

Reforming the Welfare System in the People's Republic of China

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This paper reviews the recent progress in welfare system reforms in the People's Republic of China and looks at the experiences of Japan and Republic of Korea in establishing their modern welfare systems. The paper highlights three priorities for further reform of the People's Republic of China welfare system. The first is to reduce its dualistic nature by eliminating differences between urban and rural areas in policies, institutional arrangements, coverage, and welfare provisions. The second is to rationalize government social security and welfare expenditures. The third is to rationalize the overall management of the welfare system by (i) reforming the existing compartmentalized government administration of urban cities and rural areas; (ii) encouraging better coordination among various government agencies involved in policy making and administration of the welfare system; and (iii) making the targeting of poverty reduction and social welfare programs more effective.

I. INTRODUCTION

The People's Republic of China (PRC) began reforming its welfare system in the early 1990s, initially as part of broader reforms of state-owned enterprises (SOEs). Since the early 2000s, more substantial measures have been introduced as the reform process deepened and income inequality increased. So far, notable progress has been made in education, poverty relief, employment support, and health care.

Owing to concerns over the possible adverse impact of increasing labor costs on growth and the risks of falling into the so-called "welfare trap", the PRC government has taken a cautious approach to reforming the welfare system. A key element of this approach is to strike a balance between expectations of the population for welfare entitlements/provisions and constraints in the government's fiscal capacity. While avoiding the pitfalls associated with rapid changes, this approach makes it difficult to generate consensus and garner support from the entire society.

This paper discusses what kind of welfare system the PRC needs. In the context of the PRC, "welfare system" refers to social safety nets and to policies and institutional arrangements designed for income redistribution and provision

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of public goods and services. It covers areas of poverty alleviation, social security (such as old-age support), health care, education, housing, and employment protection (Shang 2001).

The rest of the paper is organized as follows. Section II examines past trends, recent changes, and current problems of the welfare system in the PRC. Section III looks at the welfare systems in other countries, in particular that of Japan and Republic of Korea (henceforth Korea). Section IV draws policy recommendations.

II. THE PRC'S WELFARE SYSTEM IN TRANSITION

Before the reforms, the PRC's welfare system was a key element of its centrally planned economy. For urban populations, the government enacted and implemented the Labor Insurance Regulations in 1951, and established a social security system covering old-age pension, industrial injury benefits, health care, maternal benefits, etc., provided largely through state- and collectively-owned enterprises. Gradually, the system was expanded to cover all urban employees and their dependents, with the scope of welfare provision broadened to include housing. In rural areas, the remuneration schemes under the commune system contained some elements of welfare provision. There was also a rural cooperative medical support system providing health care for peasants, and a system of social protection providing minimum living allowances for the childless elderly. The government also established a disaster relief system and various state welfare programs with specific mandates. In sum, the welfare system in the PRC during the prereform period had a dual (urban and rural) structure and covered almost all members of society, with the state being the main responsible entity, employment protection being the core, and remuneration being combined with welfare provision (Zheng 2000).

The economic reforms initiated in 1978 have had a significant impact on the way welfare provision is organized in the PRC. The gradual deepening of enterprise reform (including privatization), the dismantling of the commune system and collective economy, and the inability of the state to act as the main responsible entity for welfare provision made it difficult to maintain the traditional system. Because the traditional system was not completely dismantled and a new system was yet to be established, some segments of the population became excluded from the welfare system while others continued to enjoy good coverage at the initial stage of reforms.

After the initial phase of economic reforms from the 1980s to the early 1990s, the performance of SOEs did not show significant improvement. From the late 1990s, more radical reforms were introduced. A large number of SOEs were corporatized or privatized, laying off many workers in the process. In response, the government started to build a support system consisting of urban minimum

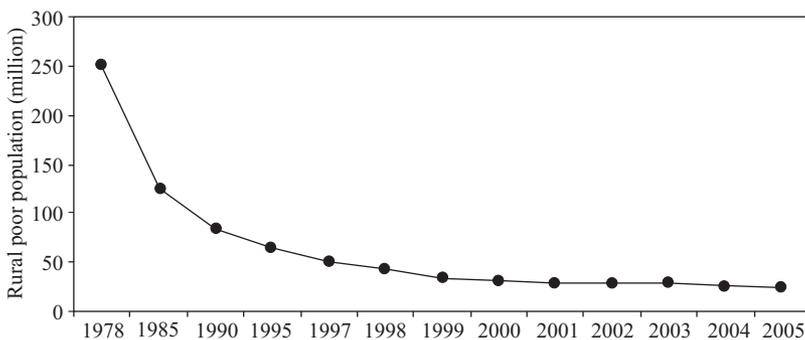
living standard subsidies, SOE laid-off employment subsidies, and unemployment insurance.

Economic reforms, on one hand, led to rapid economic growth, which helped to improve various social indicators of the PRC (UNDP 2007). On the other hand, as the government gave up some responsibilities of providing social welfare, rapid growth has been accompanied by widening income gaps and under-provision and rising prices of public services such as health care and education. Due to concerns over problems and inadequacies of the social welfare system, the Resolution of the Central Committee on Several Issues for Improving the Socialist Market System, approved by the 3rd Plenary Session of the 16th Congress of the Chinese Communist Party in 2003, listed the improvement of the social security system at the top of the agenda for ensuring social equity and justice.

