This report synthesizes the main findings of the Labor Market Study component of the China Labor Market Development AAA Program. It is accompanied by stand-alone policy notes on Unemployment Insurance, the Informal Sector, and Active Labor Market Policies, and a set of background papers.
Acknowledgements

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INTRODUCTION

In the last three decades, the Chinese labor market has undergone a remarkable transformation. This transformation has been influenced by a combination of three interconnected processes: (i) rapid industrialization, with a consequent shift of resources out of agriculture and rural areas to industry and urban areas; (ii) the transition from a planned economy to an open market system, involving massive restructuring of the state-owned enterprise (SOE) sector and fast private sector growth; and (iii) the integration of China into the global economy, leading to the rapid development of its export sectors and coastal cities. These three overlapping processes have had profound impacts on the country’s labor market, changing how, where, when, and under what conditions people find jobs.

Driven by these processes, the transformation of China’s labor market has been marked by significant structural changes:

- **Migration and urbanization.** The urban economy has emerged as the main driver of job creation in China. Throughout the 1980s, rural industrialization drove China’s employment growth, lifting millions out of poverty. However, since the mid-1990s, China has experienced a surge in labor demand in urban areas, spurred by fast growth in the manufacturing and service sectors. Official statistics reveal that for the past 15 years, urban employment has grown on average by 3-4% per annum—that is, some 7 million new jobs have been created in urban areas every year. The sharp increase in urban labor demand, particularly in the export-oriented coastal region, has pulled millions of workers out of rural areas in what has been called ‘the largest movement of people in history.’

- **Emergence of unemployment.** The aggressive restructuring of the loss-making SOE sector which took place during the 1990s fundamentally altered the nature of urban employment. Tens of millions of urban workers who had held secure, lifetime jobs in the state-owned and collective sector were laid off, and many found themselves unemployed. Survey-based estimates suggest that open unemployment has been in the 6-8% range since 1998. In addition, employment-to-population rates have dropped significantly, reflecting the fact that many discouraged workers have left the labor force.

- **Informalization.** The shedding of labor in the state sector has been accompanied by job creation in the private sector, much of it as informal employment. The share of total state-owned and collective enterprises in total urban employment declined from 95% in 1985 to less than 30% in 2005, while the share of employment in joint ventures, registered private firms, or registered self-employment grew to about 20-25% of the urban labor force (NBS, 2005).
Within the urban labor market, the fastest-growing segment by far has been the informal, unregistered sector. The informalization of the Chinese labor market has created jobs for former SOE workers—albeit with very different working conditions and less job security—and helped absorb millions of poor unskilled workers from rural areas. Various methods of measuring informality yield similar estimates of the size of the informal sector, at around half of total urban employment.

- **Rising inequality.** China’s ongoing structural transformation has brought about a marked increase in income and wage inequality. Most of the increase in inequality occurred between the end-1980s and mid-1990s, corresponding to a period of China’s opening and to rapid growth in the urban economy, as well as after 1997 following the heavy labor shedding in the SOE sector. The increase in inequality is explained in part by the fact that inequalities were compressed artificially under central planning. The widening income gaps can also be attributed to the dramatic shift from being a mainly agrarian economy to an industrialized society with a more skilled workforce. The rural-urban income gap has now widened to historic levels, while inequalities within rural and urban areas have increased, as well.

The transformation of the Chinese labor market has not been homogenous or smooth, and by some measures, it is not yet complete. The labor market in China is highly dynamic and heterogeneous, with averages masking huge variations in causes and outcomes. Labor market conditions vary dramatically across regions and municipalities: open unemployment rates may reach 20% in certain areas and remain below 2% in others; millions of rural laborers are underemployed or employed in low-productivity activities in their places of origin, while some of China’s fastest-growing export industries complain of shortages of both skilled and unskilled labor; wage differentials are large and cannot be attributed solely to differences in observable variables. Numerous indicators suggest that segmentation persists along many dimensions—between rural and urban workers, between those who hold formal jobs and those who work in informal employment, between the fast-growing coastal regions and the lagging or depressed areas of the center and interior.

These changes and trends have had major implications for China’s labor market institutions and policies. China has adopted a number of laws and regulations to govern how the increasingly competitive labor market, in which workers and employers are matched on the basis of demand and supply, should operate. The new legal framework helps define the conditions of employment and clarifies the rights and obligations of employees and employers. At the same time, the reform of the SOE sector and the dismantling of the ‘iron rice bowl’ that once guaranteed state-sector jobs and social entitlements to workers have brought a radical shift in how social insurance is provided. The government has replaced the old enterprise-based system with an urban social security system, comprised of elements such as pensions, unemployment insurance, work injury insurance, maternity insurance, and basic medical coverage.
Going forward, China faces several key challenges in further developing its labor market and responding to the structural changes described above. For example, despite the significant progress that has been achieved in introducing a legal framework for the labor market, the application and enforcement of labor standards remains weak. This problem is particularly evident in the private and informal sectors where a large majority of workers do not have contracts, making it difficult for the government to monitor and enforce the basic labor regulations that guarantee safe working conditions and fair treatment of workers.

Another challenge is to strengthen the newly developed social insurance mechanisms and ensure their implementation. Although the basic programs have been mandated by the central government, social insurance policies vary across municipalities from generous to non-existent. Even in municipalities where the programs are in place, their implementation and effectiveness are uneven, due partly to financing constraints. China’s highly decentralized fiscal system devolves responsibility for social insurance programs to the local level, so provinces or municipalities with lower revenue-raising capacity or higher numbers of unemployed, for example, may have difficulty establishing or sustaining such programs. Furthermore, coverage of workers in the informal sector—especially rural migrants—remains low as both employers and employees fail to comply with their social insurance obligations.

The unprecedented wave of migration has given rise to another challenge, namely to integrate the large number of migrants working in urban areas and provide them with better access to employment opportunities. China now has a large ‘floating population’ of people living and working in locations where they do not have household registration status and who therefore have only limited access to basic social services and oftentimes face discrimination in obtaining employment. Although recent government policies have signaled a renewed commitment to reducing barriers to migration and safeguarding the rights and interests of migrants, migrant workers continue to be in a vulnerable position and in many respects remain second-class citizens relative to their local urban counterparts. They face a multitude of problems, including low wages and delayed payments, obstacles in securing housing, and high fees for sending their children to urban schools. Greater integration of migrant workers will be needed to help prevent the emergence of an urban underclass and maintain social stability.

China must also cope with the increased pressure that the emergence of unemployment and large inflow of new labor force entrants have been placing on its labor market. Although the Government has implemented numerous programs aimed at helping laid-off workers find reemployment, the effectiveness of such programs is not yet clear. At the same time, cohorts of graduates who survived the worst years of SOE restructuring at school are entering the job market only to find a limited number of suitable employment opportunities. Furthermore, China is facing the pressing challenge of upgrading the skills of its workforce. The country’s fast-growing sectors and coastal areas are experiencing skill and labor shortages, and wages of unskilled labor are rising in proportion. By some estimates, wages of unskilled labor in coastal areas have already increased to a level sufficient to reduce competitiveness in the labor-intensive industries (World Bank,
Moving enterprises to the central and western regions where wages are low may allow China to remain competitive in some of these products for years to come, but in the coastal areas, firms are already facing the need to switch to more skill-intensive products and production technologies. Continued rural-to-urban migration will cause wages in China’s poorer areas to rise over time, as well. China’s comparative advantage in purely unskilled labor-intensive products will therefore decline eventually, making skills development a key priority going forward.

China’s ability to tackle these challenges successfully will have direct implications for the country’s future economic growth and competitiveness, poverty reduction efforts, and social stability. Economic opportunities for China’s citizens are primarily determined or at least mediated by the labor market, which determines their employment, wages, and working conditions. The functioning of the labor market thus has a profound effect on growth and on equity—across workers, in patterns of access to work, and between workers and employers. The labor market provides the main channel of opportunity for the poor to escape poverty. As the recent China Poverty Assessment documented, the immense majority of the poor in China—three-quarters of the rural poor and all but 2% of the urban poor—live in households that lack no work capacity (World Bank, 2007b). What they need are better-quality and better-paid jobs.

The central importance of these issues for the future of China’s economy and workers highlights the need to push forward on the government’s ambitious labor market development agenda and ensure that policies respond effectively to the nature and magnitude of the challenges ahead. To do so, policymakers need to be equipped with an accurate and up-to-date picture of the labor market situation and an understanding of current opportunities and constraints, which can be particularly difficult in a country as large and diverse as China. Just as importantly, labor market policies and programs need to be assessed periodically to take stock of implementation progress, evaluate their effectiveness, and draw lessons for the design of future reforms. Within China’s highly decentralized system, sharing of experience and best practices across provinces and municipalities can also provide tremendous value for local governments grappling with implementation issues.

To help fill critical knowledge gaps and provide directions for future policy, the Chinese government and World Bank have undertaken a joint China Labor Market Development Program. This collaborative effort, described in greater detail in Box 1 below, is comprised of a Government-executed technical cooperation program and complementary analytical studies by the World Bank on labor market policies and institutions. All of the program activities, which include research studies on key issues, technical assistance, and capacity building, have now been completed. This Report has been prepared as a final synthesis report to consolidate the main findings and policy recommendations that have emerged from this collaboration.
Box 1: The China Labor Market Development Program

The China Labor Market Development Program is a joint program of analytical work, technical assistance, and capacity building undertaken by the Government of China and the World Bank. This collaborative effort aims to increase understanding of the major labor market challenges facing China today and to assess the effectiveness of recent policies and programs in addressing these challenges. The outputs and findings are expected to serve as an important input to the government’s future reform efforts as well as help inform the support of donors, NGOs, and other partners in the area of labor market development.

The program consists of two major components: (i) a technical cooperation program, funded by an Asia-Europe Meeting (ASEM) grant and executed by China’s National Development and Reform Commission (NDRC), which includes policy analysis, operationally oriented technical assistance, and capacity building and (ii) World Bank analytical work, supported by the UK Department for International Development (DFID), which builds on the findings of the NDRC-led research activities. All activities under the technical cooperation component were completed in 2006, and a dissemination workshop for that component and a training workshop were conducted in March 2006. The NDRC published a book in Chinese, titled China Labor Market Development and Policy Studies, with the outputs of the technical cooperation program.

The main findings from the various program activities have been consolidated in this Synthesis Report, China’s Modernizing Labor Market: Trends and Emerging Challenges. The program has also generated numerous background papers and policy notes on key labor market issues, namely:

Outputs of the NDRC-led Technical Cooperation
- “Labor Market Development Strategy and Policy Options in China” (consolidated report)
- “Overview of Labor Market in China”
- “Active Labor Market Policies in China”
- “Human Resources Development and Employment Promotion in China”
- “Unemployment Protection in China”
- “Legal System for Labor Market and Protection of Labor Rights and Interests in China”
- “Rural Labor Migration and Employment in China”
- “Informal Employment Development in China”
- “Policy Research on the Labor Market in Resource-depleting Cities in China” (MOLSS)
- “Sampling Design for China Annual Population Change and Labor Force Survey” (NBS)

Outputs of the World Bank-led Analytical Work
- “Labor Trends and Problems in Urban China” (Zhang, 2005)
- “Labor Restructuring in China’s Industrial Sector” (Dong and Xu, 2005)
- “Job Prospects of Displaced Workers in Two Chinese Cities” (Betcherman and Blunch, 2006)
- Policy Note on Unemployment Insurance in China (building on a World Bank-developed toolkit for unemployment insurance program analysis in three municipalities)
- Policy Note on Informal Employment in China
- Policy Note on Active Labor Market Policies in China.

Source: Authors.
This Report reviews the transformation of the Chinese labor market—the institutional reforms and policy changes that drove it, the employment outcomes that have resulted from it, and the policy responses that are being implemented in response to new emerging challenges. Based on this analysis, and drawing from the vast body of existing analysis and economic literature on the Chinese labor market, the report then lays out a broad agenda for continued policy reform. This agenda is explored in more detail in the three accompanying self-standing policy notes on Improving Unemployment Insurance, the Informal Sector, and Active Labor Market Policies. The Report complements other parallel World Bank reports on poverty reduction, urban and rural social protection, public finance, and rural health.

The organization of the Report is as follows. Chapter 1 provides a brief overview of the massive transformation of China’s labor market that has occurred in the last two decades. It pays particular attention to the dynamics and immediate labor market consequences of the underlying processes of industrialization, transition to market, and integration into the global economy. It examines how these processes have affected individual workers, focusing especially on ‘new’ emerging phenomena such as urbanization and migration, the emergence of urban unemployment, the informalization of employment, and rising inequality in labor incomes. The subsequent chapters review the first generation of labor market policies that are being implemented in response to these challenges, focusing on the key areas of: improving the labor market framework and enforcement (Chapter 2), strengthening social insurance (Chapter 3), fostering labor mobility and integrating migrant workers (Chapter 4), and facilitating reemployment and addressing skills gaps (Chapter 5). To the extent possible, each chapter assesses the effectiveness of policies and programs based on existing evidence and proposes an agenda for continued analysis and policy reform in each area. Finally, Chapter 6 takes stock of China’s progress in labor market development and concludes with a very brief summary of cross-cutting policy issues.
CHAPTER 1: A LABOR MARKET IN TRANSITION

I. Introduction

The Chinese labor market has undergone a remarkable transformation over the past 30 years. This transformation has reflected the combined influences of three inter-connected processes: rapid industrialization, the transition from planned economy to an open market system, and the integration of China into the global economy. Under central planning, China had created and sustained a massive institutional divide between rural and urban areas. Industrialization and economic reforms started to erode this divide, with resources being shifted out of agriculture and rural areas to industry and urban areas. The shift from a centrally planned economy to an open market system has also been profound, with the massive restructuring of the state-owned enterprise (SOE) sector and fast private sector growth.\(^1\) Market behavior has been introduced as the government has withdrawn from direct allocation of labor, and the private sector now accounts for more than 50% of total GDP (OECD, 2005). At the same time, China’s integration in the global economy and its emergence as a global economic power has spurred the rapid development of its export sectors and coastal cities.

