

**LABOUR MARKET REFORM IN CHINA  
HOW 700 MILLION CHINESE WORKERS ARE COPING WITH  
GLOBAL CAPITALISM**

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I am honoured to be delivering the Sefton Memorial Lecture this year. I have had a long association with the University of Toronto, the Centre for Industrial Relations, and many people here tonight.

Reading through the impressive list of talks that have been given in this series, I note that the lectures have concentrated on Canadian labour relations issues. However, because of my experiences over the past six years at the World Bank, I have chosen an international topic to talk about tonight. While China may be a long way away, I hope you will agree that, because of its sheer size and importance in the emerging global economic order and because of the fascinating development story that has emerged over the past quarter-century, labour market reform in China is a worthy subject for this series.

What I plan to do is to briefly trace out the path of economic and social change in China since liberalization began in the late 1970s and then turn to the key challenges facing workers and labour policy-makers in this reform process. Finally, I will end my talk by linking what is happening in China to the broader globalization debate.

My interest in China actually dates back to my undergraduate years at the University of Toronto. Those were the days of the Cultural Revolution and, really for the first time, post-1949 China was the subject of widespread scholarship in the West. Books were

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<sup>1</sup> The content of this lecture reflects my own personal views and does not represent the World Bank or its member countries.

being written and courses were being developed explaining what was going on with what had previously been a largely inaccessible, yet enormous social and economic experiment. Unfortunately, we have since found out that almost everything we learned about China in those days was ill-informed, misinterpreted, and wrong!

I am by no means one of those old “China hands” who speaks the language (or, more properly, languages) and has been in all corners of the country witnessing the incredible transformations over the past decades. I first went to China in 1999 to work in cities in the “rust belt” where the World Bank was financing retraining and other labour adjustment programs for workers losing their jobs in state-owned enterprises that were shutting down or scaling back. After this “on the ground” experience, for the last couple of years, I have been involved at the national policy level in Beijing, where the Bank is providing technical support to various ministries involved in designing and implementing labour market policies and programs.

From these experiences, I have been struck by the challenges facing China because of the country’s remarkable, but uneven, development. Even though economic growth has been sustained at historically unique levels since the late 1970s – something I will get to in a minute – very clearly, there have been winners and losers in the process. In my talk, I am going to talk about two groups falling into the latter category – the laid-off workers from the state sector that I came across when I first worked in China and the rural migrants. These groups probably include about 50 million and 100 million workers, respectively – one thing about this country is that you have to get used to dealing with large numbers!

These two groups – and the problems they are experiencing – raise major challenges for the Government. Obviously, the magnitudes alone would make these major challenges. But they also underscore the stresses, and in some ways the incompatibility, of the increasingly open economy operating in a social and political context that is much slower to adjust. Fully addressing the labour problems associated with the massive restructuring of the state-owned sector and the rural-to-urban migration will require fundamental

rethinking in many ways – where people can live; how security is provided; the value of private vs. public activity; and the rights of workers to express “voice.”

