budget is in keeping with the government policy of splitting the social security costs among employees. A further rise in payroll tax for unemployment insurance would reduce the deficit, but at the likely cost of reducing coverage. The current financing system is under stress in particular cities, and its financial sustainability over the medium to long run would depend crucially on the level of the territorial government at which social security accounts are balanced and deficits are financed. The present arrangement whereby each city is responsible for covering the deficit on social security schemes within its jurisdiction, is too decentralised for long-term sustainability, as it does not provide for sufficient risk pooling. There is as yet no regular framework for spreading the financial burden of UI and other social security schemes across cities. The need for such a framework will grow in importance as the number of claimants relative to contributors rises with the transfer of "laid-off" employers from enterprises to UI. The central government policy is to raise the level of financing to the province, but there is as yet no national framework for putting the policy into practice. A crucial precondition for the institution of any financial integration of social security schemes in a province is the establishment of a province-wide data base with details of contributions and expenditures cross-classified by various levels of sub-provincial government, which most provinces lack at present.

Drawing on international experience, the Chinese unemployment insurance scheme is not marred by any obvious design flaws, though there would seem to be scope for improvement through changes in specific details. On the benefit side, the flat rate payment is low enough to preserve an ample incentive for benefit recipients to take up employment at the minimum wage rate and to constitute a disincentive for a
worker to give up a job for unemployment benefit. These issues loom large in discussion of UI in
developed market economies, but do not seem to be important in the Chinese context, at least as yet. The
answer to the question "whether the benefit is adequate to prevent severe hardship?" is mixed.
Unemployment benefit is widely seen as no more than a basic income for an individual. Unadjusted for
household size or income, it is insufficient to prevent severe hardship in households with no earners. This
is officially recognised in that benefit recipients are eligible for newly introduced social relief on the
grounds of poverty. The implication is that UB is too low to leave any room for reducing expenditure by
cutting the benefit. The maximum benefit duration of two years seems long by international standards.
But as yet the provision has had little purchase because very few qualify for the maximum duration,
which requires eight years of uninterrupted contribution. The scheme started only 13 years ago and a
large majority of UB recipients are workers previously employed on contracts shorter than eight years.
Most of the unemployed workers with a long record of employment are currently regarded as "laid-off"
employees and thus entitled to a "living allowance" from their work units instead of unemployment
benefit. However, this will change over the next two years as "laid-off" employees still without a job are
transferred to the unemployment register with two years' entitlement to unemployment benefits and the
category itself is phased out. Thus, there is a need to assess the maximum duration of UB. But to avoid
economic hardship, such an assessment has to be done in conjunction with special measures for
unemployed workers with low chances of re-employment.

Accounting for 61.6% of the unemployed urban workers (counted according to the ILO
definition) the laid-off employees form, as it were, the submerged bulk of the urban unemployment
iceberg. As they are formally still employed, they are outside the UI umbrella. They receive a living
allowance that is a percentage of the local minimum wage, not from Labour and Social Security
Departments but from their enterprises, which are also responsible for their re-training and re-
employment. "Laid-off" worker is a transitional category due for abolition in 2002. The remaining "laid-off"
workers will, from then on, be treated as unemployed workers. The numbers of laid-off employees
shifting from their ex- work units to unemployment will rise even before the abolition because after two
years laid-off workers still without a job have to transfer to unemployment insurance. Laid-off workers
transferring to unemployment insurance are entitled to benefit for up to two years depending on their
employment history.

The abolition of the category "laid-off" workers, which is crucial for divesting enterprises of their
social welfare responsibilities, has far-reaching administrative and financial implications for UI. It will
imply a transfer of functions from work units to labour and social security departments, increasing their
workload up to three-fold. It will also mean increased expenditure on UB without any rise in
contributions because, like unemployed workers, "laid-off" employees are not liable for UI contributions.
The abolition will amount to a part transfer of the cost of supporting "laid-off" employees from enterprises to the municipal budget, only a part because the UI fund and the municipal budget already cover up to two-thirds of the cost. Except in cities with strained budgets, the administrative implications of the phase-out are more serious than are its financial implications.

4. Rural Social Security

In contrast, to the elaborate social security benefits enjoyed by most of the urban population, social security provisions in rural areas are sparse and highly variable. Labour Insurance does not apply to town and village enterprises (TVEs), despite the fact that they employ 125.4 million compared to 90.6 million in the State sector (SSB1999b: 229 & 436). The rural social security system consists of special assistance to officially designated "poor counties", means-tested social relief to destitute persons and households and disaster relief. In addition, there are also locally organised and financed partial old-age pensions. Rural medical care now largely takes the form of fee for service, though some localities have co-operative health insurance (discussed in Section 5). The sparseness of social provisions in rural areas would suggest that China's success in preventing deprivation in rural areas is due more far more to households having opportunities for earning a living either through farming and non-farming activities rather than to social security schemes.