These three overlapping processes have brought large structural changes to the labor market, including unprecedented levels of migration and urbanization, the emergence of unemployment, the informalization of employment, and the appearance of large wage and income disparities. Most of these phenomena were unheard of in the past, when mobility between urban and rural areas was severely restricted and workers enjoyed lifetime employment in SOEs with attached housing, health care, and pension benefits. The situation has changed dramatically as controls on worker mobility have been relaxed and as reform of the SOE sector has dismantled the ‘iron rice bowl’ that once guaranteed state sector jobs and social entitlements. China’s ability to manage these structural changes and respond to the resulting challenges will have direct implications for its future economic growth and competitiveness, poverty reduction efforts, and social stability.

This chapter provides an overview of China’s labor market transformation, describing the historical, institutional, and policy context within which this transformation has occurred. It examines the emerging phenomena of migration and urbanization, unemployment, informalization, and income inequality, looking in particular at how these structural changes have played out for both workers and employers. It then points to the numerous challenges China faces in responding to these changes and in further developing its labor market.

---

\(^1\) The evolution of Chinese economic reforms and their impact on the labor market have been reviewed comprehensively elsewhere (see, for example, Fox and Zhao, 2002; Knight and Song, 2005; Cai, Park and Zhang, 2004; Cai, Du and Wang 2006).
II. The Movement to Cities

Until the late-1970s, labor in China was allocated via a centralized, managed employment system in which the spatial mobility of labor was tightly controlled and restricted. The main instrument for controlling worker mobility was the residential registration system or *hukou*. *Hukou* conferred legal rights to the holder as a resident of the community and entitled the holder to share in the community resources. In the case of villages, it involved rights for land, farming, and housing. In the case of cities, it involved rights to a benefits package, including access to guaranteed employment plus state-subsidized food and housing. The *hukou* system accentuated the rural-urban divide and effectively shielded the urban workforce from the competition of rural labor.

However, by the late-1970s, it became clear that such policies failed to provide incentives for efficient production in either rural or urban areas, and China began a remarkable process of economic reform. At the onset, severe restrictions were placed on farmers for participating in trade, especially long-distance trade, which was allocated to the urban sector. This policy was relaxed in 1983-84 with the development of township and village enterprises (TVEs). The rural sector responded immediately by increasing rural non-farm employment by an astonishing 61% in 1984 and another 34% in 1985. The growth of the TVE sector accelerated further between 1985 and 1993: total employment in TVEs rose from 28 million in 1978 to 70 million in 1985 and to 123 million by 1993 (Cai, Park and Zhao, 2004). TVE growth had two important consequences for the labor market. First, it absorbed rural labor and facilitated industrialization and structural change without a significant increase in migration. Second, because TVEs were relatively unregulated, their free entry into numerous markets increased competition faced by the SOE sector, creating pressures for SOE reform. This rural industrialization drove China’s employment growth throughout the 1980s, lifting millions out of poverty.

The phenomenon of rural-to-urban migration arose in the second phase of reform, when a number of “push” and “pull” factors spurred rural workers to seek employment elsewhere. The growth of TVEs eventually stalled, and the deceleration of rural off-farm employment combined with vast surpluses of labor in the countryside pushed rural workers to look to cities to improve their livelihoods. At the same time, economic reforms brought improved employment opportunities and a surge in demand for labor in urban areas, leading to a gradual relaxation of migration controls. By the 1990s, migration—not a local wage or self-employment job—had become a dominant labor activity for people leaving agriculture (de Brauw et al 2002). As a result, China began to experience steady, massive labor flows from rural to urban areas in what has been called the ‘largest movement of people in history.’ As noted in the recent World Bank Poverty Assessment, rural-to-urban migration has now become the main pathway for poverty reduction in China (World Bank, 2007a). It has been an important contributor to China’s overall strong economic growth and a crucial element in sustaining China’s labor-based comparative advantage in global markets.
The Growth of Urban Employment

The urban economy has now become the main driver of job creation in China. Since the mid-1990s, urban areas have generated all of the sizable net employment growth. Official statistics show that for the past 15 years, urban employment grew on average by 3-4% per annum—that is, about 7 million new jobs were created in cities every year—while the share of agriculture in total employment fell continuously from 70% in 1978 to 45% in 2005 and rural industry stagnated (Figure 1.1).

Figure 1.1 Employment in China

![Graph showing employment in China by sector from 1978 to 2005.](source: NBS (2005, 2006))

The expansion of urban employment, however, has been very uneven across regions and cities, with net employment growth driven mainly by the strong economic performance of provinces in the South and Southeast plus Beijing. As described in Box 1.1, these ‘fast-growing regions’ have experienced much higher employment growth and evidenced higher labor force participation rates and lower unemployment than the rest of China. As a result, the share of urban employment concentrated in the Coastal and Southeast areas increased from 44.1% in 1995 to 50% in 2004. In contrast, employment growth in most of the Central, Western, and Northeastern provinces has remained sluggish. (Cai, Du, and Wang, 2006).

These employment dynamics have led to rapid urbanization, with 42% of China’s current population now classified as urban. In historical terms, this rate of urbanization is comparable to that of the United Kingdom in 1850, the United States in 1910, or Japan in 1950 (CEEFS, 2007). Nevertheless, a large pool of unskilled labor remains to be tapped in rural areas. While gradually decreasing, agriculture remains the main source of employment for over 485 million workers. By some estimates, around 150-200 million of these are ‘surplus’ labor who could shift gradually into manufacturing and the service sector, giving an additional boost to China’s economic growth (Cai, 2007).

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2 This shift may reflect in part the conversion and subsequent statistical reclassification of rural areas into urban areas. Taking this reclassification into account, UBS (2006) gives a modified estimate of China’s urban population of only 20%.
Box 1.1: Employment Expansion in China’s Fast-Growing Regions

Despite the large wave of layoffs resulting from aggressive SOE restructuring, employment in China’s urban areas has expanded rapidly, particularly in the “fast-growing regions” (FGRs). These FGRs, concentrated in the coastal provinces and especially the southeast, are characterized by high levels of economic growth and non-agricultural employment expansion. As a result, these regions have higher labor market participation as well as lower unemployment rates than other regions, both among residents with local hukou and those who migrated to the FGRs for work.

A number of indicators suggest that the labor markets in FGRs are more developed and efficient than in other regions. For example, human capital appears to play a greater role in determining labor force participation and employment in FGRs. It has been estimated that in FGRs, one additional year of schooling increases the probability of labor force participation by about 1.1%, compared to only 0.8% in other regions. Likewise, for workers who have been involved in a training program, the probability of labor force participation increases by 16.5% in FGRs, versus 9.8% in other regions. Furthermore, returns to education as measured by wages are higher among both local residents and migrants, with little difference in return rates between the groups.

The success of FGRs offers useful insights into the type of environment that is conducive to growth and job creation, a critical issue for China as it faces the challenge of absorbing large cohorts of new labor force entrants and the unemployed. First, firms in FGRs generally enjoy greater flexibility and more favorable policies compared to those in other regions, for example in tax treatment. Second, the FGRs have a higher proportion of private firms, which tend to have greater managerial autonomy in their operations than publicly owned enterprises. Private firms have more leeway to hire and fire employees as needed, enabling them to respond more rapidly to changes in the market, and they tend to compensate employees according to their productivity. Third, the types of firms and their product markets suggest that firms in the FGRs are under greater pressure to stay competitive. A higher proportion of FGR firms are listed in the stock market, providing incentives to make business decisions according to the rules of the market. The FGRs are also more integrated into global markets than other regions, and their firms receive a much larger proportion of income from export sales. They therefore have greater impetus to exercise strict financial discipline and maintain their competitiveness. The table below highlights some of the key differences between FGRs and other regions.

<table>
<thead>
<tr>
<th>Characteristics of Enterprises: Comparison between FGRs and Others</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FGRs</strong></td>
</tr>
<tr>
<td>Time since establishment (years)</td>
</tr>
<tr>
<td>Proportion of stock list companies (%)</td>
</tr>
<tr>
<td>Share of public ownership (%)</td>
</tr>
<tr>
<td>Employment by contract type</td>
</tr>
<tr>
<td>Proportion of permanent workers (%)</td>
</tr>
<tr>
<td>Proportion of temporary workers (%)</td>
</tr>
<tr>
<td>Managerial power on hiring, firing, wage (%)</td>
</tr>
<tr>
<td>Sales income per capita in 2002 (thousand yuan)</td>
</tr>
<tr>
<td>Proportion of income from export (%)</td>
</tr>
</tbody>
</table>

Source: Cai, Du, and Wang 2006
**Patterns of Rural to Urban Migration**

The expansion of jobs in cities has attracted millions of migrant workers from rural areas. The recent growth in migration is illustrated by Figure 1.2. However, the exact magnitude of this phenomenon remains surprisingly difficult to measure. Results differ based on the definition of migration used as well as by data source and coverage. According to Cai, Park, and Zhao (2004), the most authoritative source is the 2000 Population Census, which identified 131 million persons—around 10% of the population—who had changed their place of residence (except within a current district) between six months and five years before the survey. Of these, 85 million or about 65% did not have full hukou in their current place of residence. About 53 million or 41% of the total were rural-to-urban migrants, of which about 37 million or two-thirds had migrated for work reasons. These numbers could be augmented by an unspecified yet undeniably large number of migrants residing in their new places of residence for less than six months and those who had escaped the 2000 Census entirely, living in non-enumerated residences such as temporary worker dormitories or construction sites. After factoring in a dynamic increase in migration since the census year, migrant labor would account for about one-third of total urban employment. Clearly, the scale of migration is large, with an estimated one in five rural workers being a migrant worker and 43% of the rural population living in households with one or more migrant workers (World Bank, 2007a).

**Figure 1.2: Recent trends in number of rural migrants**


### Table 1.1: Distribution of interprovincial migrants

<table>
<thead>
<tr>
<th>From</th>
<th>Coastal</th>
<th>Northeast</th>
<th>Central</th>
<th>Southwest</th>
<th>Northwest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coastal</td>
<td>95.9</td>
<td>1.2</td>
<td>1.9</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Northeast</td>
<td>9.1</td>
<td>88.6</td>
<td>1.7</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Central</td>
<td>66.1</td>
<td>1.1</td>
<td>30.4</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Southwest</td>
<td>53.1</td>
<td>0.4</td>
<td>2</td>
<td>42.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Northwest</td>
<td>16.9</td>
<td>0.3</td>
<td>4.1</td>
<td>1.2</td>
<td>77.6</td>
</tr>
</tbody>
</table>


---

3 There is no single correct definition of a ‘migrant,’ and definitions vary according to the research question (Knight and Song, 2005). Migrants can be defined by their hukou status or by residence being elsewhere for some time before a survey. Different criteria on length of stay or geographical/administrative scope of relocation also affect estimates of migration. Moreover, data from different sources such as the census, sample surveys, and administrative data yield different estimates.

4 For example, in a 1995 sample of formal sector urban firms in four cities, Knight, Song, and Jia (1999) found that migrants accounted for 22.8% of workers.
thirds of all migrants—including those moving within the same province—choose the coastal region as their destination. Almost all migrants from the coastal region stay within the coastal region itself, even if they move across provinces (Table 1.1). The coastal region is also the destination for nearly two-thirds of migrants from the central region and half of migrants from the southwest.

What drives this migration? A consistent finding is that education, young age, being male and single, and having less land and more labor surplus in the household positively influence the probability of migration (Knight, Song and Jia, 1999; Du, Park, and Wang, 2005; Knight and Song, 2003a; Rozelle et al 1999). Few migrants actually come from poor households because the poor face higher barriers to migration—they have fewer resources to finance migration and less access to social networks. Du, Park, and Wang (2005) find an inverted U-shape relationship between household endowment (as proxied by income) and migration probability, with both poor and rich peasants being less likely to migrate. It also appears that the vast majority of workers who migrate go as individuals, leaving their families behind. The share of migrant workers who migrate with their families is relatively small at less than 10% (World Bank, 2007a).

A subjective list of factors affecting the migration decision as reported by Cai, Park, and Zhao (2004) includes, in descending order of importance: education level, farm labor requirements, (lack of) information or social networks, financial constraints, child care issues, urban government policies, local government policies, cost of living in urban areas, local income level, hukou policy, and quality of life in urban areas. The pursuit for more life experience and better skills is also important on the list (Knight, Song, Jia, 1999). Research stresses the paramount importance of information and networks set up by sending villages in destination cities (Rozelle, et al., 1999; Giles, 2006), which give rise to so-called ‘chain migration.’ As many as three-quarters of surveyed migrants received specific information about an urban job beforehand (Knight and Song, 2005).

The benefits of migration are clear. First, migrant workers themselves gain the possibility of earning significantly higher incomes. Khan and Riskin (2005) estimate that by migrating from rural to urban China, a typical migrant household nearly doubles its per capita income. The share of migrant income in total rural income is high, estimated at nearly 30%. Second, the higher incomes are oftentimes spread to family members who benefit from remittances sent by migrant workers. Evidence from the Rural Households Survey indicates that households who have migrant workers are less likely to be poor than those without migrant workers, even when controlling for a number of household and area characteristics. Third, the higher incomes generated by migration may also induce productive investments in the rural economy as well as affect wage rates in rural labor markets (World Bank, 2007a).

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5 Nearly half of migrant workers are adults between the ages of 16 and 25, and the average age of migrants is 29 years. On average, migrant workers have more years of education compared to non-migrant rural workers, and about 82% of all migrant workers have at least a junior high school education (World Bank, 2007a).