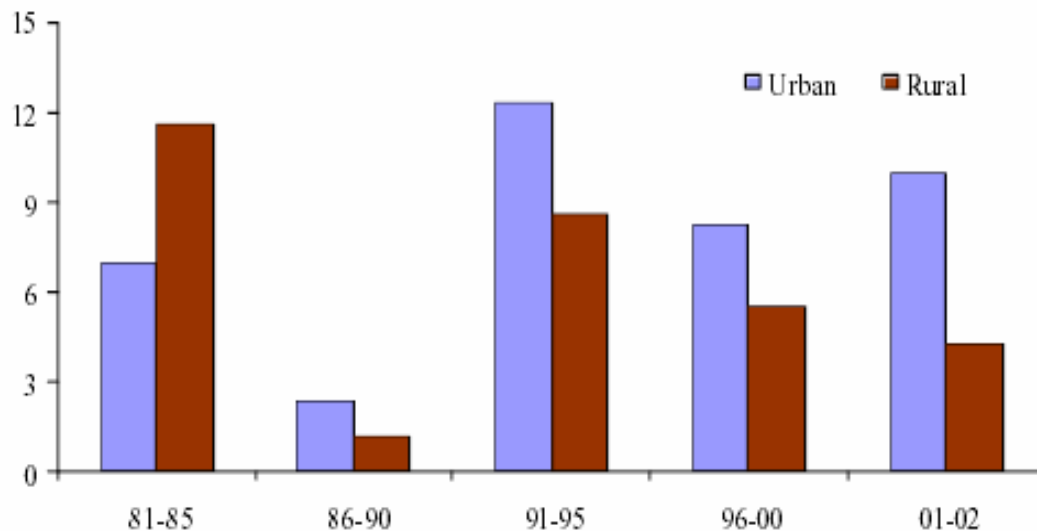
The scale of the challenge is not lost on Beijing. And, in fact, a reorientation of how policy is conceived is taking place, albeit slowly. The exception here, at least to this point, concerns worker voice. While China does have unions, they are virtually without exception under the control of the All-China Federation of Trade Unions, which is not independent of the Government and the Party. Collective bargaining, as we think of it, does not exist. Nor do legal strikes or neutral dispute resolution. Unlike some of the other fundamental challenges I noted above, reforming worker representation is not a “technical” issue, but is tied up in the broader question of political reform and democratization. This is the wild card, of course, when it comes to China.

Having set the stage, let me quickly review the chronology of China’s economic liberalization. Reform – essentially the process of opening up a tightly-controlled state economy to market processes -- began in 1978, following the economic, political, and social debacles of the decade-long Cultural Revolution. The first stage of reform in the early 1980s focused on the agricultural sector which, as we will document shortly, dominated the very undeveloped economy at the start of this period. In the mid-1980s, external trade began along with openness to receiving foreign direct investment. In the early 1990s, the process of reforming the ownership structure of the economy was initiated. For the first time, the legitimacy of private economic activity was recognized at the highest level. As Deng Xiao-Ping, the initial architect of economic liberalization, famously put it: “it doesn’t matter if the cat is black or white, as long as it gets the mouse.” In the early-to-mid 1990s, reforms to the state-owned sector began as “hard” budget constraints were introduced (though unevenly, to say the least) and selective privatizations and other forms of enterprise restructuring were initiated. In 2001, the first loosening up of the “hukou” system – the residency controls – was introduced. Then in 2002, China was granted WTO accession which both locked in the reforms that had already been initiated and called for additional liberalization over the upcoming years.

During this 25-year period, China has experienced extraordinary growth. In real terms, GDP has been growing year after year between 5% and 15%. Measured by purchasing-power parity, China now has the sixth largest economy in the world. When a country sustains those types of growth rates for such a long period of time, the economic dividends for its citizens are formidable, to say the least. The per-capita growth performance was enhanced in China over these years because of the “one-child” policy that radically slowed down population expansion.

Chart 1 illustrates how the aggregate growth, coupled with the population slowdown, translated into per capita income growth during these years. At the beginning, as the chart shows, per capita growth was especially high in the rural areas, reflecting the concentration of initial reforms in the agricultural sector. Then, the urban areas took the lead, with the gap widening in the first years of this century. This is something we will come back to when we discuss the rural migrants issue.