A. Poverty Reduction

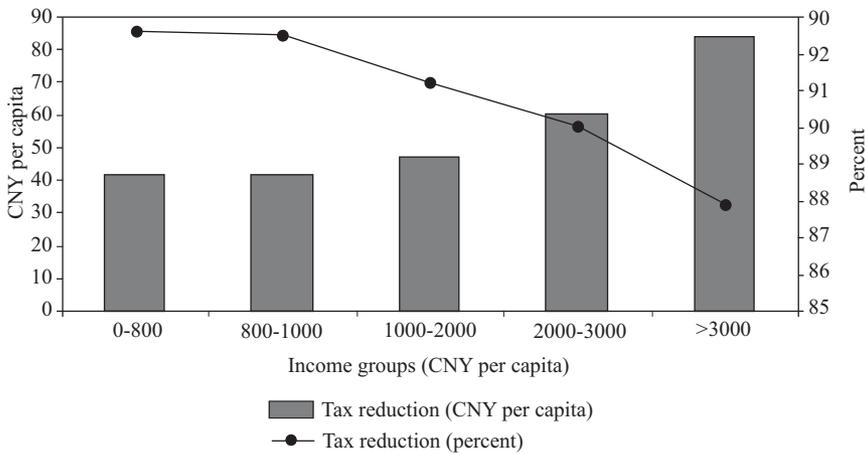
Reforming the economic system has been the most effective means of reducing poverty in the PRC. Adopted in 1978, the policy of allocating land to farmer households, and other subsequent rural reforms, lifted a large number of the rural population out of poverty. Based on the official poverty line, the number of rural poor decreased from 260 million in 1978 to 23 million in 2006 (Figure 1). Likewise, the abolition of the agricultural tax in 2006 significantly improved the economic conditions of low-income farmer households (Figure 2). Rural health care and education reforms in recent years have also benefited large numbers of poor farmers.

Figure 1. Rural Poor Population



Source: *China Statistical Abstract* (NBSC 2006a).

Figure 2. Rural Households' Agricultural Taxes



Source: CDRF (2007).

The PRC government has adopted a two-pronged approach to poverty reduction—development and relief. In rural areas, the focus has been to help poor farmers improve their production facilities, and assist villages in impoverished areas to improve infrastructure through increased government investment and low-interest loans. In urban areas, creating employment has been the main policy tool to reduce poverty, supplemented by assistance in securing small loans and training, and by preferential taxation policies. Some urban governments have experimented with paying people to provide public and community services as a way of ensuring that at least one person per household (with physical capacity) is employed, so as to eliminate “zero-employment households.” The experiment has had considerable success.

In the area of poverty relief, the government has implemented since 1999 a policy of providing basic living allowances in urban areas to subsidize the living expenses of people who are below the locally defined poverty line. At the end of 2006, 22.4 million people in urban areas were receiving subsidies averaging CNY83 per person per month. This ensured that households had at least CNY170 per month to spend on necessities. With some modifications, this policy was extended to rural areas in 2004, where eligible farmers receive a specified sum from the local government (CNY30–50 per month, depending on the province). Nearly 15.1 million rural residents in 25 provinces across the PRC received living allowances, which totaled CNY4.2 billion in 2006.¹ In late June 2007, the State Council held a meeting on the establishment of a minimum living security system in rural areas, and put forward three principles: (i) local governments are responsible for implementing the system and adapting it to their local contexts; the central government will provide appropriate subsidies to provinces with

¹These figures are based on data published by the Ministry of Civil Affairs (2008).

financial difficulties; (ii) local governments need to design schemes taking local conditions into account; and (iii) the policies and arrangements should be comprehensively planned (Hui 2007).

As far as poverty reduction is concerned, both approaches (development and relief) have been evaluated and there are also some new developments. For example, human resource development in poor areas has been incorporated into poverty reduction programs. In rural areas, new policies such as exemption from agricultural taxes and provision of grain subsidies significantly benefited the poor. In urban areas, the minimum living allowance, although better targeted and managed than before, still needs significant improvement. Recent surveys in 14 cities show that only 37.1 percent of eligible households and 5.5 percent of noneligible households received the allowance. Compared to urban areas, even more needs to be done to improve the system of ensuring the minimum living standard in rural areas.

B. Education

The PRC implements a 9-year compulsory education system. In rural areas, education expenses were borne by rural collectives before 1978. However, when the household contract responsibility system led to the dismantling of rural collectives, education costs had to be borne by individual households. In many cases, the lack of financial resources needed to run local schools led to delays in paying teachers' salaries and inadequate teaching facilities. To improve the situation, the government decided in 2001 to bear part of the education costs in rural areas. Under the burden-sharing scheme, farmers no longer had to raise money to keep schools open, which would henceforth be funded by the central government, as would rural teachers' salaries and the cost of building rural schools. Further, in 2006, all tuition and miscellaneous fees were abolished for 150 million poor rural students for the duration of their 9-year compulsory education. Poor rural students could also receive free textbooks and subsidies for boarding fees. On average, this policy saved each primary school student CNY140, each junior middle school student CNY180, and each boarding student CNY500, every year. The policy thus provides substantial financial relief for many poor rural households whose per capita annual income barely exceeds CNY1,000.

Progress has also been good in higher and secondary vocational education. The government increased public investment and encouraged private investment in both levels. In 2006, the gross enrolment ratio reached 59 percent for senior middle schools, and 22 percent for higher education.²

²In the absence of students' age distribution, the calculation of "the gross enrolment ratio" does not exclude overaged students.