The pronounced urban bias in social security provisions is not particular to China. It is found in many developing economies. Though highly inequitable, to a degree it is unavoidable, given serious problems in designing and financing social insurance schemes for the self- or the informally-employed even in developed economies. The main problem in China lies with the anachronistic administrative distinction between the urban and the rural population, which regards the rural labour force as self-employed. This assumption has been rendered obsolete with the rapid growth of town and village enterprises, which in 1998 employed more people than the state sector. The present administrative distinction between the urban and rural population is particularly anomalous in the case of the labour force in the rural counties in the vicinity of large cities, where a majority of the labour force may be wage employed in non-farming activities.

The extension of labour insurance to rural wage employees is desirable in principle and a number of cities have already extended selected schemes to rural counties within municipal boundaries. But this extension raises two sets of issues: one, administration and, two, equity. Municipal Labour and Social Security Bureaux that are now supposed to be responsible for labour insurance are still in the process of establishment. Even after these are established, it will take them a number of years to fully take on the functions that work units currently perform in the administration of labour insurance for the urban labour force. Turning to equity, in the case of old-age pensions, which is by far the largest component of labour insurance, at least for the period needed to qualify for the basic pension (15 years) rural wage employees would be making contributions but not receiving any benefit. Given that in most cities contributions are used
to finance current pension expenditure and not accumulated, rural wage employees would for sometime be financing the pensions of retired urban workers, predominantly ex-state sector employees. This does not pose a problem in a settled system, but it does in a system that is undergoing a fundamental transformation and is still far from financially secure. The widespread default on payment of pensions of existing retirees does not inspire confidence among rural employees that they would receive their due pensions when they come to retire. The implication is that there is little justification for extending labour insurance, with its existing administrative structure and makeshift financing pattern, to rural wage employees.

5. Health Status and Health Care

5.1. Health Status
There are three aspects of the health status of the population which deserve attention and call for a concerted policy for their reversal: first, the slow improvement or retrogression in child health over the reform period, second, the persistence of wide inter-provincial variations, and, third, a significant, and in some cases even a rising, incidence, of easily preventable infectious and parasitic diseases, especially in rural areas.

One indicator of the health status is the causes of death, which vary between rural and urban China (Table 4) and, following the usual convention, divide into three groups:

Group 1: Communicable, maternal, perinatal and nutritional conditions
Group 2: Non-Communicable diseases
Group 3: Injuries and Toxicosis

Emblematic of poverty and lack of adequate health care, the first group of diseases claims virtually all of their victims from developing countries. But, contrary to the usual presumption, non-communicable diseases are neither diseases of affluence nor necessarily of old age. In urban China these diseases claim around 72% of deaths, three-and-half times as many as that claimed by Group 1 diseases. In the age group 30-44, these diseases are responsible for 57% of male deaths and 60% of female deaths (Harvard School of Public Health 1996). In contrast to urban areas, the pattern of the causes of death in rural China is similar to that in low-income economies. Thus China, like other developing economies, is burdened with both communicable and non-communicable diseases.

With the death pattern akin to that in middle-income economies, urban China is in the middle stages of the "epidemiological transition" from the prevalence of deaths from Group 1 to the Group 2 diseases as the main cause of deaths. But rural China is still in the initial stage. Communicable diseases still take a substantial and avoidable death toll. Their incidence is much higher than suggested by their rank in causes of death in rural and in urban areas. A survey in Sichuan revealed as much as 40% of infectious ailments in rural areas go unreported (Chen 1989).
### Table 4
Causes of Death in Urban and Rural China

<table>
<thead>
<tr>
<th></th>
<th>Urban Areas</th>
<th>Rural Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>20.2%</td>
<td>35.2</td>
</tr>
<tr>
<td>Group 2</td>
<td>72.9</td>
<td>52.6</td>
</tr>
<tr>
<td>Group 3</td>
<td>6.8</td>
<td>12.2</td>
</tr>
</tbody>
</table>

*Note: The above classification is not precise, and should be taken as illustrative of the broad pattern.*


Looking forward over the coming decades, how would the disease pattern change and what implications would it have for health care? Already the biggest killer, non-communicable diseases would further rise in importance as the main cause of deaths, as would their incidence, especially amongst the elderly population. The pattern of death causes in urban areas, if not in rural areas, will approach that in developed economies. The speed of elimination of infectious diseases will depend crucially on the implementation of the existing plan for their elimination (PRC Government 1994). Moreover, the narrowing of the gap between rural and urban areas will depend on extending access to health care by raising the health insurance coverage in rural areas and reducing inequality in health-care provision. The growing importance of non-communicable diseases suggests the need for campaigns for a healthier life-style and an additional tax on tobacco, a major cause of such diseases. With the ageing of the population, the need for long-term care will rise.