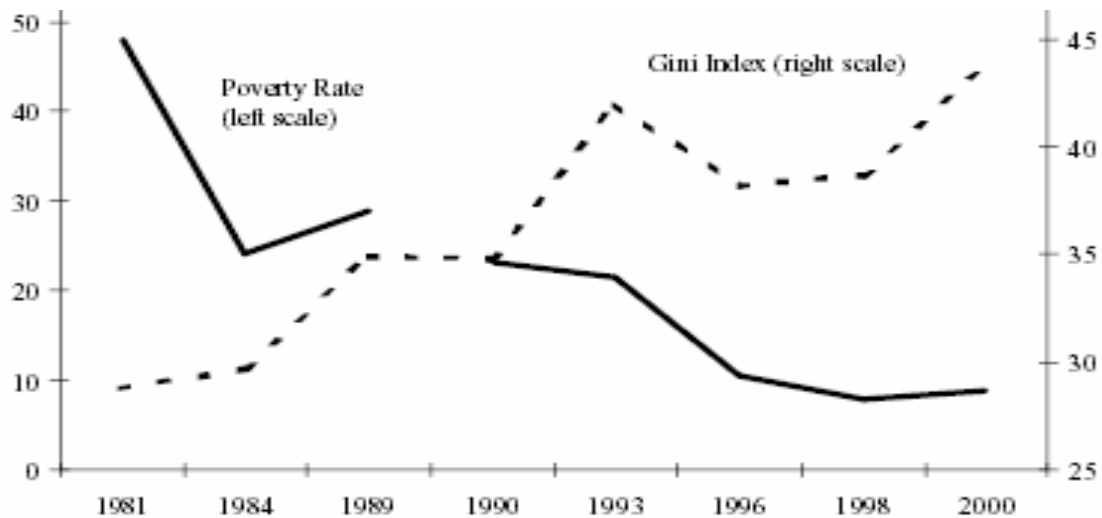
Chart 1: Average Annual % Per Capita Income Growth, 1981-2002



The per capita income growth has translated into historically unprecedented reductions in poverty levels, as well as other development goals. Chart 2 traces the national poverty

rate (defined as the percentage of the population living on less than \$1US a day) over the past two decades. The gains shown in the chart – from almost half of the country to about 10% -- has resulted in over 300 million fewer poor people. Especially when contrasted with other developing countries, where the poverty-reduction track record has been almost universally very disappointing, this performance is remarkable.

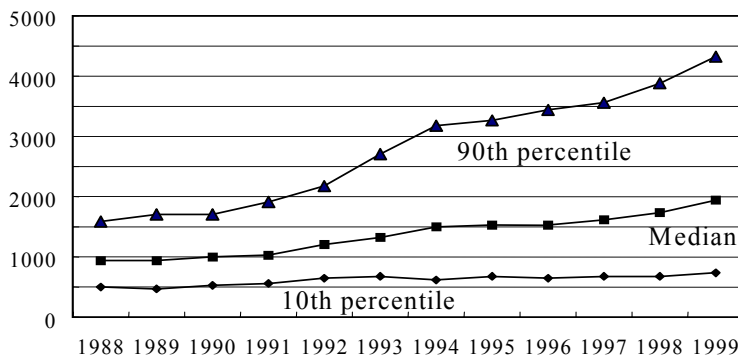
Chart 2: Poverty and Inequality Trends, 1981-2000



However, the other trend shown in the chart signals a less favourable feature of China's recent economic development – a striking growth in inequality. The indicator of inequality used here is the “gini coefficient,” which ranges from 0 to 1 where 0 represents perfect equality in a society (i.e., everyone has exactly the same income) and 1 represents complete inequality (i.e., one person receives all of the income). At the beginning of the 1980s, China's gini coefficient was about .10, indicating an extremely high level of equality – what one would expect of what was still a communist, planned economy. By 2000, however, the index had reached nearly .45, which puts China in the upper half of countries in terms of inequality, though still below the most unequal societies like South Africa and Brazil.

The labour market has played an important part in this inequality story (Chart 3). During the period of liberalization, wage differentials have widened considerably as high-wage earners (e.g., 90<sup>th</sup> percentile) have benefited from sharply rising real earnings while low-wage workers (e.g., 10<sup>th</sup> percentile) have seen virtually no real wage growth despite the aggregate economic growth. As a result, by 2000 the 90<sup>th</sup> percentile wage worker had earnings about seven times those of the 10<sup>th</sup> percentile earner, compared to three times in the late 1980s. Certainly, widening differentials would be expected as an economy liberalized. But the trend in Chart 3 underscores that, along with the winners in China's reform, there have also been losers.

