“Recent years have seen a marked shift away from single-minded emphasis on economic growth toward the development of a ‘harmonious society.’ Progress in improving China’s social security system probably will be much quicker over the next 20 years than in the previous 20, but reform will still be piecemeal.”

Repairing China’s Social Safety Net

ATHAR HUSSAIN

Until the late 1990s, when it was still a low-income economy with per capita income of less than $760 a year, China stood out for its resemblance to middle-income economies in social welfare indicators such as a life expectancy, infant mortality, and adult literacy. Yet China’s record of improvement in social welfare has been a combination of advances and reverses.

In particular, economic reforms since 1979 have brought about an unprecedented rise in the average living standard, but they also have undermined inherited social welfare arrangements and created new challenges for social security. These new problems include a sharp increase in the number of retirees, the emergence in the second half of the 1990s of urban poverty and open unemployment, and the appearance of a large population of migrants who are not covered by rural or urban social security schemes.

Restructuring social security in China has been a continuing reform theme since the 1980s. Until the mid-1990s, reforms were aimed at propping up inherited programs, particularly the old-age pension plan. Since then reforms have been concerned with the establishment of a new social security system, starting with the urban population. The development of programs for the rural population, previously neglected, is also beginning to receive some attention. The process of building a new social security regime is, however, far from finished.

THE DEMOGRAPHIC CHALLENGE

The issues confronting social security in China have their roots in the dramatic transitions the country has been undergoing over the past 20 or so years. China’s economic development has seen the transformation of an agrarian economy into an urbanized economy dominated by industry and services. The country has replaced a planned economy with a (socialist) market economy. It has also undergone a demographic transition to a constant or decreasing total population.

This demographic transition was triggered by a downward trend in the fertility rate that dates back to 1970 and precedes Beijing’s “one child policy” by a decade or so. In recent years, the trend has been sustained by a below-replacement fertility rate of 1.9 children per woman over life.

A corollary feature of this demographic transition is the progressive aging of the population, one indicator of which is the rising median age (now 32 years). This trend is expected to persist for several decades and has two consequences that are particularly relevant for welfare and social security. The first is the rising ratio of the elderly (those above age 65) in the population and the second is a falling ratio of children (under age 15).

The first phenomenon has attracted considerable attention in China and has stimulated widespread discussion about the financial support and personal care of the rising numbers of the elderly. But an exclusive focus on the ratio of the elderly can be misleading because it neglects the economic bonus—including fewer mouths to feed and fewer pupils to educate—provided by a declining ratio of children.

Moreover, the cost associated with the rise in the ratio of the elderly relative to working-age adults will be mitigated in the near future by the fact that China is, and will for sometime remain, a labor-surplus economy. This suggests that the withdrawal of a substantial percentage of working-age adults from the labor force (which is what the rising ratio of the elderly does) will have no or little short-term effect on the burden of supporting dependents, whether children or the elderly. The implication is that China has more time to adjust to the aging population than is generally believed.

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Consider what demographers call the dependency ratio: that is, the ratio of the elderly and/or children to the population aged 15–64. The dependency ratio of the elderly is projected to rise from 10 percent in 2000 to 16.5 percent in 2020. But the dependency ratio for children over the same period is projected to fall from 32.7 percent to 28 percent. This means the total dependency ratio, including both children and the elderly, will rise from 42.7 percent currently to only 44.5 percent in 2020. That would still be substantially less than the total dependency ratio of 62.1 percent in 1982.

TOTAL DEPENDENCY

By around 2030, however, the total dependency ratio will rise in tandem with the rising ratio of the elderly and will pose the problem of how to cover the increased costs of supporting the elderly. This challenge is not simply a matter of devoting a larger share of gross domestic product to support of the elderly. How the increased cost is distributed across the economy also matters, and this will depend on the sources of support for social security. These are, first and foremost, the family, then government programs (including old-age pensions and social assistance to the indigent elderly), and personal savings.

Most of the costs arising out of the rising ratio of the elderly will continue to fall on families, which also bear much of the cost of raising children. The implication is that any offset that the falling ratio of children provides against the rising cost of supporting the elderly will accrue to families. But, as the Chinese increasingly realize, their country's demographic trends and socioeconomic changes cannot continue to accommodate the current heavy reliance on the family for old age.

With rising life expectancy, especially at old age, each succeeding cohort of the elderly will need support for a longer period than did the preceding. Added to this, because of birth control policies that in many localities mean one child per couple, future cohorts of the elderly will have fewer offspring to depend on than does the present cohort.