6 For example, Rozelle, et al. (1999) find in their rural survey of villages that migration in 1988 predicts migration in 1995.
However, despite the promise of better job opportunities in urban areas, migrant workers remain second-class citizens in many respects relative to their local urban counterparts. The income of migrant workers remains between one-half (when measured per worker) and two-thirds (per household member) of the income of a native urban resident, and only about one-half of the income differential between migrants and urban residents can be explained by a difference in observable productive characteristics (Knight, Song, and Jia, 1999). Moreover, because of the types of jobs they undertake, migrants face low returns to human capital, proxied by education. For example, in 1995, a migrant graduate from senior secondary school earned only 8% more than a migrant with primary education. Migrants also have greater income inequality (Gini of .38 in 2002 in the sample of Khan and Riskin, 2005) than either rural (Gini of 0.375) or native urban residents (Gini of 0.318). Another widely publicized problem for migrant workers has been delays in wage payments, particularly in the construction industry. Estimates of unpaid wages to migrant workers have ranged from 12.4 billion USD to 43 billion USD.\(^7\)

<table>
<thead>
<tr>
<th>Sector</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>30.3</td>
</tr>
<tr>
<td>Construction</td>
<td>22.9</td>
</tr>
<tr>
<td>Services</td>
<td>10.4</td>
</tr>
<tr>
<td>Accommodation and catering</td>
<td>6.7</td>
</tr>
<tr>
<td>Wholesale and retail</td>
<td>4.6</td>
</tr>
<tr>
<td>Transportation, storage, and postal service</td>
<td>3.4</td>
</tr>
<tr>
<td>Mining</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Sheng and Peng, 2005

Migrants are also concentrated in occupations that expose them to greater risk of work-related injury and illness. As shown in Table 1.2, the majority of migrant workers are employed in the manufacturing and construction sectors. Many of them reportedly work under unsafe conditions without adequate safety devices. Migrant workers accounted for 80% of deaths in construction, mining, and chemical factories and approximately 90% of patients suffering from workplace-related diseases.\(^8\) However, few migrants are covered by any social insurance programs, so any serious injury or illness can impose an immense burden on migrant workers and their families. In the China Urban Labor Surveys (CULS) conducted in 12 cities in 2004 and 2005, only a very small proportion of migrant workers reported participating in the main social insurance programs: 6.8% for medical insurance and 4.4% for unemployment insurance, compared to 52.3% and 18.8%, respectively, among local residents (World Bank, 2007a).

Furthermore, migrant workers are reported to experience social discrimination, both institutional and non-institutional, in urban areas (Zhao, 2003; Fox and Zhao, 2002). In the 1990s, municipal governments adopted policies restricting migrants from working in particular occupations, safeguarding better jobs for local residents who were laid off from SOEs (Cai and Chan, 2000). Although these regulations are being relaxed, particularly in the coastal cities, progress has been uneven across municipalities. Likewise, the various

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7 See, for example, China Labor Bulletin, “China's Catch 22: When it costs more to claim wage arrears than the wage arrears are worth” (5 October 2005) and the China Daily, “Zeng: Pay all owed wages to migrant workers” (24 August 2004).

fees levied upon migrant workers by local governments are only now being dismantled gradually. For example, schooling—which is free in theory but attached to hukou registration in reality—is often not accessible to migrants unless they pay high fees. In 2005, mean school fees in cities were twice as high as school fees in the rural areas where migrant workers held their hukou, and city school fees for migrant children would have been 35% lower on average if migrants had local urban hukou (World Bank, 2007a). The high cost of raising children in urban areas serves as a disincentive for rural workers to migrate and discourages workers from bringing their families. An estimated 23 million children have been left with relatives in rural villages by migrant parents (United Nations, 2005). In addition, finding suitable and affordable housing in cities is becoming a greater challenge for migrants, who live in housing with much less space, access to drinking water, toilets, and heating compared to local residents (World Bank, 2007a).

### III. The Emergence of Unemployment

As described above, until the late 1970s, labor in China was allocated via a centralized, managed employment system which protected jobs. Under this system, the urban employer or work unit (danwei) was given the function of providing pensions, housing, and health care to all its workers. In this sense, China went even further than the Soviet Union or other transition economies in making the firm the central welfare agent of the state. A byproduct of this approach was that the system of lifetime employment with its attached housing, health care, and pensions benefits became entrenched.

By the late 1970s, it was clear that the system’s lack of incentives drove down productivity, smothered innovation, and caused the misuse of resources. China embarked on a series of major SOE reforms that sought to harden budget constraints, grant enterprise managers greater autonomy and flexibility, and render enterprises more responsive to market competition, but the results of these initial reforms were insufficient. As SOE losses continued to accumulate and started to threaten the solvency of the Chinese banking sector, the reform process accelerated. In 1994, the government moved to privatize some small and medium SOEs, and in 1997, it moved ahead with an aggressive SOE restructuring program that would mark the end of the ‘iron rice bowl’ of guaranteed lifetime employment and benefits for urban workers.

Millions of urban workers who had held secure, lifetime jobs until then were laid off, and many found themselves unemployed. By 2001, the number of SOEs had fallen to 54,000, down from 118,000 in 1995. More than 35 million workers were laid off from the SOE sector, and reductions in the urban collective enterprise sector were proportionately even larger. All in all, the total number of workers in the state sector—including workers in SOEs, urban collective enterprises, and cooperatives—fell from 144 million in 1995 to 78 million in 2004, while those in the private sector increased from nearly 14 million in 1995 to 61 million in 2004 (Table 1.3).

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9 See Fox and Zhao, 2002; Dong and Xu, 2005.
Table 1.3: Urban employment (millions) by sector, 1995-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>State sector (incl. SOEs, UCEs, cooperatives)</th>
<th>Private sector (formal)</th>
<th>Informal sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>144.1</td>
<td>13.7</td>
<td>32.6</td>
<td>190.4</td>
</tr>
<tr>
<td>1996</td>
<td>142.6</td>
<td>15.7</td>
<td>40.9</td>
<td>199.2</td>
</tr>
<tr>
<td>1997</td>
<td>139.3</td>
<td>18.4</td>
<td>50.1</td>
<td>207.8</td>
</tr>
<tr>
<td>1998</td>
<td>111.6</td>
<td>25.0</td>
<td>79.6</td>
<td>216.2</td>
</tr>
<tr>
<td>1999</td>
<td>104.3</td>
<td>27.3</td>
<td>92.5</td>
<td>224.1</td>
</tr>
<tr>
<td>2000</td>
<td>97.6</td>
<td>31.0</td>
<td>103.0</td>
<td>231.5</td>
</tr>
<tr>
<td>2001</td>
<td>90.8</td>
<td>35.7</td>
<td>112.9</td>
<td>239.4</td>
</tr>
<tr>
<td>2002</td>
<td>84.5</td>
<td>44.2</td>
<td>119.1</td>
<td>247.8</td>
</tr>
<tr>
<td>2003</td>
<td>80.5</td>
<td>53.0</td>
<td>122.9</td>
<td>256.4</td>
</tr>
<tr>
<td>2004</td>
<td>78.0</td>
<td>61.3</td>
<td>125.4</td>
<td>264.8</td>
</tr>
<tr>
<td>2005</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>273.3</td>
</tr>
</tbody>
</table>

Source: Statistical Yearbook, 2005
Note: informal = self-employed, private non-formal, residual

Notably, not all of the decrease in employment in the state sector represented ‘real’ job losses, as at least one-third of this reduction resulted from ownership changes or from the incorporation of ‘state-owned’ into ‘shareholding’ or ‘limited liability’ enterprises, which may retain significant government involvement. Moreover, underlying these net changes in aggregate employment, much gross job turnover and churning have been taking place at the level of firms, with job creation and destruction proceeding simultaneously. High rates of job turnover are particularly apparent at times of intense labor restructuring and are usually associated with better alignment between skills and work as well as between pay and productivity. Firm-level data suggest that over the past decade, job turnover in China resulting from the restructuring effort of firms has been very intense: the excess job allocation rate in Chinese industry has been around 9% of total employment per year.\(^{10}\) This rate is relatively high compared to other transition economies, which averaged about 7% in the 1990s, and higher than the usual rate of about 6.5% in developed countries (Dong and Xu, 2006).

Job turnover in China has been highest in the growing coastal regions and in the northeast, where much of the restructuring has taken place. Excess job allocation rates in those regions were around 9-12% per year during 1999-2002, compared to 6-7% in the interior and western regions. Excess job allocation rates are also higher in the private sector than in the state sector (9.8% versus 5.8%, respectively) and in smaller rather than larger firms (Dong and Xu, 2006). Since job turnover and net job creation typically go together, it means that most net job increases have taken place in the private sector, small firms, and the fast-growing coastal regions. High job turnover is in general a positive sign, as it

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\(^{10}\) The excess job allocation rate is defined as the job creation rate plus (absolute value of) job destruction rate minus (absolute value of) net job employment growth rate. Thus, excess job allocation measures the portion of labor churning in excess of the amount required to accommodate changes in employment demand. This measure is often used as an indicator of firm restructuring, reflecting simultaneous job creation and destruction (Dong and Xu, 2006).
implies that much efficiency improvement is taking place, which in turn will lead to higher productivity and higher wages in the future.

However, high job turnover is also associated with much dislocation for the workers involved and for their families. Estimates suggest that in the wake of aggressive restructuring of the SOE sector, dislocation in China was widespread: in 2002, almost one-fifth of all Chinese households reported having been affected by at least one episode of SOE retrenchment. By all measures, SOE restructuring had a profound effect on the functioning of the labor market and the welfare of millions of urban workers. Most urban centers experienced a sharp rise in unemployment and a large reduction in labor force participation as many older and discouraged workers left the workforce. The elderly, women, and the less educated were particularly hard hit (Cai, Park and Zhao, 2004). As described in Box 1.2 below, studies of workers laid off during this period have found that a very low proportion of them would eventually find a new job in the formal sector. Most ended up in informal employment or dropped out of the labor force altogether (Betcherman and Blunch, 2006).

Concern over the impact of SOE restructuring on displaced (xiagang) workers motivated the Chinese government to establish a one-time urban layoff program to cushion the shock and help xiagang find reemployment. All SOEs were required to assume responsibility for their retrenched workers by setting-up Re-employment Service Centers, which would provide living allowances, pension and health care benefits, and training and job placement assistance to xiagang workers for up to three years. The xiagang subsidies drew upon unemployment funds as well as central and local budgetary funds and enterprise contributions. The Government started to phase out the Reemployment Service Centers in 2001, although in practice, many local governments extended benefits to 2003.
Box 1.2 Prospects for the Unemployed in China - the Experience of Xiagang Workers

What happened to the millions of workers laid off during China’s massive SOE restructuring? One study attempted to answer this question using survey data from two large industrial cities, Shenyang and Wuhan, to track the experiences of over 2,000 workers who were observed as displaced and unemployed in 1998. It analyzed how the labor market situation for these xiagang workers changed over the next two years, both in terms of success in finding reemployment and in terms of quality of work for those who had found new jobs by 2000.

Overall, the study found that the surveyed workers in Shenyang and Wuhan had difficulty finding reemployment. Despite high economic growth during this period in both cities, employment creation was not substantial. In 2000, unemployed workers—characterized as those without work but searching—comprised over half of active workers, and this unemployment rate is a low estimate because it excludes discouraged workers who did not have jobs but were not searching. Exit rates from the labor force were high, with over half of surveyed workers reporting that they had left the labor market, and most of them being of working age but no longer active.

Most of the wage employment found was in the private sector, although the quality of jobs was generally lower compared to former jobs in the SOEs. Although wage employees would be expected to have better access to formal social protection, evidence suggests that even for those who did find wage employment, their jobs were often precarious and without benefits. About 70% of wage employees had no labor contract, 14.1% were covered by pensions, and only about 10% reported having access to medical benefits or unemployment insurance coverage. Thus, the level of benefits was much lower than those enjoyed by workers before being laid off from their SOEs.

Given the lack of wage employment opportunities, many displaced workers resorted to self-employment, which grew by 16.4% annually in Shenyang and 13.9% in Wuhan. Among those who were reemployed by 2000, the workers were almost evenly split between wage employment and self-employment. Compared to workers in wage employment, the self-employed had lower earnings and worked longer hours. The survey results suggest that workers were driven to self-employment due to lower human capital or failure to obtain a job in the formal wage sector.

What factors explain the likelihood of reemployment? The study found that men, younger workers, and the better educated were more likely to remain in the labor force and find employment faster than other workers. Higher educational attainment was also associated with success in finding wage employment rather than self-employment. The study had mixed results regarding the effectiveness of active labor market programs. It found that training had a positive effect on how quickly displaced workers become reemployed, while most formal job search methods had no impact on employment.

The study also sheds light on the implementation of the Reemployment Service Centers which were in place during this period. Over half of the sample reported that they had received the living allowances SOEs were expected to provide to their xiagang workers. Notably, individuals receiving this allowance were about 10 percentage points less likely to be in the labor force compared to those without the stipend, indicating that the stipends served as a disincentive for workers to reenter the labor market. One-half of the xiagang workers were receiving medical coverage, and a similar proportion had pension contributions being made on their behalf. Less than one quarter had unemployment premiums paid. The partial receipt of benefits suggests that some had exhausted their three-year eligibility period, while others may not have been receiving benefits for which they were eligible. It also appears that some SOEs did not sever their relationship with xiagang workers even after they no longer had legal obligations.

Source: Betcherman and Blunch. 2006.
Measuring Unemployment in China

Although there is little doubt that SOE restructuring was associated with a large increase in unemployment, the exact level of joblessness in China is difficult to measure, particularly as official unemployment statistics are inconsistent with ILO definitions (Knight and Xue 2004). According to official statistics, registered unemployment in China increased steadily from 2.9% in 1995 to 4.2% in 2004 (China Statistical Yearbook 2005). However, the actual unemployment rate is thought to be much higher than official figures indicate, since many unemployed workers are not registered as being unemployed. $^{11}$ A number of studies have attempted to measure China’s ‘true’ unemployment rate using standard international practices: these survey-based estimates suggest that open unemployment has been in the 6-8% range since 1998. $^{12}$ Most estimates have shown an increase in unemployment rates during the height of SOE restructuring, which then dropped off in the past few years. One analysis of survey data shows that an internationally comparable unemployment rate in urban areas, including all migrants, increased from 4% in 1995 to 7.3% in 2002 then fell to 4.4% in 2005 (Giles, Park, and Cai, et al 2006a). Table 1.4 shows the range of estimates for unemployment rates in China.