Chart 3: Real Annual Earnings (in RMB) by Percentile, 1988-1999



With this background, then, let's turn to the two groups I identified at the beginning of the talk – the rural migrants and the workers laid-off from the state-owned enterprises.

First, the rural migrants. This phenomenon is tied up with the structural shift in the Chinese economy over the past quarter century, as agriculture has become relatively less important with growth has increasingly in urban areas, in industry and services.

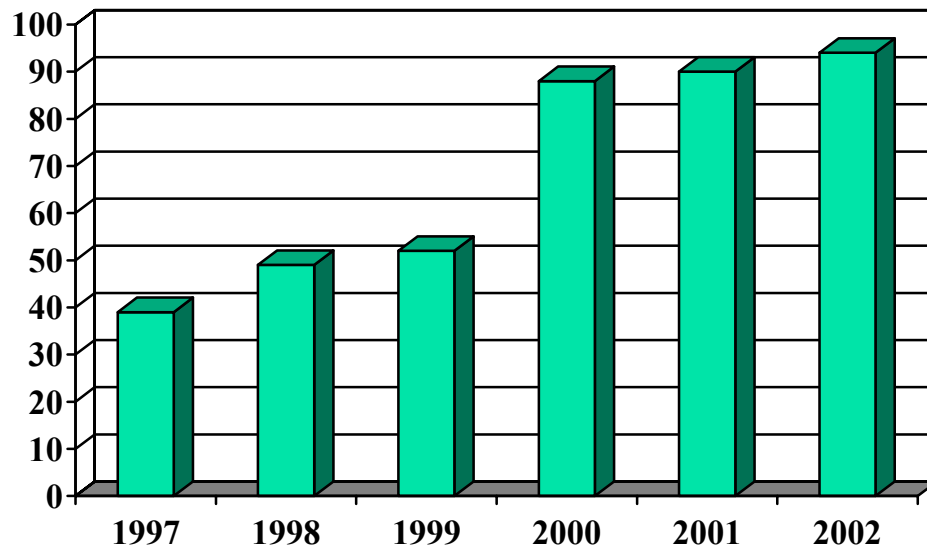
While agriculture has declined as a share of total GDP (over one-quarter in the late 1970s to well under 20% now), this shift has been especially dramatic in terms of employment.

In 1978, almost four out of every five Chinese workers were in agriculture. Now less than half are. This translates into over 150 million fewer agricultural jobs. The fact that employment has changed so much more than output reflects the increasing labour productivity in agriculture during the reform period. Simply put, advances in technology and in the organization and ownership of the sector have led to far fewer farmers needed for agricultural production.

This story is by no means unique to China. It is an inevitable aspect of development and the emergence of a surplus pool of agricultural workers is a familiar story at one point or another in all industrialized or industrializing countries. Typically, what we see in these situations is large movements of rural workers to the cities. However, in China, the human adjustment to industrialization has been complicated by laws that have restricted the freedom of workers to move from the countryside to the cities. Under these laws, known as the “hukou” system, people have not had the possibility to migrate with residency rights. For example, workers with a rural hukou could not move to Beijing or Shanghai and expect to have publicly-provided social security, health insurance, or be able to send their children to school without paying a fee that was obviously far out of reach.

During the early years of economic reform, much of this surplus labour force found employment in the rural non-agricultural activities, thus keeping the pressure for urban migration somewhat at bay. However, as economic restructuring proceeded through the 1990s, more and more rural workers could not make ends meet -- or at best could only eke out a subsistence living -- in the countryside and migrated to the cities, even without the urban hukou. Chart 4 provides an estimate of the growing stock of these workers. In fact, because the national statistical system has not captured these workers very well, some estimates of the number of rural migrants are much higher than those shown in the chart (e.g., up to 150 million).

Chart 4: Stock of Rural Migrants (millions), 1997-2002



This pool of migrant workers is a heterogeneous population. Some come to the cities on a seasonal basis while others move permanently, despite their lack of access to residency rights. However, as a group, these workers comprise a population that bears a high risk of exploitation.