### 5.2. Health-Care Provision

Comprising three loosely connected strands, two large and one nascent, China's health care system disposes of a large infrastructure and employs a huge number of personnel. There are in total 314,097 health establishments and 4.4 million medical personnel, including doctors of both Western and Chinese medicine, nurses and paramedics (SSB 1999a). Most of the two million doctors are employees of either public health departments or work units; the proportion of the self-employed (private practitioners) is small but growing. At the core of the health-care system are 67,081 hospitals (including small clinics) with 2.9 million beds. These vary widely in size and services provided; around 50,000 of them are rural (located in townships and villages, excluding those in county seats). Hospitals also provide outpatient care, even in cases of minor ailments, and specialised outpatient facilities are rudimentary and tend to offer low quality medical care.

There are three separate health-care networks, loosely connected and each fairly decentralised. One is public, the second is "occupational" and the third is private. The distinction between them lies in the
supervising agency, the source of funding and their clientele. The largest is the "Public Health Network", which performs the dual function of serving government employees and also the population at large and covers both rural and urban areas. It is not free at the point of service and only partially subsidised by the government. Generally, public hospitals receive all but a small percentage of their income from user charges. The tight government control of charges for basic medical treatment, which takes up most of doctors’ time, provides a huge incentive to doctors to demand side payments and for hospitals to branch out into high-tech treatments whose prices are uncontrolled. The network is "public" in the restricted sense that its staff are employees of departments of public health from the central down to the county level. As state enterprises, public hospitals are graded according the territorial division of the government. Thus a large city may have central, provincial, municipal and urban district hospitals. Allied to the urban public network is the rural network of clinics and hospitals run by townships (the lowest government tier in rural areas) and villages (a communal rather than a governmental unit), which cover a large proportion of townships but as yet not all. Except in some regions, their staff are not employees of public health departments.

The "occupational" network is run by state-owned and larger collective enterprises, the armed forces, prisons and a range of other institutions. It is mainly urban and extensive, comprising a disparate range of facilities each serving a restricted category of patients, to whom it is predominantly free at the point of service. The network is predominantly financed by "work units" and their staffs are not employees of public health departments but of the parent unit. With the trend towards divesting enterprises of their social facilities, larger enterprise hospitals market their services and some of them are far more profitable than their parent enterprises.

The third is the private medical service, which is more prevalent in rural than in urban areas. Unlike their peers, private practitioners are not employees but self-employed. Their proliferation is a post-1978 development prompted, in rural areas, by the collapse of co-operative health insurance and, in urban areas, by the rise in the number of people without health insurance. Aside from curative services, there are three networks of preventive and early diagnostic services. These include the Epidemiological Prevention Services (EPS), Maternal and Child Health Service (MCH) and Family Planning Service (FPS) which receive budgets from provincial and county government. But increasingly they have come to depend on fee-for-service, which has had a deleterious effect on preventive and early diagnostic services in some rural areas. Operating relatively independently of each other, these networks provide overlapping services, which suggests scope for raising efficiency through administrative co-ordination and consolidation.

5.3. Medical Provision in Rural Areas

Compared to that in urban areas, two features characterize medical provision in rural areas: it is sparser and more variable from locality to locality. There still remain many villages without any medical facility; the plan
is to have a clinic in most villages by 2000 (PRC Govt 1994: 67). A three-tiered medical network serves the 69.6% of the population classified as rural. The first tier consist of around 40,000 village health stations or clinics staffed by 733,315 medical personnel (SSB 1999f: 277). These include "village doctors" developed from the original "barefoot doctors" of the pre-reform period. They are the first port of call for rural inhabitants needing primary medical care and channel patients to township health centre/hospitals. They engage in medical practice either full-time or part-time, as a sideline to farming. Except in a few localities where "Rural Co-operative Health Insurance" survives or has been re-introduced, they charge fee-for-service and also receive a mark-up (typically about 15%) on prescriptions, which provides an incentive to over-prescribe drugs, an incentive that pervades the Chinese health-care system.

The second tier consists of 9,600 rural health centre/hospitals at the rural township level (the lowest government tier). These operate on fee-for-service basis, but a part of their costs is covered by the rural local government. The extent of subsidies varies widely depending on local revenue. Richer localities with developed TVEs tend to have better facilities than poorer ones. The first two tiers are local and are not an integral part of the public health network, though they are supervised by county health bureaux. The top tier of the system is made up of county hospitals, with one million beds; these dovetail into city hospitals with around two million beds. The county hospitals are usually the last point of referral for rural patients, since few can afford the services of large specialised city hospitals. The urban-rural gap in health-care provision is wide, and, more serious, rather than closing it has widened. Since 1985, the number of hospital beds and medical personnel (doctors, nurses and paramedics) have been rising in urban areas, falling in rural areas (SSB 1999a: 735). A part of the decline in hospital beds in rural areas is due to the consolidation of facilities in urban hospitals, which are more intensively used than rural hospitals. But, as for most rural inhabitants county hospitals are the medical facilities of last resort, the reduction in the number of hospital beds in rural areas represents a reduction in accessible medical facilities for a part of the rural population.