<table>
<thead>
<tr>
<th>Year</th>
<th>Registered unemployed</th>
<th>From NBS labor force surveys</th>
<th>From CULS - local residents</th>
<th>From CULS – local and migrants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>2.9</td>
<td>4.0</td>
<td>6.1</td>
<td>4</td>
</tr>
<tr>
<td>1996</td>
<td>3</td>
<td>3.9</td>
<td>6.8</td>
<td>4.5</td>
</tr>
<tr>
<td>1997</td>
<td>3.1</td>
<td>4.5</td>
<td>7.7</td>
<td>5</td>
</tr>
<tr>
<td>1998</td>
<td>3.1</td>
<td>6.3</td>
<td>8.5</td>
<td>5.6</td>
</tr>
<tr>
<td>1999</td>
<td>3.1</td>
<td>5.9</td>
<td>9</td>
<td>5.9</td>
</tr>
<tr>
<td>2000</td>
<td>3.1</td>
<td>7.6</td>
<td>10</td>
<td>6.5</td>
</tr>
<tr>
<td>2001</td>
<td>3.6</td>
<td>5.6</td>
<td>10.8</td>
<td>7</td>
</tr>
<tr>
<td>2002</td>
<td>4.0</td>
<td>6.1</td>
<td>11.1</td>
<td>7.3</td>
</tr>
<tr>
<td>2003</td>
<td>4.3</td>
<td>6.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>4.2</td>
<td>5.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>4.2</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


$^{11}$ The official unemployment figures are calculated as the number of administratively registered unemployed divided by total number of registered employed and unemployed workers. These figures do not capture all of the unemployed. First, the official unemployment rate does not include individuals who were laid off from SOEs and urban collectives and transferred to the enterprise-based Re-employment Service Centers and who hence retained ties with their former work units. These workers are classified as xiagang rather than as unemployed. Second, the figure does not include farm contract workers who migrated to cities but are actively looking for jobs. Third, it does not include young college and high school graduates.

$^{12}$ Standard international practice would usually measure unemployment rates from household surveys and use a definition of unemployment as being able to work, not working in the past week, and actively looking for a job.
In looking at these estimates, it should be noted that national averages hide a high degree of variation across the country. Unemployment rates vary greatly across provinces and regions from just over 2% to nearly 20%, as illustrated by Figure 1.3.

**Figure 1.3: Urban unemployment by province**

![Urban unemployment map](image)

Note: Calculated from 0.95 per thousand sampling of 2000 census*

**Profile of the Unemployed**

Giles, Park, and Cai (2006a) find that among personal characteristics, only post-secondary education predicts lower probability of unemployment in 2001 (6.5% lower for men and 17.5% lower for women). Controlling for other factors, age (except for the youngest cohort) does not seem to matter in the unemployment equation. Despite suffering from a much higher unemployment rate, women are only 2.7% more likely to be unemployed compared to men of similar age and education in the same city. Unemployment rates among permanent urban dwellers are much higher than those among migrants, as migrants usually return to their rural villages when the labor market tightens. Using the China Labor Survey (CULS) data collected in a sample of five large cities in 2001 and 2002, Giles et al 2006 estimate that the unemployment rate for permanent urban dwellers in 2002 was 11.1%, compared to 7.3% for all of urban China. However, data from the second round of the CULS, conducted in 2005, shows a marked fall in unemployment for urban residents to 6.7%, nonetheless still above the level of unemployment for migrants. Yet another estimate of urban unemployment comes from the recent World Bank Poverty Assessment which used the NBS 2003 urban household survey to calculate a national unemployment rate of 8.8% for urban residents.

In a recent labor market phenomenon, cohorts of graduates who survived the worst years of restructuring acquiring more education at school are entering the labor market only to

13 Because unemployment among migrants is low, unemployment among permanent urban dwellers is viewed to be a more meaningful indicator (Fox and Zhao 2002).
have difficulty finding suitable employment. Although it may seem strange when many businesses in China are reporting skill shortages, it appears that some of these graduates, who were trained for jobs in SOEs, have difficulty finding a job in the new private sector.\textsuperscript{14} Indeed, a number of studies point to a disconnect between what graduates learn in school, which is often theoretical, and the needs of modern private firms (Venter, 2003, McKinsey Global Institute, 2005). Many of these graduates may also have high reservation wages, arising from past expectations of jobs in protected SOEs. The phenomenon of young graduates being unemployed is not particularly unusual; in most countries, youth unemployment is significantly—as much as two times—higher than the average rate and is often associated with a longer period of search for the right job and with a need to adjust expectations. In many instances, the job market problems of graduates tend to dissipate over time. Nonetheless, rising youth unemployment does raise important social concerns, as longer transition periods from school to work increase the risk of youth becoming discouraged and disconnected from the labor market. Moreover, pressures on the labor market from new entrants are likely to continue as official data show that for the past decade, growth in the urban working-age population has been exceeding urban employment growth by a wide margin of about 2 percentage points. Although many new jobs are being created, they are not sufficient to offset demographic pressures associated with a youth ‘bulge’ (NBS, 2005).

**Declining Labor Force Participation**

In addition to rising unemployment, China has also experienced a steady decline in labor force participation rates. Already for a decade or so, Chinese urban residents have been less eager to look for and take up employment, a phenomenon reflected in declining economic activity rates, which fell from over 80% in 1996 to 71% in 2005 (Figure 1.4).\textsuperscript{15} Reasons cited for the falling labor force participation rates include: the easing of employment to a more realistic level, following inflated labor force participation under central planning’s full employment policy; extensive use of early retirement as an instrument to relieve labor market pressures, particularly during the aggressive

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\textsuperscript{14} See, for example, The Wall Street Journal, “A Chinese Puzzle Surprising Shortage of Workers” (16 August 2004), which reports that firms in the Pearl River Delta face increasing difficulties filling both skilled and unskilled jobs.

\textsuperscript{15} Data from CUL Surveys of CASS, 1996 for population 16-64 years old, 2005 for population 16-60 years old.
period of SOE restructuring which started in 1998; the discouraged worker effect, in which long-time unemployed, older, and unskilled workers lose faith in their employment prospects and withdraw from the labor force; and the increase in Chinese youth who are taking up or prolonging their education to delay entry into a tightening urban labor market.

Existing evidence lends support to all these explanations. Giles, Park and Cai (2006a) document that the decline in economic activity was particularly severe among older workers and low-skilled workers who either retired early or withdrew, being unable to find a new job. Controlling for other factors, women are less likely to be in the labor force, and the difference increases with age as shown in Table 1.5. A robust and positive correlation between regional unemployment rates and participation rates reported in Zhang (2005) or in Cai, Du, and Wang (2006a) suggests that the discouraged worker effect is strong. Almost by default, migrants have much higher activity rates than urban residents as they arrive to take up a specific job and often leave when this job is finished (Fox and Zhao, 2002). Finally, school enrolment rates indicate that as much as one half of the decline in labor force participation—but less at times of restructuring—is a result of a drive to invest in education.16

### IV. The Rise of the Informal Sector

The emergence of the informal sector has fundamentally transformed the structure of China’s labor market. It has played an instrumental role in creating jobs, being the biggest source of net job creation over the past decade. As the state sector was shedding labor, about 80-90% of laid-off workers joined private and small businesses or engaged in self-employment (Betcherman and Blunch, 2006; Giles, Park, and Cai, 2006a). Most jobs created by private and individual firms are informal jobs, such as daily work, hourly work, seasonal work, and temporary jobs. The informal, unregistered sector has thus become the fastest-growing segment of the urban labor force. The increasing informalization of employment poses a significant challenge to conducting effective labor market policies, as the sector remains largely beyond the reach of government regulations.

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16 Estimates are from NBS (2005).
Characteristics of the Informal Sector

The rapid growth and large size of the informal sector are unquestionable, regardless of the definition used.\(^{17}\) The informal sector in urban China, as proxied by unaccounted workers, comprises about one-half of total employment. These workers, who are labeled as “missing workers” because they reflect differences in the number of workers reported through different statistical systems, include unreported urban workers and unregistered informal employment. Overall, employment in the informal sector, including the self-employed and non-registered employment, rose from 32 million in 1995 to 125 million or 47% of total urban employment by 2004.\(^{18}\) Other methods and definitions yield similar estimates. For example, using social security coverage as an indicator of informality, at least half of workers in a CASS survey lack some component of social insurance (medical or old age), and a third lacks both.\(^{19}\) Cai and Wu (2006), counting informal workers by profession and type of job, arrive at an estimate of 50.1% of urban employment in 2002.\(^{20}\) If lack of a labor contract is used as the determinant of informality, the size of informal employment in 2005 was 32.6% for native urban residents and 84.3% for migrants, up from 18.5% and 72.5%, respectively, in 2002 (Du, Cai, and Wang, 2006).\(^{21}\)

As illustrated by Table 1.6, the informal sector is highly dynamic, with labor mobility being two to three times higher than in the formal sector. Among workers who entered the labor market after the ‘breaking of the iron bowl,’ mobility rates are three times higher than among those in the state sector. The job mobility of migrants is almost six times that of urban workers. Similar to other countries, younger people in China tend to be more mobile, while those with higher education are less mobile (Knight and Yueh 2004a; Du, Cai, and Wang, 2006).

<table>
<thead>
<tr>
<th>Table 1.6: Labor mobility: formal vs. informal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Status in 2002</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Formal sector</td>
</tr>
<tr>
<td>Informal sector</td>
</tr>
</tbody>
</table>


\(^{17}\) The international literature on informality proposes several different definitions of the informal sector. An older, widely used definition of the informal sector is ‘firm-centered,’ emphasizing firms’ small size (e.g., less than 5 people) as well as their loose compliance with the legal framework as determinants of informality. The newer ‘job-centered’ approach, which has been institutionalized recently to replace the increasingly inadequate first definition, emphasizes job characteristics such as lack of social security or labor contract, poor working conditions, and so on as indicators of informal employment (Proceedings of the 17\(^{th}\) International Conference of Labor Statisticians, 2003).

\(^{18}\) These numbers for the informal sector equal the gap between total reported urban employment in the labor force surveys and the sum of all registered employment (from the business register) in the urban sector. Several biases are possible. First, the labor force survey is believed to miss many unregistered informal migrant workers living in collective or non-enumerated dormitories. Second, the Labor Reporting System is believed to miss many new enterprises that have emerged in China. Third, many units underreport their workforces. Finally, self-employed businesses oftentimes do not update the number of employees as they expand. See Cai 2004, Box 3 on data and Cai, Du, Wang 2006.

\(^{19}\) By this criterion, the whole rural sector could be considered as informal, as social contributions in TVEs are not mandated and rural pension schemes and health insurance are severely underdeveloped.

\(^{20}\) Figures are from the Ministry of Labor’s 66-city survey.

\(^{21}\) Using the same CULS surveys but including five small cities in addition to five large ones, the recent World Bank Poverty Assessment estimates that informal sector employment in 2005 was 38.2% for local residents and 87.1% for migrants (World Bank, 2007a).
In terms of composition, the informal sector in China is heterogeneous. Depending on the definition used, informal employment accounts for as much as two-thirds of the trade and catering sector and an even higher proportion of the construction sector. In the service sector, informal workers are predominantly engaged in cleaning, vending, catering, child and elderly care, transportation, and community services. In the construction and manufacturing sectors, informal workers are hired as contract workers, usually by formal sector firms. Micro-enterprise and household workers are also oftentimes linked to the formal sector through subcontracting arrangements. According to the ACFTU, about 24% of surveyed informal workers work out of their homes. At the other end of the spectrum, some informal sector enterprises in China may look like well-established small-scale enterprises in other parts of Asia (Amin, 2002).

Table 1.7 Formal vs. informal sector: Characteristics of Work

<table>
<thead>
<tr>
<th></th>
<th>Formal work</th>
<th>Informal work</th>
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<tbody>
<tr>
<td></td>
<td>Locals</td>
<td>Migrants</td>
</tr>
<tr>
<td>Working days per week - 2005</td>
<td>5.3</td>
<td>6.0</td>
</tr>
<tr>
<td>Working hours per day - 2005</td>
<td>8.2</td>
<td>8.7</td>
</tr>
<tr>
<td>Hourly wage (yuan) - 2005</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Hourly wage (yuan) - 2001</td>
<td>5.7</td>
<td>3.2</td>
</tr>
</tbody>
</table>


Comparisons of income and benefits between the formal and informal sectors are somewhat difficult due to information constraints. Wages might be supplemented by unobserved payments in kind, such as social benefits for formal workers or food and lodging for informal workers. Looking at wages alone, both urban residents and migrants in the informal sector earn less than their counterparts in the formal sector (Table 1.7), but the extent to which the differences can be attributed to lower human capital is unclear. Formal sector workers do tend to have more education than informal sector workers, with a modest gap of about 1-2 years.

Wage growth in the informal sector has been low at 2-3% per year, which is to be expected in a low-skilled labor abundant economy. However, anecdotal evidence shows that many growing markets in China, particularly in the coastal areas, are experiencing shortages of cheap labor. In those areas, wages for informal sector and migrant workers are starting to rise. Du, Cai, and Wang (2006) found a significant improvement in wages of migrants relative to local residents in the formal sector between 2002 and 2005, which they attribute in part to the government’s recent migrant-friendly policies. They also find that in the fast-growing coastal areas, returns to education are higher for both local residents and migrant workers, regardless of whether employed in formal or informal sectors. As noted in Box 1.1 above, both local residents and migrant workers in these areas have almost the same returns to education, implying that the labor market there is less segmented between formal and informal and is more competitive overall. Zhang (2006) also reports that since 2006, firms are prepared to pay significantly higher wages to migrants they recruit. Since most migrants are employed informally, this trend is a good proxy for rising informal sector wages and may indicate that China is starting to move out of a ‘labor surplus’ mode. Cai (2007) also finds that the annual growth rate of average monthly wages for migrants has increased significantly in certain areas, from 2.8% in 2004 to 11.5% in 2006, and suggests that this is indicative of China exhausting
its population dividend and reaching a ‘Lewis’ turning point. Others, however, argue that this tightening of labor supply is artificial and in large part a result of fragmented labor markets and regulatory constraints on labor mobility (Box 1.3).

Box 1.3: Is China reaching the end of its labor surplus phase?