Education expenditures accounted for 15 percent of the government's total expenditures and 2.9 percent of gross domestic product (GDP). However, this proportion is small when compared with other countries at similar levels of economic development. In addition, large rural–urban and regional gaps in the average educational resources per student persist and are a matter of concern. Furthermore, under the current educational system, the local governments, which finance the school facilities jointly with the central government and also take full managerial responsibilities of the schools, find it increasingly difficult to accommodate the increasing number of school-age migrants.

C. Employment

Because the PRC has a large labor force, it is critical for the government to support the expansion of employment opportunities. Since 1992, a market-oriented employment system has emerged and, in 1998, the government clearly put forward the principle of “workers finding their own jobs through markets, and the government plays the role of promoting job creation.” As the economy continues to grow, so does the level of employment (Table 1).

Table 1. **Total Employment and Urban Unemployment Rate**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Employment (million)											
Total	679.5	688.5	696.0	699.6	705.9	720.8	730.2	737.4	744.3	752.0	758.2
Primary industry	354.7	347.7	347.3	348.4	353.6	360.4	365.1	368.7	365.5	352.7	339.7
Secondary industry	156.3	161.8	165.0	164.4	162.4	162.2	162.8	157.8	160.8	169.2	180.8
Tertiary industry	168.5	179.0	183.8	186.8	189.8	198.2	202.3	210.9	218.1	230.1	237.7
Structure of employment (total=100%)											
Primary industry	52.2	50.5	49.9	49.8	50.1	50.0	50.0	50.0	49.1	46.9	44.8
Secondary industry	23.0	23.5	23.7	23.5	23.0	22.5	22.3	21.4	21.6	22.5	23.8
Tertiary industry	24.8	26.0	26.4	26.7	26.9	27.5	27.7	28.6	29.3	30.6	31.4
Registered unemployment rate in urban areas (percent)	2.9	3.0	3.1	3.1	3.1	3.1	3.6	4.0	4.3	4.2	4.2

Source: *China Statistics Yearbook 2006* (NBSC 2006a).

Starting in the 1980s, the government gradually abandoned the “universal employment and universal allocation” system, allowing the private sector to grow and to create employment opportunities. However, for a considerable period of

time, SOEs and collective enterprises remained the major channels through which new entrants to the labor market were absorbed. Since the SOEs did not have full autonomy in hiring and firing workers, the problem of redundant labor worsened. When more radical reforms were introduced in 1998, SOEs and collective enterprises were required to lay off redundant personnel within 3 years, and at the same time, to guarantee basic subsistence allowances to laid-off workers for 3 years. However, due to the large number of laid-off workers and wide-ranging concerns, allowances have been given for periods extending well beyond 3 years.

To help laid-off workers, the government set up reemployment service centers; provided subsistence support for laid-off workers; paid for their social security fees such as pension and medical insurance; and provided for one free job consultancy, three employment information service offers, and one vocational training opportunity. The government also provided reductions in and/or exemptions from taxes and administrative charges, and extended small security-backed loans to laid-off workers. In addition, the government granted social insurance subsidies to service, commercial, and trading enterprises if they employ laid-off workers in newly created posts.

The government's policy package to promote reemployment of laid-off and unemployed people also included improving reemployment services, increasing capital investment for job creation, strengthening vocational and technical training, and actively guiding unemployed people to change their "job-for-life" mindset. From 1998 to 2003, the central government allocated a budget of CNY73.1 billion for the subsistence allowances and reemployment of laid-off workers from SOEs. Between 1998 and 2004, of the 21.6 million workers laid off from SOEs, 19.4 million were reemployed.

In addition, the PRC's unemployment insurance system has been improved gradually. The coverage of unemployment insurance has been extended from the former SOE workers to other enterprises and public institutions in urban areas. The proportion of institutions paying for unemployment insurance has increased while workers have also started to pay a premium equivalent to 1 percent of their wages. By the end of 2006, 111.9 million people were covered by unemployment insurance, with 3.3 million people receiving unemployment subsidies.

Although the government has been implementing proactive employment policies, unemployment of young people has become an increasingly critical problem. A survey by a research institution attached to the Ministry of Labor and Social Security indicated that about 10 million people wish to enter the labor force in the PRC annually, but only 40–50 percent can find jobs. The unemployment rate for people aged 15–29 years is 9 percent, which is higher than the 6.1 percent average (Sun 2006).

D. Old-Age Support

The PRC government adopted the pay-as-you-go model of providing old-age pensions in 1997, based on the Three-Pillar Model proposed by the World Bank (1994). Of the three pillars, the first is funded by the employer on a pay-as-you-go basis, and amounts to 20 percent of each employee's annual income, considered as the minimum subsistence level. The second is a cumulative account jointly funded by the employer and the employee and is equivalent to 40 percent of the latter's annual income. The third consists of enterprise annuity and is at present only practiced in profitable enterprises. The number of people covered by insurance grew from 86.7 million in 1997 to 186 million in 2006 and currently covers 48 percent of urban employees.