5.4 Health Care Financing - Sources and Uses
Currently, China devotes around 4% of GDP to health care, which is up from 3.0% in 1978 and is comparatively high for a low-income country. The reported percentage would be higher still but for comprehensive government price control on medical treatment and drugs, and may be an underestimate due to an under-reporting of out-of-pocket expenses and the exclusion of under-the-table payments to doctors. Extrapolating from international trends, this percentage will rise driven by two factors: first, the ageing of the population; second, rising cost per treatment as a result of rising wages of medical personnel and increasing non-labour cost.

Turning to sources of health care expenditure, their importance derives from their implication for the distribution of the demand for medical care and its cost. For example, under financing through fee-for-service
(without any insurance), the burden falls entirely on patients and is distributed according to medical care dispensed. This usually means that a proportion of those struck with illness either purchases medical treatment at the cost of slipping into poverty or cuts down and foregoes treatment, but pays the price in ill health and a higher risk of avoidable death. Either choice creates a vicious circle between inadequate medical care and poverty. Fee-for-service is particularly inequitable when it is mostly confined to the relatively poor section of the population, as it is in China. Most of the population with a health insurance cover (albeit now eroded) is urban, and all but a small proportion of the rural population is subject to fee-for-service. Financing through insurance (commercial or non-profit) by spreading the burden widely over the covered population rather than just patients, loosens the link between payment and medical care. An inevitable consequence of health insurance is a higher demand for and expenditure on medical care. A part of this increase is justified and fits in with the social purpose of health insurance: to provide medical care to those who need but are forced to forego it under the fee-for-service arrangement. But there is also a part that is wasteful arising from "moral hazard". However, the main problem is that it is not easy to distinguish between justified increase in demand and moral hazard.

The three main sources of financing for health care in China are government subsidies, the health insurance schemes and individuals (termed "out-of-pocket" expenses). Over the reform period the first two have diminished in importance, shifting a greater burden of financing to the third. Government financing for health is channelled in two forms: first, subsidies on curative and preventive services for the population at large (here termed "spending from the budget") and, second, re-imbursement under the "Government Health Insurance Service" (GIS). Grouping the latter with the other employee health insurance scheme (Labour Insurance), the composition of health financing in selected years of the reform period is shown in Table 5. Out-of-pocket expenses cover a variety of payments by individuals with different distributive implications. These include "full" fee-for-service, co-payment and registration fee (which fall entirely on those receiving treatment), on the one hand, and individual contribution towards insurance (which falls on all those covered under the scheme). The latter is only common in rural co-operative schemes and still rare in the occupational schemes covering the urban population. With the implementation of the planned municipal scheme, individual contribution will become a universal feature of health insurance. In the 15 years from 1978 to 1993, the composition of health expenditure has undergone a major change with a highly adverse implication for the distribution of medical expenditure by income groups and between the ill and the healthy. In the eight years from 1978 to 1986, the principal change consisted in a huge reduction in the share of rural co-operative insurance schemes and a significant rise in the share of out-of-pocket expenses due mainly to the shift to fee-for-service in rural areas.
### Table 5
Sources of Health Financing

<table>
<thead>
<tr>
<th></th>
<th>1978</th>
<th>1986</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Budget(^1)</td>
<td>28%</td>
<td>32%</td>
<td>14%</td>
</tr>
<tr>
<td>Insurance Schemes(^2)</td>
<td>30%</td>
<td>33%</td>
<td>36%</td>
</tr>
<tr>
<td>Rural Insurance Schemes</td>
<td>20%</td>
<td>5%</td>
<td>2%</td>
</tr>
<tr>
<td>Out of pocket(^3)</td>
<td>20%</td>
<td>26%</td>
<td>42%</td>
</tr>
<tr>
<td>Others</td>
<td>2%</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Health Expenditure, % of GDP</td>
<td>3.0</td>
<td>3.2</td>
<td>3.8</td>
</tr>
</tbody>
</table>

1. Excludes insurance expenses for government employees.
2. Includes the insurance schemes for government employees (GIS) and Labour Insurance (LI).
3. Includes both user fee, copayment and fee-for-service

Source: World Bank 1996b

The following seven years saw a change as major as that in the preceding period, but this time it consisted largely of a shift of expenditure from the government budget to the pockets of urban as well as rural patients. The share of out-of-pocket expenses is likely to be an under-estimate because it excludes under-the-table or side-payments to medical personnel, which are improper or illegal and therefore go unreported. Circumstantial evidence suggests that these have risen in importance.

### 5.5. Health Insurance Schemes

Compared to developing economies in Asia, in China a high proportion of the population has been covered by some form of health insurance, (as yet) mostly non-contributory in urban areas and contributory in rural areas. Given its high rate of growth and its long experience with health insurance, China has the potential for extending health insurance cover to a large majority of the population in the near future. This will involve the replacement of the inherited health insurance in urban areas, which has seriously eroded with the worsening financial position of state enterprises, and the institution of cooperative health insurance in rural areas.