More and more, media reports are focusing attention on China’s emerging shortage of workers. Guangdong province claims some 2.5 million unfilled job vacancies and other provinces such as Jiangsu, Shandong and Zhejiang also report facing labor shortages. Wages have been increasing steadily across sectors and at all skills levels, with many multinational firms reporting average wage increases of over 10% per year for the last several years. A recent study documented that wages of unskilled rural migrants increased by 6.5% in 2005, and by 11.5% in 2006 (Cai Fang, 2007). Other evidence suggests more modest, but nevertheless sizeable, wage increases for migrants – a recent survey by the Chinese Ministry of Agriculture, for example, found that monthly wages for migrants increased by 6.1% between 2005 and 2006 (Ministry of Agriculture, 2007). At the same time, many firms complain of high and increasing turnover rates, even among unskilled labor. Both rising wages and increasing turnover are revealing of growing competition between firms for workers. On the basis of these trends a number of analysts have argued that China is moving out of its labor surplus phase and faces a tightening labor supply, which will inevitably lead to increased wages. Since China’s export competitiveness has been largely based on its low-cost labor, prospects of rising labor costs are feeding concerns about future competitiveness among foreign investors, policymakers and academics. But are such concerns fully warranted on the basis of existing data and analysis?

Effective labor supply is determined by a combination of demographic, behavioral and policy factors. To date much of the debate over China’s tightening labor supply has focused almost exclusively on the demographic aspects. Yet while critically important, demographics are not the only driver of labor supply. Policies, which influence individual and household decisions concerning when and how to invest in education or whether to participate in the labor force, also affect the supply of labor.

Demographics. China has experienced a remarkably compressed demographic transition. Rapid and extensive drops in fertility starting in the 1970s yielded a large bulge in the working age population which translated into high employment rates and low dependency ratios. This ‘bulge’ acted as a stimulus to economic growth right at the time when China was undergoing some of its most radical economic reforms. Feng and Mason (2004) estimate that the ‘demographic dividend’ accounted for about 15 percent of China’s growth between 1982 and 2000. Cai Fang (2007) revises this estimate upwards to suggest that it may have accounted for as much as one quarter of total GDP growth during the period. However, in China as elsewhere, the demographic dividend is a transitory phenomenon which plays itself out as the population ages. China’s working age population is projected to peak in 2011 at 882 million, after which it will gradually decline at a rate of 0.1%-0.4% per year. The effect of falling fertility rates is seen clearly in the shrinking size of cohorts under the age of 24: by 2015, the cohort entering the labor market (age 15-24) will be 10 percent smaller than in 2005. This trend will accentuate going forward so that by 2050 the cohort entering the labor market is 30 percent smaller than it was in 2005. As a result of these shrinking cohorts of new entrants, the share of the population of working age (15 to 59) in the total population will fall from 67 percent in 2000 to 57 percent by 2050. In the absence of behavioral or policy shifts these sizeable demographic shifts will contribute to a much tighter labor supply.

See, for example, Business Week, March 27, 2006; Financial Times, June 2006; The Economist, January 13, 2007.
**Structural factors.** These broad demographic trends conceal significant sub-national variation. In urban China, the population is aging more rapidly and the supply of new labor market entrants has already started to shrink. In rural China, where declines in fertility started later, there is a slower aging process and much stronger labor supply. The latter has been one of several factors driving the substantial rural to urban migration flows that have taken place during the past decade. Such rural to urban flows have resulted in an increase of **effective** urban labor supply. Rural-urban demographic differences will continue to fuel rural-urban migration flows for the near future and can be expected to dampen pressures on the urban labor force arising from the underlying demographic changes.

How big is this ‘reservoir’ of rural surplus labor? And how quickly and effectively can it be transferred to the urban labor force? These questions are now focusing the debate of many analysts. Estimates by Cai Fang (2007) and others suggest that some 150-200 million workers could still move out of the rural labor force to join the urban workforce in the next decade. But these workers face significant barriers to moving, both regulatory (related to **hukou** status) and skills-based. The latter are perhaps the most formidable. Indeed, if one decomposes the rural labor force by age groups, it becomes clear that the large remaining labor surpluses in rural areas are among workers 31 years and over (Cai Fang, 2007). But many of these middle-aged farmers and rural inhabitants lack the basic skills that would make them employable in good jobs in cities. Too old to be reached through formal education programs, they could be trained by future/interested employers. However, many firms are reluctant to provide any training for fear of then quickly losing their investment in a labor market with high turnover. Poor labor market information systems also contribute to mismatch between labor demand and labor supply, as rural migrants depend almost exclusively on informal (and imperfect) networks for information on vacancies and jobs.

Measures to equip rural workers with better skills, and efforts to improve the flow of information on vacancies and job opportunities could foster greater movement of labor and moderate the future tightening of labor supply in urban areas. Such efforts could also help dampen existing mismatches across localities in demand and supply of workers. Equally important is the reform of the whole set of policies that in effect restrict labor mobility and limit the scope for spatial agglomeration of resources. Au and Henderson (2006) have shown that these restrictions have a high cost in terms of foregone productivity growth, including within the agricultural and rural sectors. As such they also work to constrain the size of the pool of surplus labor available in rural areas. These reforms are addressed extensively in Chapters 2 to 5 in this Report.

**Behavioral Factors.** Demographics and rural to urban migration are not the only drivers of labor supply in China. Individual choices to participate in the labor force are also influenced by income, the decision to continue to invest in education, and for women, by the availability of services to care for children and other dependents. Enrollment in upper secondary and tertiary education in China remains low relative to other countries of the region, but is rising quickly. Among 15 to 24 year olds in 2000, only 22.1% of girls and 23.5% of boys had completed or were enrolled in senior or specialized middle school, and only 5.6% of girls and 6.1% of boys in the same age cohort had completed or were enrolled in college (NBS, 2004). Given the rising demand for skills in China, it can be expected that enrollment in upper secondary and tertiary education will increase quickly. This means that many young adults in the (already shrinking) 15-24 age cohort will delay their entry into the labor market to invest in more schooling. While this delayed entry will yield substantial benefits to China overall in terms of increased productivity and competitiveness.
of its workers, it will nevertheless accentuate the squeeze on labor supply in the coming decades. We can simulate the impact of these educational decisions by making some assumptions about the projected path of secondary and tertiary enrollments. The figure below presents the total and the ‘effective’ size of cohorts of new labor market entrants (age 15-24) under the assumption that both upper secondary school and college enrollments converge to levels comparable to those of China’s regional competitors by 2050 (Thailand and Malaysia were used as benchmarks). The figure shows that if we take into account the likely increase in upper secondary and higher education enrollments, the implied decline in the effective labor supply for the 15-24 age cohorts between 2005 and 2050 is almost twice as large as projected by demographics alone.

While education dynamics may work to accentuate the squeeze on labor supply, other factors can work in the opposite direction. For example, current labor force participation rates among older workers – those aged 50 and over- are very low, partly as a result of a discouraged worker effect resulting from past SOE restructuring. As the cohorts that are currently part of the working age ‘bulge’ reach retirement age, they may extend their participation in the labor force, especially if they face prospects of remunerative employment. Policies to encourage these workers to remain active until a later age could help mitigate the impact of demographic changes (particularly given the large size of those cohorts). This might require providing strong financial incentives to late retirement.

Other policies can target groups with weaker labor force attachment, with a view to increasing their participation. We know from international experience that the labor force participation of women, for example, is very sensitive to the availability of care for dependents – especially children. In China, women’s labor force participation also seems quite sensitive to the health and need for care of elderly family members. For example, Giles (2007) finds that having an elder family member who is ill and requires care significantly reduces women’s labor force participation. Policies that aim at providing affordable care for dependents can help boost the labor force participation of women in China, which fell substantially after economic restructuring, and again help mitigate the overall squeeze in labor supply resulting from demographic factors.

The bottom line is that the invariable tightening of China’s labor supply, driven by demographic patterns, is not a given: it can be modulated through appropriate policies. More careful analysis of the determinants of labor supply decisions is needed, however, in order to design adequate policy interventions.

Source: Authors.

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23 A more complete analysis would project demand for education on the basis of expected returns, income and price. Here we have simply assumed that China will converge to levels of enrollments comparable to those of the emerging countries of the region such as Malaysia and Thailand.
Factors Contributing to Informalization

Informal employment in China has been fed by three main sources: self-employed small business, migrants, and laid-off workers. At the start of reforms in 1978, informal urban employment was negligible, but it gradually increased as the environment for private business improved starting in the early 1990s. It received a significant boost over the 1990s from rural migrants, who were cheaply employed in urban firms but often ineligible for formal status. Depending on the definition of informality used and on the assumed share of migrants in total urban workforce, migrant workers now comprise between half and two-thirds of informal employment. The informal sector also almost doubled in size during the period of heavy SOE restructuring, as laid-off workers tried to support their incomes in the informal economy. Betcherman and Blunch (2006) report that among xiagang workers who found employment within two years of being laid off, about 45% did so as ‘self-employed’ in the informal sector.

A complex set of factors is sustaining the existence of the informal sector in China. First, productivity in China and the state of organization of economic activities are not high enough to sustain 100% formality in an economy abundant in unskilled labor. Figure 1.5 illustrates the relationship between the share of urban workers in the informal sector and GDP per capita for a subset of countries (mainly Latin America plus selected Asian countries and China). It shows that the level of informality in China is below what its level of GDP per capita would predict, even when a comprehensive definition of informality is used. Further formalization will come with development and GDP growth, as access to capital becomes broader and the benefits to becoming ‘formal’ greater.

Figure 1.5: Share of Informal Employment and GDP per capita

Demographic pressures are also contributing to informalization, as the formal sector has not produced enough jobs to respond to the rapid growth in the working age population in China’s cities. The urban formal sector, which was already overstuffed, burdened with high labor costs, and shielded from reforms for some time, has been unable to provide sufficient employment opportunities to meet the demand from new labor force entrants and migrants. Many of these workers have turned to the informal sector, where the possibilities for self-employment and/or small business creation are greater. The strong development of the services and trade sector may have also favored informalization, as new micro and small firms have sprung up to fill unmet business needs. Many of these firms may then remain informal due to shortages of capital.
Segmented and noncompetitive markets also play a role in sustaining informality. Large SOEs that are not yet fully market-oriented profit maximizers may be sharing rents such as generous social benefits, higher wages, and job security with their worker-insiders, at the cost of not expanding employment (Fox and Zhao, 2002). For example, Dong and Xu (2006), estimating the production functions for a sample of firms, conclude that the state sector is not using its labor efficiently, an indication that they are still shielded from the full forces of competition. This situation is facilitated by imperfect competition, weak corporate governance, and strong regulations which protect employment. As shown in Figure 1.6, China has some of the highest mandated firing costs in Asia. High levels of regulation and employment protection, combined with low enforcement, can create cost advantages for firms that do not abide by regulations, allowing such firms to compete with larger and more productive firms. This situation introduces an incentive to use ‘informal’ contracts and/or outsource tasks to the informal sector, even for large formal firms, giving rise to the phenomenon of informal employment in the formal sector which is now quite common in China. Cai and Wu (2006), for example, estimate that as much as 75% of employment in the private sector and 22% of employment in the state and collective sectors is informal in nature and involves no labor contract.

The weakness of formal safety nets in China has contributed to informality. As noted above, during the heavy industrial downsizing in the second half of 1990s, the informal sector acted as a safety net. Many laid-off SOE workers turned to the informal sector to maintain their livelihoods; in contrast, those transition countries that have instituted formal safety nets during restructuring experienced much less growth in informality (Boeri and Terrell, 2002). Furthermore, in China, various features of the social protection system such as lack of portability of social entitlements and the fragmented nature of social insurance appear to discourage formalization.

Finally, restrictions on migrants have also sustained informality. Despite recent progress on lowering barriers to migration, migrants continue to be institutionally excluded from social protection. As described above, they may also face discrimination in obtaining jobs in the formal sector, which then confines them to informality.

**The Impacts of Informalization**

The importance of the informal sector in China cannot be overemphasized. As noted above, it has been the most significant source of new jobs in recent years, absorbing

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24 In contrast, they find that the private sector uses its labor efficiently.
many laid-off workers during SOE restructuring and providing employment to large numbers of rural migrants. The informal sector has also played a key role in China’s development process by serving as an essential source of cheap labor. Informal sector workers, more flexible and cheaper than formal sector labor, have contributed enormously to building modern China. The informal sector has supplied goods and services that are not available from the formal sector, such as household services and small-scale vending, and has been flexible enough to respond to market demand quickly and efficiently (MoLSS 2002). Generally speaking, the informal sector is governed by market rules to a greater extent than the formal sector. Wage regressions show that the informal sector has much less segmentation and less discrimination than the formal sector, as well as better alignment between pay and productivity.

Table 1.8: Formal vs. informal sector: Social insurance (%,
2005)

<table>
<thead>
<tr>
<th></th>
<th>Formal work</th>
<th>Informal work</th>
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<tbody>
<tr>
<td></td>
<td>Locals</td>
<td>Migrants</td>
</tr>
<tr>
<td>Pension</td>
<td>82.1</td>
<td>29.0</td>
</tr>
<tr>
<td>Unemployment insurance</td>
<td>39.7</td>
<td>17.8</td>
</tr>
<tr>
<td>Accident insurance</td>
<td>29.1</td>
<td>31.7</td>
</tr>
<tr>
<td>Health insurance</td>
<td>71.4</td>
<td>29.7</td>
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One negative consequence of informalization has been the significant drop in job-related social protection. Both local and migrant workers in the informal sector receive significantly less social insurance coverage than their counterparts in the formal sector, with very few migrant workers in the informal sector having any coverage (Table 1.8). Cai, Du, and Wang (2006a) note that the informalization of employment has been an important cause of the decline in health insurance coverage rates. Giles, Park, and Cai (2006a) report that overall health insurance coverage fell from 81% in 1996 to 69% in 2001 for the working population. Informalization makes it challenging to develop sustainable social insurance systems that cover most of the population. Furthermore, because the government has little information on informal economic activities, regulating this activity and enforcing protective regulations for the safety and fair treatment of workers in the informal sector are extremely difficult.