Although the overall structure of this model is in place, the details are being constantly improved, and some issues remain unresolved. First, the shortfall in accounts held by people who worked under the old scheme but will be paid under the new one is currently funded by budgetary allocations. However, financing implicit debt this way is clearly unsustainable. Second, the old-age insurance scheme is still plagued by limited coverage. Expanding the coverage to the self-employed and those working in informal sectors (who account for nearly half of the workforce) remains a challenge. Third, the management and investment of the funds could be improved. The accounts are currently managed at the provincial level, which creates problems when the account holders want to work in another province. In addition, the PRC's underdeveloped capital markets and poor oversight make it difficult and risky to invest the huge amount of funds generated by the system.

In the countryside, old-age security has traditionally been provided by the farmland and the extended family. However, as family size shrinks, more people move to cities for jobs, and as the rural population ages, old-age insurance becomes imperative. In 1992, the urban model (as described in the foregoing paragraphs) was adopted in some counties on a trial basis. By the end of 2005, it had been expanded to cover more than 54 million people in over 1,900 counties. In the same year, 3 million people collected an average old-age pension of CNY707. In 2005, the more developed municipalities and provinces, such as Beijing, Guangdong, Jiangsu, and Shandong, decided to allocate more funds to subsidize old-age insurance so that it is not funded entirely by individuals in their rural areas.

The PRC government has also borne the cost of old-age insurance for two categories of rural people. One is childless elderly people who used to be supported by rural collectives. In 2006, 4.8 million childless elderly people received subsidies each month from the state, costing the central government CNY4.1 billion. Another category is people in rural areas over 60 years old who only have one child (son or daughter) or two daughters, eligible to receive at least

CNY600 per year from the state as a reward for not having more children. This policy was introduced on a trial basis in 2005 and was adopted nationwide 2 years later. In the western region, 80 percent of these allocations come from the central government and the rest is funded mainly by the provincial government. In the central provinces, the cost is shared equally between the central and the provincial governments.

Despite all the progress, the low coverage and poor transferability of the current pension system constrain labor mobility. The significant rural–urban differences in the pension system also contributed to rural–urban inequality.

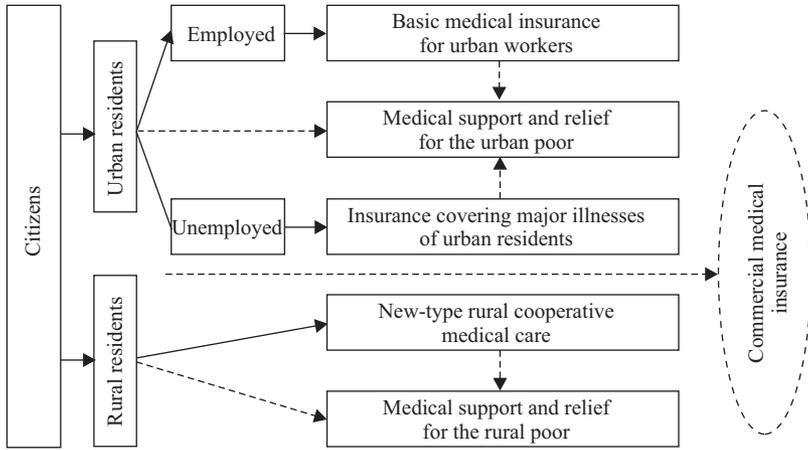
E. Health Care

In the 1960s and 1970s, the PRC government provided health services to the world’s largest population at a low cost. It managed to do this through the nationwide “patriotic public health campaign” and prevention system, supplemented by “barefoot doctors” in rural areas and free medical care in cities. These policies helped extend life expectancy and cause a significant decline in infant mortality.

Since market-oriented reforms were adopted, there has been a significant expansion of medical resources and improvement in medical facilities. The number of clinics and health workers, and supply of medical equipment and medicine grew rapidly. Nationwide expenditures on health reached CNY759 billion in 2004. However, as medical expenses grew faster than personal incomes, nearly one fifth of patients across the PRC in 2003 could not afford to visit a doctor. A nationwide survey conducted by the Ministry of Health in 2003 showed that 65 percent of the population did not have medical coverage. The figure was lower in cities at 45 percent, but staggering at 70 percent in rural areas. In another large-scale survey, three fourths of the population ranked expensive medical bills as the top social issue in the PRC.

As the costs of health care continue to rise, a large proportion is borne by patients. Public health expenditure accounted for only 36.2 percent of all health expenditures in 2003. Consequently, the World Health Organization ranked the PRC 196th, out of 199 countries surveyed, on the proportion of public spending to total spending on health. Since 2004, the government has been taking steps to reform the urban and rural medical care system (Figure 3). In urban areas, the system relies mainly on the employee medical insurance scheme, which currently covers 130 million workers. Jointly funded by the employee and employer, the scheme covers outpatient and hospitalization expenses.

Figure 3. Urban and Rural Medical Care System



Source: Zhang and Wu (2007).

For the rural population, the government began experimenting with cooperative medical care in the countryside in 2003. Under the scheme, large medical bills or hospitalization expenses are covered by a fund to which individual farmers contribute CNY10 annually while central and local governments contribute CNY40 annually per registered resident. At the end of 2006, 410 million farmers, or 45.8 percent of the rural population, were covered. The scheme is expected to cover all rural residents by 2010.

In 2006, a model similar to the rural cooperative medical care system was adopted in the cities, aiming to cover the expenses of treating major illnesses of people who work in the informal sector or are unemployed. Children, the elderly, and rural and urban unemployed people are entitled to subsidies at par with people covered by the rural cooperative scheme provided they or their households have contributed certain annual sums as required. In addition, support will soon be offered to impoverished people in urban and rural areas by subsidizing some or all of their medical expenses, depending on the degree of poverty.