Following the trial experiments in, initially, two cities (Zhenjiang and Jiujiang) and then in another 57 cities, the central government has decided to replace occupational health insurance schemes with
municipal schemes. The principal features of the new municipal scheme, still to be introduced in all but experimental cities, include the following:

- joint financing by employers, employees and the municipal government;
- individual medical accounts to cover "small" expenses, financed by employee contributions and a part of employer contributions;
- a social fund to cover "major" expenses financed by a part of employer contributions and the municipal government;
- a cap on the expenses covered by the social fund.

The details of the scheme are not fully worked-out, still less tested and tried.

From the point of view of insurance, the new scheme has three major features. First, the scheme covers only a part of the urban population: wage employees paying in contributions, pensioners and recipients of unemployment benefit. The insurance status of those on urban poverty relief is unclear and dependants are uncovered. Second, the coverage of "small" expenses, which are yet to be defined precisely, depends crucially on the accumulated fund in the personal account. The implication is that whereas younger employees, with low incidence of illnesses, would pay little or nothing from their own pockets, older employees, especially those with chronic ailments, would be covering "small" expenses themselves. Third, because of the cap on re-imbursement from the social fund, the scheme will leave most catastrophic illnesses uncovered. The cap will be set at a fixed multiple of the yearly salary of the individual not the average. The implication is that the extent of the cover will vary inversely with the income of the individual. In principle, employees will be expected to take out commercial insurance to cover catastrophic illnesses, but that will be voluntary not mandatory. This will introduce a serious potential problem of adverse selection. Whilst younger employees facing a small risk of catastrophic illnesses will have little or no incentive to purchase commercial health insurance, older workers facing a higher risk will have the incentive to do so. Moreover, employees with a high wage, with a more extensive cover under the mandatory scheme, will have less incentive to purchase supplementary commercial insurance than low-wage employees have. Currently municipalities maintain a relief fund to cover the cost of major medical expenses of those without means. But there is as yet no regular system of financing of these funds. Richer cities tend to have large funds and poorer ones small ones. In many cities the relief fund is exhausted well before the end of the financial year. Finally, as pointed out above, the operation of individual medical accounts raises massive operational problems. Evidence gathered during fieldwork suggests that most cities regard the central government target of having a fully operational health insurance scheme by the end of 2000 (shifted by 12 months at the end of last year) as being highly optimistic. The implication is that the transition period from the occupation schemes, which in many cases have broken down, to municipal schemes is likely to take a number of years.
Rural co-operative health insurance developed as an off-shoot of collective agriculture. A part of collective income went into the establishment and the running of health stations (co-operative medical care clinics) at the brigade (village) level. These were staffed by local inhabitants with elementary medical training on top of primary education, known as "barefoot doctors" (now termed rural doctors). They were paid by the collectives on the remuneration system used to pay farmers. The system was partly financed by the collective, partly by pre-payment and co-payment. The system received a boost during the Cultural Revolutionary period and by the mid-1970s covered around 90% of villages.

The decollectivisation of the rural economy unravelled the co-operative health insurance schemes with which it was intertwined. Their collapse was due to three factors: first, the disappearance of the administrative underlay of the schemes; second, a decline in collective funds, which subsidised the schemes; and, third, the erosion of cooperative ideology. The scheme as inherited from the pre-reform period suffered from major defects. The quality of service varied widely and it involved coercion. But it served an important function of bringing medical care, albeit rudimentary to villages. A notable step towards a revival of rural cooperative health insurance schemes was the "Sichuan Rural Health Experiment". The experimental scheme was organised in 1989-90 and covered a sample of 26 villages and 40,443 individuals. There is now a wide range of co-operative health insurance schemes in rural areas, but most of these are in relatively prosperous areas. A major component of the health policy announced in 1997 is the introduction of cooperative health insurance schemes in all villages. As these schemes have to be initiated and funded locally, well-governed and prosperous localities are likely to take the lead.

6. Conclusion
To conclude, we end with answers to the following two questions.

- What are the immediate priorities in social security reforms?
- What would a sustainable social security system for China comprise?

6.1. Priorities in Social security Reform
Given the urban/rural segmentation in social security provision, the immediate priorities are different in rural and in urban areas. Rural areas are unaffected by the collapse of the inherited social security system, which did not apply to them. The principal task there is establishing income maintenance schemes and health care insurance almost from scratch. In urban areas priorities are set by the unravelling of the work-unit based social security system, on the one hand, and the growing problem of poverty. State and urban collective enterprises that have been the mainstay of social welfare in urban China are increasingly unable to carry on with their traditional social welfare role. Since the middle of the 1990s they have been undergoing a stringent market selection, which is mirrored in the social security field as inordinate delays in the payment of pensions
and the re-imbursement of health care expenses, or outright default in some cases. This has been a principal cause of the upward trend in urban poverty in recent years. The other is the steady rise in urban unemployment, including lay-offs that are not regarded as "unemployment" in official statistics.