V. Rising Inequality in Labor Incomes

One of the most striking features of China’s ongoing transformation has been a marked increase in income and wage inequality. The overall Gini coefficient of income inequality rose from 30.9% in 1981 to 45.3% in 2003 (Chen and Ravallion, 2004 and World Bank, 2007a). Adjusting for geographical differences in cost of living and other factors affects the level of inequality but not the trend (Figure 1.7). Most of the increase in inequality occurred between end-1980s and mid-1990s, corresponding to a period of China’s opening and to rapid growth in the urban economy, as well as after 1997 following the heavy labor shedding in the urban formal sector.
The fact that inequality has increased in China is not surprising. First, inequalities were artificially compressed under central planning, and as has happened in other transition economies, could only increase as rewards to skill and effort were brought in line with market realities. Second, China is in the midst of a profound structural transformation, from being a labor surplus and mainly agrarian economy to an industrialized society with a more skilled workforce. Such transformation elsewhere has almost always been associated with temporary rises in inequality (Bourguignon and Morrison, 1998; Deininger and Squire, 1996; Fields, 1989; Kanbur, 2000).

Understanding the factors behind the rise in inequality in China is an important concern. Part of the increase in inequality was no doubt necessary to improve market-based economic incentives and reward both risk taking and human capital investments. However, not all inequalities are ‘positive’ from an efficiency or equity point of view. Some inequalities are quite harmful: for example, those that foster social exclusion; impede access to credit, finance, and insurance; limit opportunities to invest in human capital; or reflect differential access to political and economic influence. Such ‘negative’ inequalities harm growth, undermine social cohesion, and can affect social stability. Most inequalities—regardless of their original cause—are played out in the labor market via dispersion in earnings and labor incomes.

Inequality has risen both between rural and urban areas and within them. Driven by very fast productivity and wage growth in cities, the rural-urban income gap has widened to historic levels: in 2003, mean income in urban areas was three times larger than in rural ones (Chen and Ravallion, 2004; World Bank, 2007a). This rural-urban divide is the largest contributor to overall income inequality. Table 1.9 shows that inequality between rural and urban incomes explained as much as 40% of total income inequality in 2003 and about 41% of the rise in income inequality in the last decade. The rise in inequality within both rural and urban areas has also been very important—each explains between a fifth and a quarter of total income inequality in 2003 and a third of the increase in inequality between 1995 and 2003. In contrast, regional and inter-provincial differences, which explained much of overall inequality in the past, have narrowed in the last decade, especially in urban areas. Coastal wages remain 20% higher than in other regions in real terms, but differences among other regions are moderate (World Bank, 2007a). The convergence in wages across regions may indicate growing labor market integration.

25 See, for example, Knight and Song, 2003.
### Table 1.9: Inequality between urban and rural areas in China

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<tbody>
<tr>
<td>Overall inequality (Theil index)</td>
<td>16.6</td>
<td>25.6</td>
<td>36.1</td>
<td>9</td>
<td>10.5</td>
</tr>
<tr>
<td>Share of overall inequality</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution to change</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inequality between rural and urban areas</td>
<td>31.9</td>
<td>39.6</td>
<td>40.2</td>
<td>46.6</td>
<td>40.9</td>
</tr>
<tr>
<td>Inequality rural areas in different provinces</td>
<td>11.9</td>
<td>13.5</td>
<td>7.9</td>
<td>14.1</td>
<td>-3.4</td>
</tr>
<tr>
<td>Inequality within rural areas and provinces</td>
<td>41.6</td>
<td>22.9</td>
<td>24.8</td>
<td>12.4</td>
<td>32.5</td>
</tr>
<tr>
<td>Inequality between urban areas in different provinces</td>
<td>3</td>
<td>9.9</td>
<td>5</td>
<td>12.6</td>
<td>-8.3</td>
</tr>
<tr>
<td>Inequality within urban areas and provinces</td>
<td>11.6</td>
<td>14.2</td>
<td>22.2</td>
<td>14.3</td>
<td>38.4</td>
</tr>
</tbody>
</table>


Note: All estimates based on large nationally representative samples without adjustments for spatial price differences.

High economic growth and related productivity increases in the 1980s and 1990s contributed to an impressive unbroken record of increases in urban wages, which in real terms grew almost five-fold since 1980 in the urban formal sector and more than doubled over the past decade. These increases, which were recorded in all sectors, were not uniform (Figure 1.8). From 1992 to 2002, wages grew strongly in finance (up 270% in real terms) as well as science and research (+240%), while less so in construction (+84%) and mining (+90%). The dynamic performance of urban productivity and wages contrasts with the much more sluggish performance of rural productivity and wages. With agricultural productivity growth stalling in the mid-1980s, the growth rate in value-added per worker from agriculture fell from 9.7% during 1978-1985 to 3.4% during 1986-1993, while the growth rate of net income per capita decreased from 12.3% to 2% (World Bank, 2007a). These factors help explain the widening rural-urban wage gap.

While the diverging evolution of rural and urban wages offers a proximate explanation for widening rural-urban income differentials, the underlying causes of this entrenched divide are found elsewhere: in the very different educational endowments of rural and urban workers. Barely 16% of rural inhabitants had more than 9 years of schooling in 2003, compared to more than 75% of those residing in urban areas. In a context in which economic reforms have sharply increased the returns to education in China (Figure

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26 Data from NBS, 2005.
1.8), the low educational attainment of the rural population has become a major handicap and is a direct determinant of their lower incomes. A study by Siculair, et al (2005) shows that differences in educational endowments explained 25% of the rural-urban gap in mean incomes in both 1995 and 2002. Education is also the most critical determinant of inequality within rural areas, as it determines the ability of rural workers to access off-farm employment.

Another major contributor to the overall rise in income inequality has been increasing inequality in labor incomes within urban areas, which was an expected outcome of the reforms. Under the old system, wages were based on a grid, with wage increases based on seniority rather than productivity and with differentials due to education or occupation severely compressed. Few incentives or rewards were given for skill acquisition or effort. In the early phases of reforms, as greater managerial autonomy was introduced in the SOE sector, wages started to differ between enterprises depending on their profitability, and newly introduced ‘bonuses’ became a significant part of total remuneration (Knight and Song, 2003b). Then with the development of a vibrant private and non-state sector, competition over workers and resources has ensured that wages move to reflect market scarcities and relative productivities. Significant wage differentials have emerged between workers of different levels of skills and experience and across occupations and sectors. Park, et al (2006) document this rise in wage inequality: using the NBS Urban Household Survey, they show that the standard deviation of log urban wages in China increased from 0.45 in 1988 to 0.67 in 2003. Other measures of the dispersion of wages have increased, as well.

<table>
<thead>
<tr>
<th>Table 1.10: Returns to characteristics</th>
<th>One year of schooling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Various work characteristics</td>
<td></td>
</tr>
<tr>
<td>1 year schooling</td>
<td>10.6%</td>
</tr>
<tr>
<td>1 year experience</td>
<td>3.0%</td>
</tr>
<tr>
<td>Sex: male</td>
<td>14.5%</td>
</tr>
<tr>
<td>Sector: State</td>
<td>9.2%</td>
</tr>
<tr>
<td>Region: Beijing</td>
<td>33.3%</td>
</tr>
<tr>
<td>Liaoning</td>
<td>0.3%</td>
</tr>
<tr>
<td>State</td>
<td>12.2%</td>
</tr>
<tr>
<td>Collective</td>
<td>8.5%</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>60.9%</td>
</tr>
<tr>
<td>Years since school</td>
<td>13.4%</td>
</tr>
<tr>
<td>Guangdong</td>
<td>160.6%</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>-18.6%</td>
</tr>
<tr>
<td>CPC member</td>
<td>18.1%</td>
</tr>
<tr>
<td>1–10</td>
<td>3+</td>
</tr>
</tbody>
</table>

*Note: Average for 1999-2001.*


Many researchers have studied wage determination in China. A robust finding is that education is the most important single determinant of wages and the main factor driving the increase in wage inequality. Several studies document an increase in the returns to schooling (Figure 1.8 above), with the increase being most pronounced for higher education. Zhong and Zhao (2005), for example, note that the college wage premium increased from about 25% in 1988 to over 70% in 2003. The returns to education are high even after controlling for factors such as ownership, sector, and occupation. The recent World

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28 A robust finding in the literature is that with reforms, remuneration started to vary according to firm profitability (Dong, 2005). Two preferred explanations have been given: (i) rent sharing between workers (insiders) and enterprises in an environment of soft budget constraints, imperfect competition, and the traditional collectivist culture of *danwei* and (ii) the need to pay efficiency wages to induce effort and retain workers. Although this alternative is debated (Dong, 2005), it seems that neither option can be ruled out and that they are plausibly intertwined in China (Knight and Li, 2005).

29 See, for example, Park, Song, Zhang and Zhao (2005); Appleton, Song, and Xia (2005); Knight and Yueh (2004a,b); Dong (2005); Knight and Song (2003b).

30 See Park, Song et al. (2006), Zhong and Zhao (2005), and Appleton, Song and Xia (2005).
Bank Poverty Assessment, for example, estimates the raw return to a year of schooling (not controlling for any other factors) at 11.6% in 2003. After controlling for other factors, the return to a year of schooling falls to 6.9%, which is still high by international standards. Another robust finding from the literature is that returns to education are higher for women than for men and higher in non-state enterprises (Table 1.10). More recent education is also more valuable than older education, presumably reflecting a mismatch between the skills acquired under the old system of education and those demanded by the labor market today.

Besides education, other individual characteristics such as occupation, gender, or being a Party member also affect wages (Table 1.10). Park, et al (2006) estimate the male wage premium to be about 15% and the Party membership premium to be 18%. Ownership also seems to matter, with SOEs and foreign-earned firms consistently paying higher wages, controlling for other factors. Significant wage differentials also exist by sector even after controlling for education and other productive characteristics (Park, et al. 2006).

Fast growth in real urban wages has raised concerns in some circles about China’s ability to continue to compete with other low-cost producers in manufacturing, especially in low-skill sectors. Yet these concerns seem unwarranted for the time being, as productivity growth has compensated for a large share of recent wage increases. Among five large emerging economies (Brazil, China, India, Indonesia, and Russia), China had the highest increase in value added per worker between 1995 and 2004, with an average annual growth rate of 5.5% (Figure 1.9). Growth in value added per worker for Chinese manufacturing averaged 11.6% per year between 2000 and 2005, compared to 12% per year growth in real wages. Comparing average hourly wages in manufacturing for China with those of selected economies suggests that China’s low-cost labor remains highly competitive (Figure 1.10).

**Figure 1.9: GDP per worker, emerging economies, 1995 and 2004**

![GDP per worker, emerging economies, 1995 and 2004](image)
VI. Labor Market Challenges

With the structural changes of migration and urbanization, unemployment, informalization, and rising inequality, China now faces a number of key challenges in its labor market development. China’s ability to tackle these challenges successfully will have direct implications for the country’s future economic growth and competitiveness, poverty reduction efforts, and social stability. These challenges include:

- **Enforcing labor standards.** China has made considerable progress in adopting laws and regulations to govern how the increasingly competitive labor market should operate, but the application and enforcement of labor standards remains weak. As noted above, this problem is particularly evident in the private and informal sectors where a large majority of workers do not have contracts, making it difficult for the government to monitor and enforce the basic labor regulations that guarantee safe working conditions and fair treatment of workers.

- **Strengthening social insurance mechanisms.** As will be described in the following chapter, the government has replaced the old enterprise-based system with an urban social security system, comprised of elements such as pensions, unemployment insurance, work injury insurance, maternity insurance, and basic medical coverage. Although the basic programs have been mandated by the central government, social insurance policies and the extent to which they are implemented vary widely across municipalities. Furthermore, coverage of workers in the informal sector—especially rural migrants—remains low as both employers and employees fail to comply with their social insurance obligations.
• **Fostering labor mobility and integrating migrant workers.** Although recent government policies have signaled a renewed commitment to reducing barriers to migration and safeguarding the rights and interests of migrants, migrant workers continue to be in a vulnerable position. As described earlier, China now has a large ‘floating population’ of people living and working in locations where they do not have *hukou* status and who therefore have only limited access to basic social services and oftentimes face discrimination in obtaining employment. Improved labor mobility would help increase the efficiency of the labor market, while greater integration of migrant workers is needed to help prevent the emergence of an urban underclass and maintain social stability.

• **Facilitating reemployment and addressing skills gaps.** The emergence of unemployment and large inflow of new labor force entrants have been placing increased pressure on China’s labor market. As described above, many laid-off workers have had difficulty finding reemployment, particularly in the formal sector. At the same time, cohorts of graduates who survived the worst years of SOE restructuring at school are entering the job market only to find a limited number of suitable employment opportunities, in part due to a disconnect between the education system and the demands of the labor market. Furthermore, China is facing the pressing challenge of skills development for its workforce to maintain its success as a global exporter of manufacturing products, particularly as its comparative advantage in purely unskilled-labor intensive products begins to fall.

The government has already made significant strides in addressing these challenges through a variety of labor market policies and social insurance programs. The approach has evolved considerably over the past two decades, moving from policies targeted mainly at cushioning the shock of restructuring and protecting jobs in urban areas to a wider range of policies aimed at improving the functioning of China’s labor market and enhancing its competitiveness. Across all areas, the critical issue is how the various policies are applied, implemented, and financed.

The following four chapters describe some of the most important policy initiatives in each area in greater detail. Chapter 2 covers the labor market framework and efforts at enforcement. Chapter 3 looks at policies to strengthen social insurance, focusing on pension reform and the unemployment insurance (UI) system. Efforts to foster labor mobility and integrate rural migrant workers into urban areas are discussed in Chapter 4. Chapter 5 reviews policies aimed at facilitating reemployment and addressing skills gaps, looking at active labor market programs, education policy, and the development of technical and vocational education training. Finally, Chapter 6 takes stock of China’s progress in labor market development and concludes with a very brief summary of cross-cutting policy issues.