After over two decades of reform of the health insurance system in rural and urban areas, progress has been made and coverage has continually expanded. However, the overall coverage is still limited and further expansion is required. In addition, there remain large differences in health services available to different groups and areas, which require further reforms and adjustment.

F. Housing

Under the command economy, urban employees commonly lived in apartments provided by their employers. However, this welfare provision ceased

in 1998. The new policy is varied: the poorest families can rent subsidized apartments provided by the government or their employers; lower-to-middle income households can buy inexpensive apartments, the cost of which is subsidized; and the more prosperous families can either buy or rent commercial apartments at market prices.

The PRC population now enjoys much better housing conditions, with housing area reaching 28.69 square meters per capita in 2005. However, not all people have benefited equally, as some local governments encouraged the development of commercial housing at the expense of affordable or low-rent housing. Skyrocketing housing prices have become the subject of widespread complaint and a politically contentious issue. The government has responded by issuing new regulations prescribing greater housing provision at a price affordable to ordinary wage earners. Local governments across the PRC have formulated plans accordingly to cater to the low-income population by either subsidizing their rent or building more low-rent apartments.

G. The PRC's Current Welfare System

As the previous discussion reveals, the PRC's current welfare system has the following characteristics:

- (i) A dual structure on the way to integration. The PRC operates a dual economy with separate social welfare systems for urban and rural areas—a feature reflected in its poverty relief, pension, medical care, education, and housing programs. The government's medium-term goal is to establish a system covering the entire population, and its ultimate goal is to integrate welfare programs currently divided between urban and rural areas.
- (ii) Wide coverage with low levels of provision. Welfare provision has traditionally focused on "basic needs." Examples are the 9-year compulsory education, basic medical care, and small subsidies to impoverished populations. This was a necessary compromise toward achieving universal coverage and fair treatment. The challenge for the future is to improve the quality and level of provision.
- (iii) Rapidly increasing burden on the government. The government has replaced SOEs and rural collectives as the provider of welfare and its welfare budget has been ballooning. The disintegration of the traditional "work units" has shifted the responsibility of looking after their employees to the government. As the economy and society grow, both the absolute and relative cost of welfare provision will continue to increase, constituting a challenge to the government in both financial and managerial terms.

- (iv) The goal: universal social security. The goal is no longer equal pay through income redistribution but universal social security with special focus on the low-income group. The welfare programs in the PRC should be market-based like those in Japan and Korea (discussed below). The responsibilities of the individual, the family, the community, and the employer will remain fundamental to welfare provision, with government playing a supplementary role to protect the vulnerable.
- (v) Human development is increasingly emphasized. Human development is increasingly becoming the focus of welfare provisions. School and health systems are not only important for establishing social security but also promoting national competitiveness.

III. WELFARE SYSTEMS IN OTHER COUNTRIES

Welfare systems vary across countries and constitute an essential part of modern economic systems to protect the poor, the vulnerable, and the unemployed to mitigate risks in the market place (Esping-Andersen 2003a). A number of long-term trend—including demography, globalization, family structure, and structure of jobs—have major implications for the design of welfare systems.

Concerns regarding the welfare system generally appear at two levels. The first is the difficulty in sustaining high levels of government welfare expenditure during periods of low growth. During recessions, social welfare expenditure requirements are often high, particularly on items such as unemployment support. This in turn raises the burden on the government budget, increasing public debt and sometimes creating a spiral of low growth. Changes in the social structure might also influence the welfare system. For example, an aging population has lowered the proportion of the working population to the whole population in many countries, lowering taxable incomes while raising pension expenditures (Tanzi and Schuknecht 2005). The second level is about the influence of welfare policy on economic development. A high level of social welfare provision will necessarily require high public subsidies and transfer payments. Many believe that excessive welfare support through taxation, transfer payments, and subsidies could distort the incentive system and create moral hazard problems. For example, high unemployment subsidies may undermine certain people's incentives to look for jobs and stay employed.

This section discusses the welfare systems in two East Asian countries: Japan and Korea, complemented by brief comparisons with Europe, Latin America, and North America.

A. Focus on Growth and Employment

A distinct feature of the welfare systems in Japan and Korea is their focus on growth and employment. Japan adopted a policy of “redistribution along with growth” and its welfare system has gradually improved since the 1950s and 1960s. In contrast, Korea adopted a policy of “growth first, redistribution follows.” Although the related legislations were put in place in the 1960s and 1970s, implementation of the welfare system in Korea did not begin until the mid-1980s. Notably, the evolution of the welfare system in these countries has been synchronized with the changes in the labor force structure. After the 1960s, when Japan’s economy started to boom, the economy gradually achieved full employment and labor supply fell short of demand. In Korea, the turning point of labor supply occurred in the mid-1980s. With the labor supply shifting from abundance to shortage, the comparative advantages of these two countries also changed. The establishment of their welfare systems conformed to the requirements of such structural change, enabling their economies to grow continuously.