Thanks to a series of reforms in recent years, the blueprint of the alternative to the work-unit-based social security in urban areas is almost completed, though still far from implemented. The major impediments in its implementation are three: administrative and financial. Given the long history of reliance on work units for administering the labour insurance schemes for their employees (and indirectly for most of the urban population), municipal governments lack the administrative structure that is needed for a socialized (government-managed) social security system. Municipal Labour and Social Security Bureaux that are to function as social security agencies are still in the process of establishment in many cities. Thus one immediate priority is to speed up their establishment.

The other immediate priority is the reform of social security financing. In urban areas, all contributory schemes, including old-age pension, healthcare insurance and unemployment benefit, are now financed jointly by employer and employee contributions with the government acting as the residual source. This arrangement is common throughout the world and, in principle, provides the foundations for a financially sustainable system. But the current financing system as it operates suffers from several serious defects. First, contributions are collected separately for each of the five schemes. There is a proposal to transform disparate contributions into one composite social security tax (split between employers and employees) that is collected together with other taxes, which will simplify collection and also help to raise the compliance rate. Second, with the proposed social security law still under discussion, social security contributions lack a legal backing and have a lower priority in claims on enterprise resources than do taxes.

Third and most important, the budgeting of social security revenue and expenditure is highly decentralized. The budgetary units are 226 or so cities (excluding rural county seats) and generally deficits have to be covered from municipal budgets. As yet, there is no settled procedure for fiscal redistribution across cities. This highly decentralised budgeting weakens the financial foundation of the urban social security system because the balance between contributions and expenditures varies widely across cities, and so do their finances. Cities are generally too small a budgetary unit to ensure sufficient risk pooling to ensure sustainability. A pooling of social security contributions and expenditures at the provincial level is the professed policy aim, and would seem to be an urgent priority in the case of old-age pensions, which is by far the largest scheme in terms of expenditure. In most cases, this would be sufficient to put the urban social security system on a sound financial footing. Many of the Chinese provinces are as populous as sizeable countries. The upgrading of the level of budgeting from cities to provinces can take a number of forms ranging from a full integration to compensatory transfers within a decentralized system. It raises important issues of the appropriate degree of decentralization in administration and of how to deal with the incentive to
“free ride” arising from the pooling of expenditure and contributions. A national pooling of social security contributions and expenditures seems to be infeasible. It would also be inequitable in that, under the present financing arrangements, poorer provinces would be making transfers to richer provinces because the latter tend to have a higher ratio of pensioners to contributors than do the latter.

Turning to priorities in rural areas, poverty has fallen since the beginning of reforms in 1979, sharply until the mid-1980s and in fits and starts since then. The success in reducing extreme rural poverty is making the traditional approach to poverty alleviation obsolete. Thus far, poverty relief in rural areas has been mainly focused on relief from natural disasters and assistance to counties officially designated as "poor". Natural disaster relief will continue to remain important, but assistance to poor counties suffers from blind spots. Many of the counties designated as poor are no longer poor. More important, poor households and individuals are distributed over the whole of rural China, not confined to designated rural counties. Geographical targeting is appropriate when poverty is primarily associated with causes affecting the whole locality, such as poverty of natural resources, but not when causes are particular to individuals or households. A major lacuna in China's rural anti-poverty policy is the absence of an effective system for dealing with household and individual poverty in the midst of prosperity. The existing schemes, such as the "Five Guarantees", deal with a very restricted category of people, such as the elderly without a family, and are highly variable from locality to locality. Instead what is needed is "rural poverty relief," on the same line as the recently introduced scheme in urban areas, which is targeted at individuals and households below the poverty line and covers all urban residents. An essential pre-condition for such a scheme is a system of inter-governmental transfers because the fiscal position of rural counties and township varies even more widely than that of cities.

A combined social security system for urban and rural areas, although desirable, is infeasible in the immediate future for financial and administrative reasons. So too are a substantial narrowing of the gap in coverage and the range of benefits. The tax system these require is decades in the future. The current official position that the urban and the rural systems have to be reformed separately is therefore realistic. The problem is the low priority given to reform in rural areas. Given the growth of wage employment, social security reform in rural areas requires the institution of a parallel labour insurance financed by employer and employee contributions at least in larger rural enterprises. Rural areas have an advantage over urban areas in starting with a blank sheet; they are not handicapped with an overhang of problems left by an inherited system, such as one of financing unfunded pension liabilities.