It is only in the last few years that the governments (central, provincial, municipal) have started to openly address the challenges posed by the migration. Some municipalities (especially smaller and middle-sized cities) are relaxing hukou restrictions. Most officials now talk not about *whether* the hukou system will be eliminated throughout the country, but *when*. Nonetheless, it will still be some time. The larger urban centres are moving much more slowly in this direction as they remain very concerned about the possibility of large increases in the flows of rural migrants and the potentially destabilizing effect they could have on their labour markets and social stability. This concern for stability is indeed a prominent theme in all policy discussions on social reform.

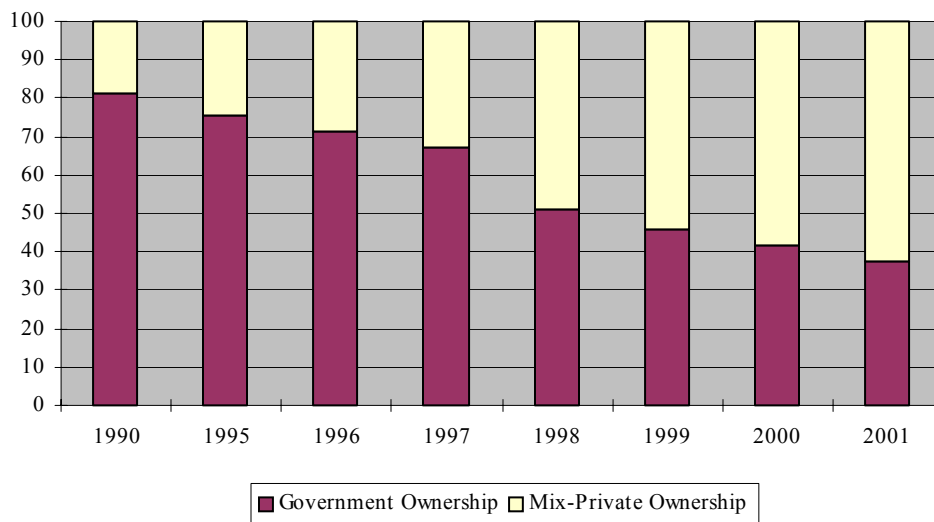
The other group I wanted to talk about are the *xiagang* -- the workers who have been laid off from the state sector. Like the rural migrants, they represent a large number displaced



by the process of economic liberalization. And like the rural migrants, their problems have raised new, and difficult, issues for the social protection system in China.

The layoffs began in the early-to-mid 1990s when the rationalization of the state-owned enterprises (SOEs) started. This restructuring, coupled with the easing of restrictions on private business, has led to a radical transformation in the ownership of China's economy. Chart 5 shows the effect of this on the urban labour force. In 1990, over 80% of workers in the cities were employed by the state, either in public administration or in state-owned enterprises. By 2001, this share had dropped to below 40%.

Chart 5: Urban Employment by Ownership, 1990-2001



By now, the total number of workers who have been laid off in this process could be as high as 50 million though, as is so often the case in China, precise estimates are not possible because of limited data availability. Before turning to who these xiagang workers are and what appears to have happened to them, let me first briefly review the institutional developments that have transformed the nature of the employment relationship in China and led to this situation of large-scale layoffs in the state-owned sector.

The post-revolution institutional and policy framework defining employment can be characterized in two stages. During the first, which was constructed in the 1950s, the Government systematically eliminated the market for labour, replacing it with a state-controlled plan for the allocation of workers. In the second stage, which began in the mid-1980s, market principles have been gradually reintroduced.

The employment model for the command economy that emerged in the first decade after the revolution involved a strict separation of urban and rural labour, enforced through the hukou system that I have already discussed. The rules governing these two realms were very different and we are concerned at this point with the urban labour situation. Urban workers were seen as critical to the development of a strong socialist economy and the rules governing their employment established them as a privileged group in many ways. This system, popularly known as the “iron rice bowl,” offered lifetime job security with the SOE where the worker had been placed. It also guaranteed a wide range of social protections and services. These included housing, education and health services, retirement allowances, and work unit responsibility for any contingencies such as illness or disability.