Unlike most European welfare systems, Japan and Korea implement an active employment policy with a “self-supporting” welfare system. Japan’s government legislated preferential policies for employment. The goal of the welfare system is to achieve self-reliance through employment (Uzuhashi and Yoon 2006). Japan’s unemployment insurance benefits, for example, include basic subsidies plus job seeking assistance, such as skills training, house moving, and job hunting (Yang and Shen 2002, Sun 2002). Korea’s unemployment insurance includes basic payment and employment promotion subsidies, vocational skill development subsidies, activity fees for job hunting, and moving costs. For the disabled, the “Act on Employment for the Disabled” clearly stipulates that firms with 300 or more employees must leave 2 percent of job positions for the disabled (Zheng et al. 2003). The Ministry of Labor also provided loans to enterprises employing the disabled and supported the costs of equipment purchased so that such employees could work.

With employment growth and increasing individual self-reliance, the governments’ financial burden was greatly reduced. In Japan and Korea, the proportion of people receiving social assistance and the proportion of GDP devoted to social assistance is rather small (Tables 2 and 3) (Uzuhashi and Yoon 2006).

In Europe, the share of social welfare expenditure in GDP rose from 10 percent in 1960 to over 20 percent in 1980 and remained very high in the 1990s, compared with those of Japan and Korea (Table 4). However, since the 1980s, with the slowdown of growth, large-scale reforms have been instituted in many countries in order to reduce public expenditures and lessen the burden on the state. Many European and North American countries have tried reforming

their welfare systems. However, rising unemployment and resulting increases in welfare expenditure requirements have made welfare reform difficult. Welfare measures had more dramatic impact in Latin America: stagnant economic growth (during 1980–1990, the average per capita GDP annual growth rate was –1 percent), along with higher unemployment rates (for example, the unemployment rate in Colombia reached 60 percent), and excessive welfare expenditures led to colossal financial deficits. Many Latin American countries expanded their money supply, which led to high inflation rates, surpassing 200 percent in Argentina, Brazil, and Peru. Others turned to foreign debt, leading to debt crises (Xu 2003).

Table 2. **Social Assistance Recipients** (percent of population)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Japan	0.71	0.71	0.7	0.71	0.72	0.75	0.79	0.84	0.9	0.98	1.05
Korea	4.5	4.3	3.9	3.3	3.1	2.5	2.5	—	3.0	2.8	2.8

Source: Uzuhashi and Yoon (2006).

Table 3. **Social Assistance Funds** (percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Japan	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.5
Korea	0.2	0.2	0.2	0.2	0.4	0.5	0.6	0.6	0.6

GDP = gross domestic product.

Source: Uzuhashi and Yoon (2006).

Table 4. **Social Welfare Expenditure Levels in Selected Countries**

	Year	GDP (billion \$)	Per Capita GDP (\$)	Share of Central Government Expenditure in GDP (percent)	Central Government's Social Welfare Expenditures	
					Share in GDP (percent)	Share in Government Expenditure (percent)
France	1993	1,249.7	21,673	47.2	18.5	39.3
Japan	1993	4,275.1	34,291	23.7	8.7	36.8
Korea	1997	442.5	9,623	18.8	2.0	10.8
United Kingdom	1995	1,107.0	19,002	41.8	13.0	31.1
United States	1997	7,844.0	29,301	21.7	6.2	28.8

GDP = gross domestic product.

Sources: Based on data from *China Statistics Yearbook 2000* (NBSC 2000a), and *International Statistics Yearbook 2000* (NBSC 2000b) as quoted in Zheng et al. (2002, 44).

B. Influence of Structural Changes

Before the 1950s in Japan and the 1980s in Korea, low-wage and low-cost industrial development strategies were adopted. In the early period of industrialization, workers' welfare received little attention because of global competition in the international market. The social welfare system was only developed and implemented after structural changes in the labor market took place. As the economies grew, labor became more scarce and more expensive, especially the middle- to low-level-skilled labor. Subsequently, the demand for improved welfare was put on the agenda and the minimum wage system and arrangements for labor security were introduced and extended to small and medium enterprises and the informal sector. The Japanese experience shows that if a country proactively improves the welfare system in the process of economic development, growth is not hampered. Korea's experience shows that if the social welfare system does not adjust to a changing labor supply structure, workers and other sectors of society will force the government to adjust and improve the welfare system.

Changes in social structure require that social policy be forward-looking to be cost-effective. For example, the implementation of the national annuity system in Japan played an important role in addressing the subsequent aging issues of the population. The proportion of national income spent on pension insurance increased from 9.4 percent in 1975 to 14.0 percent in 1985. However, thanks to the national annuity system, especially the reform of annuity payments, the financial pressure on the government budget did not rise commensurate with the increase in pension insurance paid.

C. Flexibility and Burden Sharing

Gradualism and flexibility characterize the welfare systems of Japan and Korea. In establishing their welfare systems, both countries started in a few geographical regions and sectors, gradually expanding coverage. Taking pension insurance as an example, the national annuity system in Japan initially targeted farmers, individual merchants, and employees working in small enterprises with at most four employees. In 1986, the coverage was expanded to include all in-service employees and nonworking personnel above the age of 20. In Korea, annuity insurance is divided into four categories: (i) civil service annuity, (ii) annuity and insurance of military servicemen, (iii) annuity of private school staff, and (iv) national annuity applicable to civilians aged 18 to 60. Different welfare policies were set for different categories, making the whole welfare system flexible.

Although having different welfare policies across geographic regions, sectors, and professions allow the system to stay flexible and to be gradually

established, the welfare system eventually evolved into a uniform and integrated system in both countries. In 1991, Japan unified its annuity policies by establishing public annuity as the common base. In recent years, Korea has also been considering reform proposals to unify different welfare policies across people (Zheng et al. 2002).