Thus, the conjunction of aggressive birth control policy and the rising ratio of the elderly in the population has spotlighted the issue of replacing family financial support with old-age pensions. Indeed, absent government action, existing gaps in social security will grow larger. Currently the pension program under contributory social insurance covers less than half of the urban labor force, and the rural labor force is excluded altogether. There are small-scale rural pension plans, but these cover only 54 million people (just 11 percent of the rural labor force) and promise to provide only a portion of minimum subsistence.

THE URBAN BIAS

How should Beijing deal with the challenges arising from demographic shifts, as well as from the transition to an industrialized, urban, and (socialist) market economy? To answer this question we first need to outline the salient features of China's current social security in the broad sense of that term. Rather than an integrated system, China has a mix of social security schemes aimed at poverty alleviation; income maintenance in the event of unemployment, occupational injury, sickness, childbirth, or retirement; and subsidized (including free) medical care.

These schemes include the familiar categories of both social assistance and social insurance. Generally, with social assistance programs, basic subsistence and assistance are means-tested, and they usually are financed from general taxation. In contrast, social insurance is not means-tested, and it provides benefits jointly conditional on the contribution record of the beneficiary and on the occurrence of specific contingencies such as unemployment, sickness, or retirement.

Social security coverage in China differs markedly across sections of the population. All social security programs are confined either to urban or to rural residents; as yet, none covers the whole population. Furthermore, "rural" and "urban" are defined with reference to entries in a household registration system *(hukou)*, which can only be changed through administrative discretion and do not change automatically as an individual migrates within China. Thus, migrants living and working in cities on a long-term basis may still be classified as "rural" and thus excluded from benefits for the urban population.

The bona fide urban population in principle benefits from comprehensive social insurance, which is comprised of five plans. These provide old-age pensions, injury compensation, maternity benefits, health care, and unemployment insurance. The five programs are financed from employment-based contributions—joint employer and employee contributions, with the government covering any deficit—and by design exclude those outside the labor force. In addition to social insurance, the urban population since 1997 has also benefited from Minimum Living Standard Assistance (MLSA). A social assistance program, it provides cash allowances—ranging from $17 to $44 per month—to bridge shortfalls of household per capita income from the local poverty line.

MLSA marks an important change in Chinese social security because it also covers those capable of working who in the past would have been denied assistance and instead provided with jobs. With the complementary combination of social insurance and MLSA, the urban population in China enjoys a comparatively high level of social security.

In stark contrast, social security provisions in rural areas are sparse. Apart from two limited programs financed with contributions by participants, all rural schemes are forms of social assistance aimed at relieving severe poverty only. Social insurance does not apply to the rural labor force, not even to wage-employees of town and village enterprises (TVEs), who number 133 million, compared with 72 million employees in the state sector.

The two contributory programs are rural cooperative health care and rural pension schemes. Both are organized at the grassroots level and consist of a large number of independent local initiatives. They cover only a small percentage of the rural population and provide limited protection.

Beijing's attitudes toward the two programs differ markedly. Notwithstanding the rising ratio of the elderly in the population, there is as yet no clear policy on developing rural pension plans. But following the 2003 outbreak of Severe Acute Respiratory Syndrome (or SARS, the infectious viral disease with a high mortality rate), the government has shown some urgency about raising the percentage of the rural population with access to basic health care. Rural cooperative health plans at the grassroots level also are being promoted again.

An urban bias in social security provision is not particular to China but common in developing economies. The bias is to a degree unavoidable, given serious problems in designing contributory social insurance schemes for the self-employed or the informally employed even in developed economies. The problem in China lies with the anachronistic administrative distinction between urban and rural populations, which implicitly regards the rural labor force as self-employed and engaged in farming. This distinction has been rendered obsolete with the rapid growth of wage employment in rural TVEs and the massive influx of rural migrants into urban areas.

PERILS OF DECENTRALIZATION

Both rural and urban social security programs are highly decentralized. In the case of urban schemes, although social insurance and MLSA are based on regulations issued by the central government, many of the administrative details are left to the discretion of provincial or municipal governments. More consequential for both social insurance and MLSA, the budgetary units are China's 269 cities (excluding the 393 county-level cities and towns). Generally, cities are expected to cover from their own budgets any deficits in social insurance and the cost of MLSA in their respective jurisdictions.

The balance between contributions and expenditure varies across cities, depending on the number of pensioners relative to contributors and the unemployment rate, and so do cities' general finances. Most cities are too small to provide sufficient risk-pooling to ensure the sustainability of social insurance. This financial decentralization also has an adverse effect on the operation of MLSA, which has to be financed from the cities' general revenue. In many cases, cities with a comparatively heavier MLSA burden have more strained budgets because the factors that cause households to slip into poverty also act as a drag on urban finances.