As the rules of the economy changed in the 1980s, it was inevitable that adjustments would need to be made to the employment model. In 1986, the labour contract system was introduced. From that point on, new hires in the SOEs would be employed on a fixed-term contract basis with the lifetime guarantee grandfathered for the pre-1986 workforce. Even with this legal change, however, SOE workers did not start facing the possibility of layoffs until the mid-1990s when the process of enterprise restructuring began in earnest. A series of policies progressively expanded the right of enterprises to lay off workers. The significance of this cannot be stressed too much. Breaking up the iron rice bowl fundamentally altered the urban social contract, raising the prospect (for the first time) of unemployment and, with it, the loss of the social protection and services that accompanied SOE jobs.

Unlike the rural migrants who, because of their marginal status, remained a politically invisible population for many years, the urban xiagang workers created a more difficult situation for the Government. The SOE labour force -- and the security provided by the iron rice bowl -- embodied the “workers’ paradise” built by the Communist Party. Although the urban employees did not have access to independent trade unions to represent their interests and challenge the Government, such a fundamental change as removing lifelong employment and security could not go unnoticed. Social stability has been a major concern and, not surprisingly, governments at all levels have tried to avoid breaking labour contracts, if possible. And, in fact, while a great deal of labour downsizing obviously has occurred by now, it has been a slow (and reluctant) process and surplus labour still exists in large numbers in a lot of the state-owned sector.

The concerns about social stability led Beijing in 1998 to introduce a unique labour adjustment policy requiring state-owned enterprises to maintain responsibility for xiagang workers after laying them off. Under this policy, SOEs were required to establish a reemployment service centre to provide a living allowance and maintain social services for laid-off workers for up to three years if the worker could not find reemployment. After three years, a xiagang worker who still had not found another job would finally separate from the enterprise and then would be eligible for unemployment benefits.

This system did ease the shock of restructuring for the labour force, not only economically but in a social or cultural sense as well. However, it placed potentially enormous financial demands on the SOEs. And many of these were already insolvent or close to it. There are numerous cases in recent years of angry (and illegal) labour protests erupting because payments have not been made or benefits not provided that the xiagang workers had expected. (This is what happens when workers do not have legitimate channels to express voice.) In many situations, governments have had to assume the financial responsibility. In regions like the northeast where layoffs were particularly large, municipal and provincial governments could not manage these responsibilities and, if obligations were to be met, the central government has had to step in. The scale of these fiscal transfers is not publicly known but it is widely assumed to be huge.

In the last couple of years, Beijing has introduced a new policy (“bingui”) designed to end the system of SOE responsibility for laid-off workers. Under this arrangement, the enterprise reemployment service centres are to close and all laid-off workers who have not found another job will rely on unemployment insurance benefits, if they are eligible. This marks the effective end of the iron rice bowl, at least in terms of public policy. Now China’s social protection system is intended to follow the familiar lines of western-style social insurance and social assistance. Contributory state-run unemployment, pension, and health plans have been introduced for urban workers and China now faces the challenge of making these plans financially sustainable while providing broadly-based coverage and adequate protection. A means-tested minimum living guarantee is available for those who either exhaust benefits or are not participants in the insurance plans. No distinction is made any longer, at least on paper, between the private and state sectors.

There are questions about how effective this emerging social protection system is now and will be in the future. But suffice to say that there are a number of serious issues. One is the financial viability of insurance systems in poor regions. The system is not really national. Beijing does establish the basic parameters but then the plans themselves are administered at the sub-provincial level (often municipal). So, in areas where the economy is bad and unemployment is high, insurance plans are not sustainable without either reducing liabilities (e.g., through denying benefits) or fiscal transfers. Longer-term viability will almost certainly require a higher level of “risk pooling” – preferably national.