In Japan and Korea, the family, community, and companies are equally responsible as the government in providing welfare services. Families, communities, and companies are encouraged to play more active roles in providing welfare services to lessen the burden on the government. For example, in both countries, a significant portion of the income of the elderly comes from their children, amounting to 44.3 percent in Korea. In contrast, the percentage of the income of the elderly received from their children in the United States and Denmark is negligible (Zheng et al. 2003). The elderly in most industrialized countries rely more on the public annuity provided by the government. Statistics show that in these countries, from the late 1970s to the early 1990s, public annuity accounted for a significant portion of the income of citizens more than 55 years old—36.1 percent in Australia in 1981, 32.6 percent in Canada in 1981, 41.8 percent in the Netherlands in 1983, 34.7 percent in Switzerland in 1982, 41.7 percent in the United Kingdom in 1979, and 54.1 percent in Germany in 1981 (Zhou 2006; OECD 1992). Taking the European Union as a whole, in 1990, government transfer payments accounted for 81 percent of the pension, 69 percent of the health care, 60 percent of handicap subsidies, and 60 percent of unemployment benefits. In Japan and Korea, the responsibilities are better shared among governments, companies, and families. Therefore, some scholars categorized these two countries at “early stage of welfare states” (Takegawa 2006).

IV. POLICY RECOMMENDATIONS FOR THE PRC

The PRC's labor force is currently undergoing structural change (Cai and Wang 2006, 2007). The experiences of Japan and Korea in building their welfare systems during similar periods of structural change, in particular, their focus on growth, employment, flexibility, and burden sharing, provide useful policy lessons for the PRC in reforming its welfare system over the long term. In the short and medium term, however, the PRC government should focus on the following reform priorities.

A. Reducing the Dualistic Nature of the Welfare System

The PRC's social welfare system should be redesigned to help reduce the income gap. The current social security system actually exacerbates urban–rural income differentials (Li 2001). In 1994, the average income of urban residents

was 2.9 times that of rural residents, but would be 3.3 times if social security incomes are taken into consideration; thus, the social welfare system enlarged the urban–rural residents’ income gap by 18.6 percent (Yang 2004).

In addition, rural migrant workers, referred to as “floating” population, have been excluded from the system. With the opening up of cities and towns, the size of the floating population has become large. How to include this segment of the population in the welfare system has become an important issue. The PRC’s 140 million rural migrant workers face very difficult circumstances. They spend more than half the time working in cities, but are excluded from the urban welfare system. They have homes, and most have farmland, in the countryside, but the rural cooperative health care system cannot serve them when they are residing in urban areas. As the household registration system dividing urban and rural residents is phased out, farmers may now legally migrate, settle, and find employment outside their area of registration. However, social policies and welfare provision are still divided, leaving most rural migrant workers to fend for themselves (Table 5).

Table 5. **Dual Welfare Structure and the Migrant Worker**

	Urban Residents	Rural Residents	Migrant Workers
Old-age security	Endowment insurance	Land	—
Medical care	Basic medical insurance	Cooperative medical care	Subsidized treatment of major illnesses
Education	Free	Free; subsidies	—
Labor protection	Industrial injury insurance	—	Industrial injury insurance
Housing	Subsidies; low rent	Self-built	—
Poverty relief	Urban living allowances	Rural living allowances	—

The Population and Labor Economic Research Institute (2005) found that the proportion covered by social security is much lower among the floating peasant workers than local residents (Table 6). This is a political as well as an economic issue. Migrant workers will not have equal benefits as others until rural–urban gaps in terms of basic infrastructure provision (such as schools, transport, and housing) are reduced. For a time, some cities adopted radical reforms providing the children of migrant workers free access to primary education. As education standards are higher in cities than in rural areas, many farmers then chose to migrate to cities to give their children a better education, which imposed an additional burden on urban governments and facilities. As a result, the policy had to be discontinued.

Table 6. Social Security Coverage for Local Population and Floating Population (percent)

Social Security	Local Population	Floating Population
Informal employment		
Old-age support	54.8	2.1
Unemployment insurance	12.6	0.4
Industrial injury	6.0	1.2
Health care	32.6	1.3
Formal employment		
Old-age support	82.1	29.0
Unemployment insurance	39.7	17.8
Industrial injury	29.1	31.7 ^a
Health care	71.4	29.7

^a As the floating peasant workers are engaged in special trades and types of work, the risk of injury is higher than that for the local workers; therefore, the percentage cost of their participation in industrial injury insurance in regular institutions is higher than that of local workers.

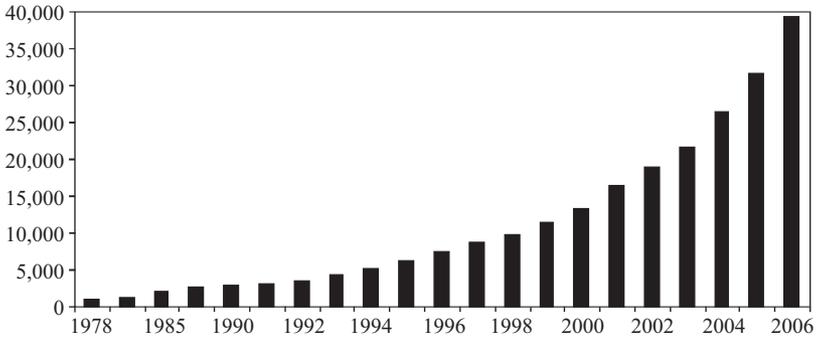
Source: Population and Labor Economic Research Institute (2005).