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Decentralization in rural areas runs even deeper. Apart from a few programs run by national and provincial governments, most of the social security schemes are organized at the village level. These include assistance to poor households and the rural pensions and cooperative medical insurance plans. The initiation, operation, and financing of rural programs largely rest with lower-tier governments; the higher government tiers (provinces and the center) confine themselves to the supervision and setting-up of pilot schemes.

The central and provincial governments provide ad hoc payments to lower-tier governments to help pay for social insurance and MLSA. But a regular framework for payments—much less a transfer formula tied to a municipality's ability to meet its social security liabilities—has yet to be introduced.

WORKING TOWARD REFORM

Although the urban social security programs have been the primary focus of most of Beijing's reform measures, the central leadership has begun to emphasize the need to establish a rural MLSA, parallel to the urban version, and health insurance schemes for the rural population. A social security law has been under discussion since the early 1990s, but it has not progressed beyond many drafts.

Modifications to urban social security programs have been driven by enterprise reforms and the massive layoffs of labor from the state sector and urban collective enterprises in the 1990s. Layoffs in the state sector undermined the social security system inherited from the planned economy, which was anchored in employment units, and thereby required its overhaul. Dismissals in urban collective enterprises led the government to accept that it could no longer guarantee jobs to the urban labor force and, as a consequence, prompted the establishment of social assistance programs open to those capable of working: both MLSA and assistance for laid-off employees.

Thanks to a series of reforms begun in the mid-1980s, a new urban social security system to replace the inherited system is now in place. The new system extends social security benefits, previously confined to state and urban collective sector employees, to all of the urban wage-employed labor force regardless of the ownership status of the work unit. It centralizes oversight and administration of the five social insurance programs in the Ministry of Labor and Social Security and its territorial subsidiaries, the provincial and city Labor and Social Security Bureaus.

The current system also replaces the financing of social insurance by employers alone with joint financing by employers, employees, and the government. And there are proposals to raise the budgetary unit for social insurance from the city to the provincial level, all with the aim of putting social insurance on a sound financial footing.

The new dispensation includes a reappraisal and formalization of entitlements under social insurance schemes. The addition of employee contributions has been accompanied by the introduction of individual accounts for old-age pensions and medical care insurance. Inspired by the Singapore example, this move was intended to lower the resistance to the introduction of employee contributions against the historical background of the financing of social insurance by work units alone.

As for MLSA, since it was introduced nationwide as a comprehensive social assistance plan for urban households falling below the poverty line, the number of beneficiaries has risen sharply, from under 2 million in 1998 to 23 million in 2004.

Social security for all?

The challenge now is to extend social security reform nationwide, and in particular to rural residents. Until recently this has had a low priority. It was thought that the transformation of the rural economy, driven by the decollectivization of farming and the explosive growth of rural industry, made reform unnecessary. The assumption was that land plots assigned to rural households were in most areas sufficient to lift the population out of poverty.

But how much economic security do land plots provide? They have not been sufficient to prevent poverty, not even extreme poverty. Most of the rural poor, who form a large majority of the poor population, have their own land plots. Yet these amount to less than a third of a hectare per rural inhabitant. Indeed, the amount of cultivated land per rural resident has been falling steadily since the distribution of land to households in the early 1980s because of the combination of rising population, impediments to rural-urban migration, and the diversion of land to nonfarm uses. The trend is expected to continue.

As measured by farm income per rural inhabitant relative to average per capita income for the whole economy, the level of economic security provided by land plots has been falling. This has led to growing recognition of the need for a comprehensive income maintenance program for the rural population. Particular emphasis is being given to setting up social security schemes targeted at the rural population divested of land plots because of diversion to non-farm uses.

Rural areas have two urgent priorities. The first is to establish and develop health care insurance suited to rural localities. The second is to replace the piecemeal poverty alleviation programs that suffer from defective targeting and blind spots with a rural MLSA that, like the urban MLSA, targets individuals and households below the poverty line. Over the past two years, the central government has begun promoting the spread of MLSA for the rural population. This is potentially a highly significant development, opening up for the first time the real possibility of instituting a social safety net that covers the whole of the population, whether urban or rural.

Filling in the gaps

What are the prospects for social security reforms? China's leadership is apprehensive of the increased risks of social instability arising from widening and increasingly visible economic inequality and a huge unemployment problem in both urban and rural areas. Recent years have seen a marked shift away from single-minded emphasis on economic growth toward the development of a "harmonious society."

Progress in improving China's social security system probably will be much quicker over the next 20 years than in the previous 20, but reform will still be piecemeal and gradual. The creation of an integrated system covering both rural and urban populations is highly unlikely in the near future.■