Turning to priorities with respect to particular social security schemes, the new two-tiered old-age pension scheme and the unemployment insurance schemes are not marred by faulty design. These follow principles tested and tried in many countries. Nevertheless, these schemes, especially old-age pensions, suffer from some serious problems. The most serious of these consists of inordinate delays in the payment of
pensions to a significant percentage of current retirees. A permanent solution is premised on the development of a social security administration and the institution of a system of fiscal transfers across cities at least within a province. Without these, the financing of unfunded old-age pensions liabilities of future retirees, which has been a major focus of multilateral and bilateral assistance to the Chinese social security system, makes little sense. The other pressing issue is the institution of an effective healthcare insurance. The work-unit based healthcare insurance in urban areas has almost collapsed and most of the rural localities have no health insurance system. Problems in establishing an effective health care insurance system are far more formidable than those in the case of old-age pensions. These concern not only financing, but also cost control and an overhaul of the health-care delivery system. Further, unlike with old-age pensions and unemployment, the proposed municipal health care insurance system in urban areas is still in a formative phase. The proposal in its current form suffers from serious design faults. It fails to provide insurance against catastrophic illnesses when it is most needed, lacks an effective mechanism to control rising costs and is costly to administer.

6.2. A Sustainable Social Security System for China

The multifarious problems besetting diverse Chinese social security schemes raise the fundamental question of the kind of the social security system a developing economy such as China can sustain. The question has a special resonance in the Chinese context because the work-unit based social welfare provision in urban China has traditionally been more extensive and generous than in other developing economies. Here it is important to emphasise that the inherited system has already undergone a massive pruning and an alternative system is in place, albeit not fully operational. The question of a sustainable system therefore is pertinent only in the context of the reformed system that is taking shape. Sustainability is premised on two sets of considerations: first, administrative capacity to operate social security schemes and, second, financial viability.

To appraise the reformed system, we divide the schemes under two headings: social insurance and social assistance (alternatively, “social safety net”). The principal differences between the two sets of schemes lie in the method of financing and qualifications for receiving benefits. Social insurance schemes are contributory and therefore benefits are limited to those with requisite contribution records. In the Chinese context, the five Labour Insurance schemes fall under this category. In principle, social insurance schemes can be self-financing, like commercial schemes. But, in practice, they are only partially self-financing because of the social consideration of ensuring a wide coverage. Thus, one issue in the assessment of such schemes is the percentage of cost financed through general taxes, which we analyse below with respect to the Labour Insurance schemes. In contrast to social insurance, social assistance schemes are non-contributory and the entitlement to assistance depends on need and is not tied to the record of employment or contribution. In the Chinese context, such schemes includes the newly-introduced urban poverty relief scheme, disaster relief and assistance to poor rural localities, and a likely addition in the near future is a rural poverty relief scheme.
similar to the one for urban areas. Apart from the first, all the rest apply to a limited section of the population
and, in terms of expenditure, social assistance schemes trail social insurance schemes by a wide margin. Viewed in these terms, it becomes clear that the social security system that is taking shape is neither open-ended nor prima facie unsustainable. There are problems with particular schemes, but, as we outline below, these can be addressed through feasible reforms.

Social insurance consists of five schemes that cover major contingencies of life: old-age pensions, unemployment benefits, healthcare insurance, and disability and maternity benefits. Though currently restricted to the urban labour force, the schemes provide the basis for developing a nation-wide social insurance system covering a substantial percentage of the labour force. A central issue in assessing the financial sustainability of these schemes as currently organized is their financial burden. Of which, there are two indicators: first, the ratio of their cost to the wage bill, and second, the balance between contributions and outlays on these schemes and thus their claim on general tax revenue. Focusing on the state sector, the sector with the highest burden, the ratio of expenditure on social insurance and also on additional welfare facilities to the total wage bill is 40.3% (SSB 1999b: 229 & 551). This is high but not an outlier by international standards. Further, the average ratio for all employees covered by labour insurance is five percentage points lower. The above expenditure does not include housing subsidies, but these are not relevant because they are not a part of social insurance and are being phased out. The provision of housing to employees is no longer mandatory and the existing housing stock is being privatized.

Turning to the current balance between contributions and outlay, the balance is positive on the five social insurance schemes taken together (SSB 1999b: 511 & 528-533). Taken individually, the old-age pension scheme is the only one in deficit. Thus, in the aggregate, social insurance does not require any supplementary funds from the government budget. As the social insurance budget is compiled at the highly disaggregated level of 226 cities, the surplus at the national level goes together with unsustainable deficits in numerous cities, a problem that can be addressed by upgrading the level of budgeting to provinces. Besides, the deficit on old-age pensions is more serious than it appears because contributions also include payments into individual accounts that should be accumulated rather than used to finance current pensions.