Effective coverage is also a problem. In the first place, the social protection systems, at this point, are restricted to urban areas. Even within cities, however, coverage is far from complete. One issue is non-compliance, where enterprises do not make required payroll tax contributions which makes their employees ineligible for benefits. Another issue is the informal sector which, by definition, is outside the reach of formal social insurance plans. As you would guess, it is difficult to get a clear handle on the size and makeup of China’s informal sector but there is little doubt that it is large and growing. In the first

place, it includes the pool of rural migrants. Furthermore, many of the xiagang workers wind up in informal employment after losing their places in the SOEs. Certainly, studies that have tracked what has happened to these workers – including analysis that I have done – conclude that relatively few xiagang are able to find a new job in the formal wage sector where they would be eligible for protection through the new social insurance plans.

The research I have carried out is based on a survey by the World Bank and the Chinese Ministry of Labour and Social Security. In this survey, a sample of over 3,000 xiagang workers was identified in mid-1998 in two large, industrial cities, Shenyang and Wuhan. Chart 6 summarizes the characteristics of our sample, as recorded at that time. The majority were women, interestingly. This may be a peculiarity of our sample because not all studies have found this. However, SOEs laying off workers have often taken family situation into account so our result may reflect decisions where managers tended to lay off women with employed husbands. The other data in the table are consistent with what most researchers have observed about the xiagang population: low levels of education, long tenure, extended periods in xiagang status, and very limited allowances and benefits provided by the SOEs.

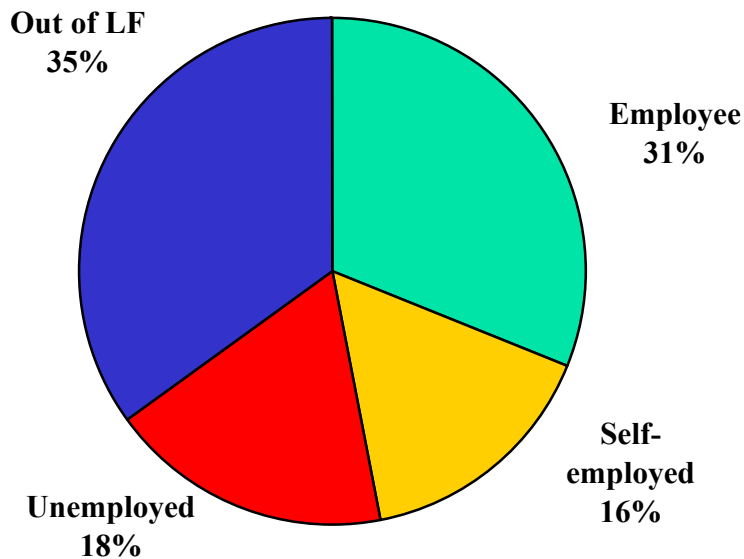
Chart 6: Who are the Xiagang Workers? Evidence from the Two-City Survey

% female	58
% with less than completed secondary education	48
% with tenure of at least 10 years in enterprise	64
% in xiagang status for at least two years	46
Median monthly allowance while xiagang	162 RMB (US\$20)
% with pension and health coverage while xiagang	50

The age, education, and narrow experience of most xiagang workers make this a group that would not easily find reemployment, especially in good jobs in the formal sector. This is what we found. Two years after collecting the baseline data, we surveyed the

sample members to find out about their existing employment situation. Chart 7 summarizes what the workers were doing.

Chart 7: Status of Xiangang Workers Two Years Later



- 35% reported they were out of the labour force – that is, they were neither employed nor actively looking for work. Only a small portion of this group (about one-seventh) indicated they were retired. The rest presumably had other sources of income – from allowances still being received from their SOE, from other workers in their households, or from working in the informal sector (these respondents presumably would not have counted this as “employment” in the survey).
- 18% reported they were unemployed, meaning they reported no job but were looking for one. Again, some of these workers may still have been receiving benefits from their SOE. We would expect that many in this group would also be working in the informal sector while searching for a better job.
- 16% reported that they were now self-employed. This would largely include informal types of activity in services, building, etc.