Currently, the only channels for farmers' families to enjoy urban welfare provisions are either through buying residential properties or having their children attend urban colleges. The government is considering providing welfare benefits to migrant workers who have a stable job in a city, because they would then be paying taxes. This proposal will need budgetary allocations from both the central and provincial governments, as municipal governments cannot carry the burden alone. To truly protect the rights and interests of migrant workers—which comprise a huge, underprivileged community—more needs to be spent on their education, medical care, housing, and pension needs.

B. Improving Management of Public Expenditure on Social Welfare

As the PRC's economy expands rapidly, government revenues are growing steadily (Figure 4). The government's budgetary revenues, mostly from taxes, are on the rise especially after the tax reform in 1994. Moreover, some government departments receive extra-budgetary revenues, such as incomes from the auction of nonagricultural land. As urbanization progresses, many local governments have increased their revenues by making agricultural land available for nonagricultural purposes. At present, such revenue sources are not managed as part of the budget and are mainly used for funding economic construction activities and government operations. If extra-budgetary and extra-system revenues are consolidated with budgetary revenues, central government revenues in 2006 would account for about 32 percent of GDP.

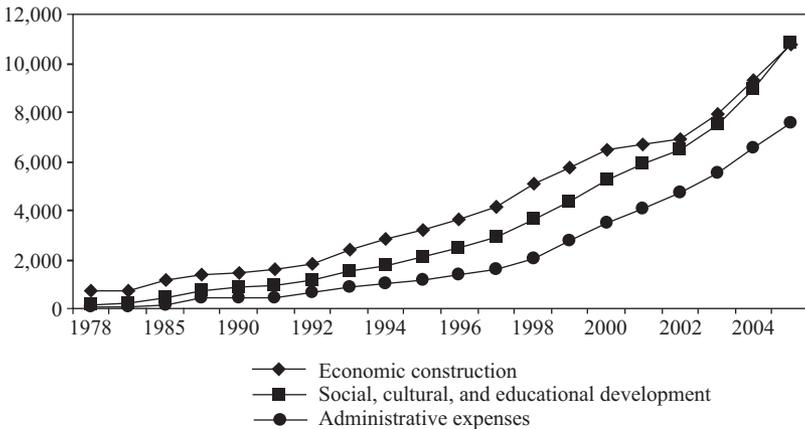
Figure 4. Government Revenue (100 million CNY)



Source: NBSC (2007).

As its financial position improves, the government is better positioned to reform the welfare system. Meanwhile, the demand for further public finance reform is growing in order to make the government budget fairer, more efficient, more transparent, and better functioning. Reform is called for from the following perspectives. First, the structure of public spending can be improved. Government investment in economic construction activities should be rationalized and spending on administrative overhead strictly controlled. Although the former has decreased from 64 percent of budgeted expenditures in 1978 to 27 percent in 2005, it still outweighs spending on social programs (culture, preservation of cultural relics, sports, publishing, education, public health, etc.). In the same period, administrative costs have ballooned, growing faster than social spending (Figure 5).

Figure 5. Government Expenditure by Function (100 million CNY)



Source: China Statistics Yearbook 2007 (NBSC 2007).

Second, budgetary management should be reformed based on sound public finance principles. While budgetary revenues and expenditures are well managed in the PRC, extra-budgetary and extra-system revenues are not. The latter, in particular, are growing rapidly, yet are poorly managed and inefficiently used.

Third, it is necessary to improve transparency in public finance. Government budgets are usually approved and scrutinized by the legislature. In the PRC's case, however, the National People's Congress (NPC) lacks both the time and skills to do so. It is critical to strengthen NPC oversight of both the government's budget and to subject all sources of government revenue to NPC scrutiny. Moreover, as spending on social programs is closely linked with the needs of the people, it should be made more transparent and involve greater public participation.

C. Strengthening the Management Mechanism of the Welfare System

Good governance is crucial to the implementation of sound social policies and the progress of welfare reforms. The government still places relatively more emphasis on economic growth goals than social development objectives. The following issues need to be addressed to improve welfare administration:

- (i) The traditional methods of administration—with rural and urban regions separated and with different sectors segmented—persist. Although the dual administration mechanism has been gradually relaxed, problems such as different administrative norms and standards for cities and villages remain. For example, management standards for the health care system are not the same for urban and rural areas. A unified social security system should be the medium-term goal of government policy.
- (ii) Social security issues are separately managed by multiple departments leading to inefficient management. In the 1950s, the Labor and Interior ministries were in charge of social security administration. After the Ministry of Labor and Social Security was founded in 1998, it bore the principal responsibility. The Ministry of Civilian Affairs, Ministry of Finance, Ministry of Personnel, and Ministry of Health participated in the administration. Problems that have become increasingly prominent include unclear management roles and functions, severe segmentation among sectors, low degree of public scrutiny, and insufficient social security supervision.
- (iii) Targeting remains a problem mainly because of poor management. As poverty reduction, minimum living security, and low-cost and low-rent housing policies are aimed at certain groups of people, effective targeting is important. Taking the minimum level living

security as an example, only one third of the eligible population was covered by the urban minimum living security in 2004, although 67.8 percent were qualified for such assistance.

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