The issue of financial sustainability in the immediate future principally concerns old-age pensions and healthcare insurance. The new city-based healthcare insurance scheme, being still in a formative stage, does not lend itself to an evaluation. Turning to old-age pensions the problem is largely in the state sector and is caused by pay-as-you-go financing with a very short-term planning horizon. Currently 77.4% of retirees are from the state sector and this percentage is likely to rise in the near future. The ratio of retirees to contributors in the state sector, which was already high, has risen sharply over the last few years with a huge labour retrenchment. In the three years from 1995 to 98, the total employment in the sector has dropped by 22 million (or 20%), and the downward trend looks likely to continue for sometime. One less employee means
one less contributor but the same or a larger number of pensioners. The latter because older state sector employees may be allowed to retire early instead of being laid-off. The implication is that the financial sustainability of the old-age pension scheme, as currently financed, depends crucially on extending its coverage of the non-state sector, so as to raise the number of contributors without adding to the numbers of pensioners in the short-run. The possible sources of new contributors are foreign-invested and private enterprises in urban areas and rural enterprises.

But the extension of the old-age pension scheme even in urban areas faces two closely related problems. The first is the operational one of collecting contributions from small enterprises with a rapidly rising share of urban employment. The second is the doubtful credibility of the promise of a pension in the distant future in return for contribution over the near future, which is what the extension of the scheme to non-state sector employees involves. Given the widespread delays and default on the payment of pensions to current retirees, this promise does not inspire confidence. The implication is that the possibilities of financing the rising cost of old age pensions in the short to medium term by extending the coverage of the scheme or by raising the contribution rate are limited. A partial financing of pension costs by the government is necessary to ensure the sustainability of the old-age pension scheme. There are various proposals concerning the possible sources of finance. One is to use assets in state ownership, such as enterprises and land, for funding the pension liabilities of the state sector. The other is to use general tax revenue.

The above discussion leads on to the general question: is social insurance covering old-age and disability pension, unemployment benefits and health care sustainable in the long run for a low-income economy such as China? Tied to wages, the benefits provided by these schemes are austere, and entitlement is confined to those with a contribution record. In design, the reformed old-age pension scheme announced in 1995 with its two components (a subsistence allowance and a funded supplement tied to contributions) is sustainable. The problem currently facing the old-age pension scheme is caused by the overhang of pension liabilities left behind by the old system, which was characterized by the absence of any forward financial planning. The pension overhang impedes the new two-tiered scheme from functioning because current contributions are fully used to cover current pension payments and there is no accumulation of reserves to fund the earnings-related component, as provided by the new scheme. This points to the fundamental problem: it is simply infeasible to use the payroll contribution both to finance the overhang of unfunded pension liabilities and to fund the earnings-related component of the new scheme. The contribution rate this requires is too high to be enforceable. To give an idea, in the state sector the current pension payment alone in 1998 came to around 25% of total earnings in the sector (SSB 1999b: 229 & 552). The new pension scheme envisages a contribution rate of 11% of total earnings to fund the earnings-related component. The two together come to 36% of total earnings, which is already 16 percentage points higher than the guidance ceiling of 20% laid down by the State Council. The policy implication is that the sustainability of old-age
pension provision over time requires a separation of the funded component of the new pensions schemes from the unfunded pension liabilities left behind by the old system, and the financing of the latter from sources other than the payroll contribution.

Turning to social assistance schemes, including urban poverty and natural disaster relief and various poverty alleviation schemes in rural areas, these raise two major issues: first, their total cost and, second, their effectiveness in preventing deprivation. The total cost of these schemes is small relative to the total budgetary expenditure, which cover only a part of government expenditure. For example, in 1999 the urban poverty relief scheme assisted 2.9 million, 22% out of the estimated 13 million or so urban residents below the poverty line, at the total cost of Rmb 2 billion (just over 0.2% of the total government budgetary expenditure). Assuming that average cost per assisted person remains constant, the total cost of the scheme for full coverage would come to around 1% of the total government budgetary expenditure. All government expenditure on social security and various relief schemes (including those in rural areas) in 1999 came to around 4.1% of the total. The conclusion is that government expenditure on social security, over and above contributions to Labour Insurance, in China is on the low, rather than on the high, side.

Turning to effectiveness in preventing deprivation, the existing social assistance schemes suffer from blind spots and fail to reach a significant percentage of those who by the prevalent criteria qualify for assistance. This raises the question "can China afford a universal poverty relief scheme on the lines of the urban poverty relief scheme?". A universal scheme would not add greatly to the cost because the rural population is already covered by a number of anti-poverty schemes. A broad-based scheme is likely to be more cost effective than the current geographically targeted schemes.

What would a social security package for China that is both financially sustainable and also provides an acceptable degree of insurance against deprivation and contingencies comprise? A universal income maintenance scheme, on the lines of the newly introduced urban poverty relief scheme is not only necessary but also appears to be financially sustainable. Given sufficient risk pooling through compensatory transfers between government tiers and a separate financing of the overhang of unfunded pension liabilities, contributory schemes covering old-age and disability pension, health care and unemployment also appear to be feasible. The universal income maintenance scheme and contributory schemes are complementary. The former is needed to cover the gap left by the latter and the latter, in turn, serves to keep in check the number of claimants in the former.
References