To the extent possible, Chapters 2 through 5 assess the effectiveness of policies and programs in addressing China’s labor market challenges and propose an agenda for continued analysis and policy reform. However, it should be recognized that lack of data and insufficient information on implementation experience pose severe constraints to
analyzing the impacts of policies and programs. For example, for China as well as other countries, little evidence is available on the degree to which active labor market policies have helped facilitate reemployment. In contrast, analysis of unemployment insurance can draw upon recent UI policy simulation pilots in Qingdao and Tianjin provinces as well as extensive studies of international experience. Therefore, the degree to which specific policy recommendations can be made varies across the different chapters. It should also be acknowledged that one-size-fits-all recommendations cannot be applied in many cases, given the large differences in local labor market conditions, financial resources, and implementation capacities across different parts of China.
As it moves toward a more competitive labor ‘market’ in which workers and employers are matched based on supply and demand, China has been developing a framework to govern how this new market should operate. In addition to broader economic policies such as SOE reform or migration policies, China has adopted a number of laws and regulations that help define the conditions of employment and clarify the rights and obligations of employees and employers. In recent years, with more investors and consumers calling for foreign companies to take responsibility for the well-being of workers at their Chinese suppliers, China has also come under increasing pressure to address issues of worker voice and working conditions in its labor regulations and improve enforcement. China’s bid for accession to the World Trade Organization, which was approved in 2001, has provided another impetus for such labor market reforms. This chapter provides an overview of the major laws and regulations which are in place, highlights some of the challenges faced in implementation and enforcement, and identifies areas for strengthening the labor market framework further.

I. Current Legal Framework

Currently, the major laws and regulations governing the labor market include:

- **Labor Law.** The adoption of the Labor Law in 1994 was an important landmark in China’s labor market development. The law, which became effective in 1995, provides the overall framework and basic requirements for the labor market. The law’s provisions include: the freedom to participate in and organize trade unions under the umbrella of the All-China Federation of Trade Unions (ACFTU), as described below; the promotion of labor exchanges, labor contracts, and vocational training; the outlawing of discrimination; the introduction of guaranteed minimum wages; the development of social insurance, for example for unemployment and retirement; and arrangements for dispute settlement. Notably, the law does not include provisions for the right to strike, although ‘work stoppages’ and ‘go-slow’ are allowed by law under certain circumstances. Nor does it include provisions for collective bargaining, although collective contracts are written in the law for SOEs.

- **Trade Union Law.** The Trade Union Law, promulgated in 2001, stipulates that union membership is open to ‘all manual and mental workers’ in enterprises, institutions, and government departments who rely on wages or salaries as their main source of income, irrespective of nationality, race, sex, occupation, religious beliefs, or educational background. The law requires that union members accept the Constitution of the Chinese Trade Unions, and it establishes the ACFTU—the official union affiliated with the Communist Party—as the unified national
organization for all trade union federations and industrial unions. An amendment to the Trade Union Law in 2003 signified a fundamental change in the role of China’s trade unions by empowering them to protect members’ rights. With the amendment, the Trade Union Law for the first time identified the task of protecting the legitimate rights and interests of union members as the basic role of trade unions. In the original version of the law, the task was classified simply as a non-binding social function.

- **Labor Contract Law.** The labor contract system, which was first introduced in 1983 to cover new entrants to SOEs and collective enterprises, represented a major shift away from the system of lifetime employment. In 1987, the Government issued regulations requiring that all new workers be hired through fixed-term contracts and that contracts be extended to incumbent workers. On June 29, 2007, the Standing Committee of the National People’s Congress enacted a new Labor Contract Law aimed at protecting the rights and interests of employees. The Law, which will take effect on January 1, 2008, attempts to address key issues that have arisen from implementation of the Labor Law such as the low formation rate of written labor contracts, the tendency to adopt short-term contracts, lack of protection of worker interests and weak enforcement of worker rights. The Labor Contract Law requires that employees have written contracts providing details such as the contract term, job description, compensation, work hours, social insurance, and working conditions. The Law also makes it more difficult for employers to lay off employees, requiring severance pay and specifying legal liabilities for breaches of contract, use of violence or threats against employees, and other violations. In addition, the Law gives the trade union and other employee representative groups the power to bargain with employers on matters such as wages, work hours, training, insurance, and benefits.  

The new Labor Contract Law has raised concerns among international corporations working in China who argue that the new regulations will increase labor costs and will be difficult to implement. Nevertheless, some of the provisions that have attracted the most attention were in fact already present in the 1994 Labor Law, and have been simply spelt out in more detail (reflecting lessons learnt about the weak points of the 1994 Law). Overall, the new Labor Contract Law represents an important step forward in addressing a number of critical gaps in China’s labor legislation framework.

Some aspects of the Law which are positive and in line with international practices include: the emphasis on labor contracts as the means to regulate the employment relationship; the requirement that labor contracts be written and specify the conditions of the contract and description of duties and responsibilities of each party; and the classification of types of contracts into fixed-term, open-ended and contracts linked to work requirement (although the third type of

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31 This description of the Labor Contract Law is based on the English translation prepared by Baker & McKenzie.
contract could give rise to conflicts over interpretation and potential abuse). Probationary periods (of 1 to 6 month) are also standard (although arguably 1 month is too short, with 3 to 6 months being more sensible depending on the occupation). Notice periods of 30 days are short from an international perspective. The reasons for termination of an employee are fairly standard but should include additionally ‘changes in the economic conditions of the firm’ to grant employers sufficient flexibility to adjust their workforces as needed.

Other parts of the Law are either weak, poorly specified or not in line with international practice. For example, there is ambiguity over the role of trade unions in negotiating massive layoffs and the extent to which they would be able to exert veto power. While the strengthening of the role of unions and collective bargaining overall is a very positive step, some of the articles have the potential to give powers to unions that would not normally be considered good practice. Also it is not entirely clear what freedom employers have to reduce workforces in the event of changes in economic conditions- this could pose severe restrictions in practice, particularly if the actual meaning of the Law is left open to interpretation by the courts. Another negative aspect of the Law is that mandated severance pay provisions are too generous for workers with long tenures. This could be very restrictive and hurt employment creation. A cap on total severance pay is probably warranted, as in other countries. Also relevant dispute resolution procedures need to be clarified, or if the expectation is to revert back to the provisions of the Labor Law of 1994, then it should be so specified. The Labor Contract Law also contains a number of inconsistencies across articles which may reflect the absence of a unifying legal vision of the principles that govern the employment relationship, e.g. the ‘employment at will’ doctrine seems to characterize parts of the Law but not others. Further clarity is also needed on how certain Articles in the Law will be implemented. For example, the Law states that the Government “will take measures to establish a comprehensive system that enables employees’ social insurance accounts to be transferred from one region to another and to be continued in such region,” but it provides no information on what such measures will entail and how such portability will work in practice.

Ultimately, the impact of the new Law will depend on how it is interpreted and applied and on how legal recourse mechanisms are strengthened in parallel to ensure its enforcement. The latter is probably the Law’s greatest challenge. Although the new law should in principle standardize labor practices throughout the country, it is likely to be interpreted differently across provinces and municipalities. Weak institutional and enforcement capacity could render the Law irrelevant in many aspects.

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32 Experience of France and Spain suggests that the highest cost to employers comes not from the legal restrictions and associated costs to layoffs themselves, but rather from the long litigation periods and associated uncertainty linked to the layoff decision.
China’s labor market regulations have been becoming more consistent with international labor standards, although concerns have been raised over ambiguities in the Labor Law and the protection of workers’ rights. One objective measure of adherence to international labor standards is the adoption of the core labor conventions of the International Labor Organization (ILO). China has adopted only four of the eight core labor conventions. Although it has adopted convention number 182 on the worst forms of child labor, it has not adopted conventions 87 and 98 on freedom of association and collective bargaining or conventions 29 and 105 on the elimination of forced and compulsory labor. The eventual adoption of these core labor conventions would help signal the determination of the Government’s commitment to improving labor standards – a commitment which would then need to be backed up through enhanced implementation and enforcement capacity.

II. Challenges in Implementation and Enforcement

Although China has made large strides in developing a legal framework for its labor market, the key question is how the various laws and regulations are applied and enforced. Even when legal requirements are very clear, their implementation, monitoring, and enforcement are oftentimes reported to be uneven. Capacity constraints in the labor inspection system hinder the enforcement of labor laws, while worker voice remains relatively weak. Compliance and enforcement are particularly problematic in the informal sector, where firms largely operate outside the reach of government.

Recent media reports have highlighted violations of workers’ rights such as excessive working hours and poor working conditions. In one of the most publicized cases in recent years, officials and state media discovered slave-like conditions in as many as 8,000 brick kilns, small coal mines, and metal-works factories in Shanxi and Henan provinces. Police freed nearly 600 workers, many of them children, who had been held against their will and abused. The incident, which has been blamed on lax enforcement by local officials, has renewed attention among policymakers and the public on the need to ensure compliance with labor laws. As noted in Chapter 1, another area in which enforcement appears to be weak is wage arrears for migrant workers, which have become a highly publicized problem and a top issue in labor disputes. According to a survey of rural migrant workers, some firms keep 20-30% of worker wages every month as a ‘risk deposit’ to be returned after three years if the worker has not engaged in misconduct. However, workers report that these deposits are usually not recovered (Sheng and Peng 2005). The new Labor Contract Law, as noted above, makes clear that these practices are illegal, and includes provisions to penalize employers that engage in them. However, the

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33 The other three core ILO conventions that China has ratified are No. 100 on equal remuneration, No. 111 on elimination of discrimination in respect of employment and occupation, and No. 138 on minimum working age (ILOLEX database as of December 2006).
34 See, for example, China Daily, “China to investigate into ‘slave labor’ incident” (16 June 2007); New York Times, “China Passes a Sweeping Labor Law” (30 June 2007); International Herald Tribune, “China to prosecute 6 in slave-labor scandal” (16 July 2007).
limited capacity of the system of labor inspectors means that in practice the new Law will be hard to enforce.

Enforcement problems are also illustrated by failures to comply with occupational health and safety standards, which have resulted in serious labor-related accidents. In 2005, China had around 127,000 fatalities from workplace accidents (China Daily, 22 December 2006). Workplace accidents and deaths have been particularly high in China’s lucrative coal mining industry—called ‘the world’s deadliest’—with over 3,300 accidents killing nearly 6,000 miners in 2005 (Xinhua, 5 February 2006). Although labor and social security inspection organs have been investigating and punishing such violations, China has a severe shortage of trained inspectors. The State Administration of Work Safety has approximately one officer for every 35,000 workers, making effective monitoring and enforcement extremely difficult (ILO, 2006).

Despite the legislation in place, China also faces a number of challenges in strengthening worker voice and developing mechanisms that provide recourse for workers. The rate of unionization in non-SOEs remains relatively low, and trade unions in some companies do not have the ability to hold negotiations on equal footing with employers, which has posed a barrier to collective bargaining (Qiao et al 2004). In addition, only the state-run ACFTU is recognized by law, and questions have been raised over whether the party organization is able to represent the voice of workers fully. Limited awareness among workers—particularly rural migrants—of their legal rights and entitlements has also been problematic. For example, not all workers are aware of the current minimum wage regulations or the minimum wage standards in the cities where they are employed, so they may accept whatever wages are offered by employers even if below the legal minimum (World Bank, 2006c). It has been suggested that even when workers are aware that their rights have been violated by employers, the complicated procedures and short timeframe for arbitration discourage them from utilizing the labor dispute settlement system (Qiao, et al, 2004).

Going forward, a major challenge will be to apply and enforce labor standards in the informal sector. As described in Chapter 1, with the deepening of economic reforms and structural adjustments, the number of workers engaged in flexible employment and the informal sector has increased rapidly. Most workers in informal employment do not have labor contracts and therefore do not have the same level of protection as those in the formal sector, in part due to the fact that monitoring compliance with regulations is more difficult among informal and small-scale employers. Industries such as construction are particularly difficult to cover under labor laws since they employ many day workers. It is not clear how the new Labor Contract Law will help address these issues in practice.

Aside from having a more precarious employment status and being more likely to face poor working conditions, informal sector workers also lack access to the social security system and social protection programs. One study finds that although 1990-2002 was a period of rapid pension system reform, the coverage rate increased from only 30.5% to

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41.7%, reflecting a surge in short-term, temporary, and non-contracted jobs (Cai, Du, and Wang, 2006a). In addition, although China has a minimum wage, many employers disregard it or treat it as a maximum wage (ILO, 2006).

III. Policy Issues for Consideration

The challenges described above underscore the need for further efforts to ensure that workers enjoy the rights to which they are entitled under law and have access to social security and social protection programs. Given the large size of China’s informal sector, different approaches will be needed to improve implementation of labor laws and regulations. Although building the capacity of the labor inspection system could help improve compliance in the formal sector, it may be a costly exercise of limited benefit for the informal sector where non-compliance is much more difficult to detect. Instead, greater efforts to develop mechanisms that strengthen worker voice and give employers incentives to comply are likely to be more effective.

Worker voice can be strengthened through a variety of channels. As a starting point, workers should be well-informed of their basic rights under the law in terms of minimum wages, working hours, and safe working conditions. If workers are aware of their entitlements, they can put pressure on employers to comply with labor laws and regulations. A study on the experience of six ‘model’ cities in China in implementing the unemployment insurance (UI) program shows how powerful information can be. The cities have taken a proactive approach to disseminating information, compiling the relevant UI policies and procedures into free leaflets and publishing numerous brochures in newspapers and other media as well as on the Internet. The materials help answer basic questions on labor and social security policies, how to apply for UI benefits, and employment training services. These outreach activities have helped boost participation in the UI program, improve contribution collection rates, and raise public awareness. Some of the cities have achieved nearly full UI coverage among their urban labor force, in dramatic contrast to the national urban coverage rate of only 39% in 2005.