- Only 31% reported they were “employees.” This can be taken as a proxy for formal wage employment. Three-quarters of these workers had found their new job outside of the state sector, mostly in private companies or in small, often family, businesses.

These results show that the restructuring of the state sector is creating a large population of xiagang workers who do not wind up in the types of formal employment that are likely to benefit from the coverage of the new social insurance systems. These workers, like the rural migrants, have lost their traditional means of economic and social participation and, to this point, neither group is fitting into the emerging framework for social protection.

A number of major challenges need to be met to improve this situation. First, the labour market needs to be integrated nationally so workers can move without losing rights and protection. This involves both mobility between rural and urban areas and movement between the state and private sectors. Currently, there are too many structural barriers hampering the Chinese labour market. Second, social insurance systems need to be reformed to improve their financial sustainability and coverage for workers. One obvious step is to centralize the level of “risk pooling,” ideally with a national plan (which would also help labour market integration). Third, real worker voice is needed. I have not dealt with this but the current situation encourages low-cost production at the longer-run cost to human capital, productivity growth, and moving China up the value-added chain. Finally, to handle the increasing labour force, China must continue to create jobs in large numbers. This is a full agenda, to say the least.

I would like to conclude my remarks by bringing all of this back to the ongoing globalization debate. Obviously, the sheer size of the country’s labour force (more than one-fifth of the world’s workers) makes the Chinese situation relevant for everyone. But, it is becoming especially relevant everywhere because, with global integration, what happens with one country’s workers increasingly affects workers elsewhere.

As everyone here knows, many western governments, trade unions, businesses, and NGOs fear a “race to the bottom” with respect to labour conditions in developing

countries and, above all, China. At the risk of oversimplification, there are two sources for this concern. One relates to worries about human rights violations in developing countries – whether it is the use of child labour, forced labour, or denial of freedom of association. The other is not so altruistic and is motivated by worries about job losses at home. In 2004, a U.S. election year with a slow recovery in the labour market and a huge trade deficit, sensitivities about a race to the bottom are particularly acute.

These ingredients came into play in March when the AFL-CIO filed a petition under Section 301 of the U.S. Trade Act requesting the Administration to impose trade sanctions on China because of persistent violations of core labour standards that were causing injury to U.S. manufacturing. The petition argued that these unfair labour practices -- including suppression of unionization, use of bonded workers, and non-enforcement of labour laws -- pushed wages down by 40-80% and thus created an unfair advantage through these low costs for Chinese producers. The result, according to the petition, was the loss of at least 700,000 American jobs.

On April 28<sup>th</sup>, the U.S. Trade Representative announced that the request for action would not be pursued. This was a difficult decision in an election year where outsourcing had become a household term. In the final analysis, though, I think the USTR made the right decision. This opinion has nothing to do with the legitimacy of the claims presented in the petition about labour practices in China which are consistent with my sense of conditions, especially in the export-oriented regions of the country. But it is difficult not to be skeptical about the ultimate usefulness of trade sanctions such as those proposed, both for industrialized countries like the U.S. and for Chinese workers.

Perhaps I am too cynical but when you are based in Washington, D.C., it is easy to be cynical, especially every four years. In the first place, even if you accept the estimate of job losses and even if you assume that none of these displaced workers finds a new job, this is very small part of the overall unemployment in the U.S. And, in the end, I agree with most serious studies that show that the U.S. (like other rich industrialized countries)



has experienced substantial net welfare gains from trade liberalization. And for the future for China and its workers, trade sanctions such as these are not likely to be helpful.

The economic reforms, which have led to such impressive development and poverty reduction, were a domestic initiative, but now, a quarter-century later, the increased integration in the global economy and membership in the WTO have locked in the reform agenda. This should continue to deliver benefits to the world's largest population, but only if China completes the transition of its social system to complement the new economic context. Engagement from the west – through a mixture of non-coercive pressure, consumer action, and technical assistance -- is the right strategy at this time to support this social imperative.