Beyond being equipped with better information, workers also need mechanisms through which they can report lack of compliance and have recourse. One possible mechanism could be a complaints window where workers could report failures by their employers to meet their legal obligations. The credibility of such a mechanism would need to be established through timely investigation of complaints and follow-up measures. Further efforts could also be made to improve the accessibility of the labor dispute settlement system for workers, for example by simplifying the procedures involved. Integrating migrant/informal workers into the ACFTU, the Workers’ Representative Conference, the

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36 Under the DFID-supported Unemployment Insurance Project, representatives from six pilot cities in Sichuan and Liaoning provinces conducted study tours to six ‘model’ cities for unemployment insurance in 2004. The model cities were Shanghai, Guangzhou, Qingdao, Foshan, Dalian, and Hangzhou. The cities were selected as best practice examples based on criteria such as: proven improvement in service delivery to the unemployed, financial affordability and feasibility of putting the examples into practice, and compliance with the wider objectives of the pilot cities (UIP Beijing Office, 2004).
Labor Supervisory Committee, and other kinds of labor organizations within a work unit would also provide a channel for expressing their aspirations and defending their rights. Efforts to reduce labor market rigidities and segmentation—for example, through *hukou* reform, as discussed in Chapter 4—should also help improve compliance with labor legislation by strengthening the bargaining power of workers vis-à-vis non-complying employers, making workers less vulnerable to potential abuse.

Another important question raised by the above discussion is how to extend access to social protection to those outside the formal sector. This question has become more pressing not only in China but also in other countries in the region with large informal sectors. To date, experience in this area has been limited and does not provide clear-cut answers on how to reach the informal sector effectively. In Latin America, most countries have ‘truncated welfare systems’ in which formal sector workers contribute to and are covered by a relatively generous multi-dimensional social security package, while informal sector workers have much more limited access to government benefits or formal risk management instruments. A number of Latin American countries have tried using non-contributory or subsidized assistance programs for informal sector workers to compensate for low social security coverage. However, evidence suggests that these programs may be causing greater fragmentation in social protection systems, in which formal sector workers must pay contributions while the poor and other beneficiaries receive modest but similar benefits for free. Making social benefits available to informal sector workers may give them more incentive to remain outside the formal sector (World Bank 2007f).

One possible approach is to adopt a broader concept of who has access to basic social protection instruments. In the ‘traditional’ model, social protection depends on a labor contract and therefore benefits a narrow group of citizens who work under formal contracts. Instead, social protection programs could be de-linked from labor contracts to provide a package of ‘minimum essential direct cover,’ financed through general taxation, for all citizens who are willing to contribute and participate. Universal social policies could include social pensions, subsidized contributions to insurance funds, and free or subsidized health care provision for the poor (Bourguignon, 2005). For example, a pension targeted toward the poor, which includes provisions for individual retirement savings, could be created as part of a broader multi-pillar pension system (World Bank, 2007f). Voluntary contributions could be introduced while mandatory contributions could be reduced, partially converted to general income taxation with progressive scales, and/or replaced with other taxes. The amount of additional fiscal resources required to provide such cover would need to be calculated carefully.

For whatever policy options are considered, it will be critical to examine the incentive effects the policies will have for informal sector workers. The extension of universal or subsidized social protection programs could lead workers to withdraw their private safety nets or decrease their labor supply, or workers who are liquidity constrained may choose not to participate in social insurance schemes at all. The non-observability of income and problems in determining the capacity to pay in the informal sector also pose challenges to de-linking social protection from labor status. It might be useful for China to study and
draw out relevant lessons from experiences in Latin America and elsewhere, as well as foster greater intra-regional dialogue on how to design appropriate social protection programs for the informal sector.
CHAPTER 3: STRENGTHENING SOCIAL INSURANCE

The reform of the SOE sector and dismantling of the ‘iron rice bowl’ have fundamentally changed how social insurance is provided in urban China. The old SOE-based system has been replaced with an urban social security system that is largely administered by the government, with a high degree of decentralization. The new system is comprised of five insurance-related components: (i) pensions, (ii) unemployment insurance, (iii) basic medical insurance, (iv) work injury insurance, and (v) maternity insurance. It also includes a social assistance component, the urban *dibao* program, which will be described later in the chapter. Table 3.1 below provides an overview of all five urban social insurance components and their coverage rates. This chapter focuses in particular on pensions and unemployment insurance, the two largest programs, which have been key components of the Government’s response to unemployment and other structural changes in recent years.\(^{37}\)

### Table 3.1: Urban Social Insurance Programs

<table>
<thead>
<tr>
<th></th>
<th>Participation by employed workers</th>
<th>Beneficiaries (million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension insurance</td>
<td>87.4</td>
<td>104.5</td>
</tr>
<tr>
<td>Unemployment Insurance</td>
<td>82.4</td>
<td>104.1</td>
</tr>
<tr>
<td>Basic medical Insurance</td>
<td>7</td>
<td>28.6</td>
</tr>
<tr>
<td>Work injury insurance</td>
<td>26.1</td>
<td>43.5</td>
</tr>
<tr>
<td>Maternity insurance</td>
<td>15</td>
<td>30</td>
</tr>
</tbody>
</table>


Note: For basic medical insurance, the number of participating workers excludes those covered under the earlier GIS and LIS health insurance programs, as well as non-contributing retirees who are covered by the scheme. Direct estimates of the number of BMI beneficiaries are not available. For maternity insurance, the participation rate is expressed as percentage of female urban employment estimated using the share of female employment in urban units as reported in the China Labor Statistical Yearbooks (World Bank, 2007a).

I. **Pensions for Urban Workers**

**Overview of the Urban Pension System**

China has three types of government-sponsored pension systems. Mandatory *old age insurance* covers enterprise workers, although beginning in 1999, workers employed by some state organizations and institutions as well as urban units also started participating in this system. The special *occupational schemes for civil servants and employees of state organizations and institutions* are separate, non-contributory pension insurance systems for these workers. The *voluntary pension insurance scheme for rural workers*, administered by the Ministry of Labor and Social Security, establishes individual

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\(^{37}\) For information on basic medical insurance, work injury insurance, and maternity insurance, see World Bank, 2007a.
accounts for all participating workers (World Bank 2005b). This discussion focuses on the old age insurance system, which covers the largest proportion of workers.

China has experimented with various social security reforms over the past two decades, with responsibility for pensions for urban workers shifting from enterprises to municipalities. In 1997, State Council Document #26 mandated a new policy framework which changed the traditional pay-as-you-go defined benefit scheme into a two-tiered pension system combining social pooling and individual accounts. The system covers enterprises and their employees as well as individual workers in urban areas. Current contributors are primarily from SOEs, although in some municipalities and provinces, coverage has been extended to workers in foreign enterprises, private firms, personal businesses, and casual workers employed by urban enterprises (World Bank, 2005b). As shown in Table 2.1 above, an estimated 131.2 million workers or about 48% of the total urban employed were participating in the urban pension program in 2005, while about 43.7 million retirees were receiving pension benefits (World Bank, 2007a). The retirement age for blue-collar workers is 50 years for women and 55 years for men, while for professionals and government officials, the retirement age is 55 years for women and 60 years for men.

The current urban pension system has three pillars. The first pillar, a basic defined benefit pension plan financed by enterprise contributions of 20% of the wage bill, provides pensioners with benefits equal to 20% of the last year’s local average wage. The second pillar, a mandatory defined-contribution plan using individual accounts funded by both enterprises and employees, provides a monthly pension of 1/120 of the account’s accumulated account balance at retirement. Total contributions to individual accounts are set at 11% of wages, with an employee contribution rate of 8% of wages and an enterprise contribution rate of 3%. The third pillar, a voluntary supplementary pension plan managed by individual employers or private insurance companies, is still in the early stages of development. A self-employed worker can also participate in the pension system by contributing 20% of the local average wage, of which 8% is put into the individual account. Retirees are eligible for pension benefits if they have contributed to their pension plan for at least 15 years. Workers with less than 15 years of contributory service are not entitled to basic pension benefits, and their accumulated individual account balances are refunded as a single lump sum payment.

**Challenges in Design and Implementation**

In the course of implementing the pension system as mandated by State Council Document #26, a number of challenges have arisen. First, despite progress in unifying the national pension policies, China’s public pension program continues to be highly decentralized and fragmented. Although the central government has provided general parameters for the system, local governments have discretion over their policies and administration of the program. As a result, contribution rates and benefit levels vary across and within municipalities, and risk pooling is inadequate. Beijing, Fujian, Shanghai, and Tianjin have achieved provincial-level pooling, but most other provinces have lower-level pooling at the municipal or county level. Furthermore, the separation of
the enterprise pension system from the special occupational schemes for civil servants and state organization employees creates labor market distortions and hinders labor movement (World Bank, 2006a).

Second, coverage of the national pension program and the number of people and enterprises contributing to the system continue to be low, which undermines old-age security for all workers. Coverage rates of selected provinces or municipalities, measured as the ratio of contributors to general population aged 15-59, ranged from as low as 2.9% to 21.3% in 2001 (World Bank, 2005b). Moreover, evidence from the 2005 China Urban Labor Survey in five large and five small cities shows that coverage is particularly low among the poor. As shown in Figure 3.1, pension participation rates among workers in poor households are about 23 percentage points lower than for workers from non-poor households in the five large cities and about 33 percentage points lower in the five small cities (World Bank, 2007b). The 2002 MOLSS 66-city survey also revealed a large gap in pension coverage between formal and informal sector workers, who had coverage rates of 85% and 37%, respectively (Cai and Wu 2006).

![Figure 3.1 Pension Coverage Rates by Poverty Status and Income Quintile](image.png)

**Figure 3.1 Pension Coverage Rates by Poverty Status and Income Quintile**

The poor are defined as those with per capita incomes below $2 per day (in terms of 1993 PPP dollars).


Third, some important policy design flaws have been identified in the national pension program. These problems include the use of an inappropriate amortization factor in calculating individual account pensions, *ad hoc* post-retirement indexation of benefits, and the low statutory retirement ages and liberal early retirement provisions (World Bank, 2006a). In a study of seven provinces and municipalities, the average retirement age was found to be around 56 for men and 50 for women—much lower than the statutory retirement ages. Average retirement ages varied significantly among provinces and municipalities depending on whether they had early retirement programs and/or enterprises in financial difficulty (World Bank, 2005b). Furthermore, continued weaknesses in pension administration have resulted in inadequate coverage and collection of contributions, higher administrative burdens for enterprises, delays in transferring contributions into investment accounts, and reduced accuracy of the information used to make pension payments (World Bank, 2006a).
These issues raise concerns regarding the financial sustainability of the pension system, particularly given the prospect of a major demographic shift in China’s population. The system is already burdened by a large ‘legacy cost’—accounting for over 27% of the implicit pension debt—resulting from early retirement policies which were used to reduce unemployment and mitigate the social impacts of SOE restructuring and from differences between past pension level commitments and what the new system can deliver. The number of pensioners is expected to grow rapidly, while the number of workers supporting them will start to decline (Table 3.2). In Liaoning province, for example, the ratio of pensioners to workers is projected to rise from 40% to over 100% in the next 20 years (World Bank, 2006a). China therefore has the pressing challenge of expanding coverage of the pension system while ensuring its long-run financial sustainability, which will be especially difficult in areas that were more severely affected by the economic transition and that have high unemployment and declining labor force participation rates.

### Table 3.2: Growth in Enterprise Contributors and Pensioners

<table>
<thead>
<tr>
<th>Year</th>
<th>Contributors Number (million)</th>
<th>% change from 1993</th>
<th>Pensioners Number (million)</th>
<th>% change from 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>80.1</td>
<td></td>
<td>18.4</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>84.9</td>
<td>6.1</td>
<td>20.8</td>
<td>13.1</td>
</tr>
<tr>
<td>1995</td>
<td>87.4</td>
<td>9.1</td>
<td>22.4</td>
<td>21.9</td>
</tr>
<tr>
<td>1996</td>
<td>87.6</td>
<td>9.4</td>
<td>23.6</td>
<td>28.2</td>
</tr>
<tr>
<td>1997</td>
<td>86.7</td>
<td>8.3</td>
<td>25.3</td>
<td>37.7</td>
</tr>
<tr>
<td>1998</td>
<td>84.8</td>
<td>5.8</td>
<td>27.3</td>
<td>48.3</td>
</tr>
<tr>
<td>1999</td>
<td>86.6</td>
<td>8.1</td>
<td>28.6</td>
<td>55.5</td>
</tr>
<tr>
<td>2000</td>
<td>91.2</td>
<td>13.9</td>
<td>30.1</td>
<td>63.7</td>
</tr>
<tr>
<td>2001</td>
<td>92.0</td>
<td>14.9</td>
<td>31.7</td>
<td>72.1</td>
</tr>
<tr>
<td>2002</td>
<td>90.9</td>
<td>13.5</td>
<td>33.3</td>
<td>81.2</td>
</tr>
</tbody>
</table>


### Policy Issues for Consideration

Recognizing the above challenges, the Government has already undertaken initiatives to help improve the national pension policy and shape future reforms. One major step was the urban social security reform pilot program in Liaoning province, launched by the State Council in 2001. The pilot program made a number of achievements, including: the establishment of funded individual accounts separate from the social pooling basic pension, funded with 8% of payroll taxes; adjustment of the pension benefit formula to improve incentives to contribute beyond the minimum 15 years; improvements in pension administration with collection by the tax administration, a shift of administration from enterprises to government, and a new information system; and greater unification of pension contribution rates and increased portability of pensions. The Liaoning pilot also underscored some continuing challenges in the pension system, such as: lack of financial sustainability; low coverage and contribution rates among workers and enterprises; relatively high pension premiums that are not yet unified across municipalities; low levels
of pooling; low investment returns on the funded individual accounts that are insufficient to provide the targeted level of benefits; and investment policies that leave individual accounts at risk to loss and potential abuse (World Bank, 2006a).

Building on the experiences of the Liaoning pilot, the State Council launched modified pilot programs in Heilongjiang and Jilin provinces in 2004 and introduced national policy changes in 2005. In the Heilongjiang and Jilin pilots, the actuarially unsound amortization factor of 120 for individual accounts was removed, and a stronger linkage was established between individual contributions and pension benefits in the new basic pension formula. State Council Document 38 on ‘Improving Basic Enterprise Pension Insurance System’ adopted some of the features of these pilots as national pension policies and also called for gradual funding of individual accounts. However, a number of parameters including specific level of funding and fund management modalities have not yet been specified (World Bank, 2006a).

Although these recent reforms are expected to help improve the financial outlook of the pension system, further efforts are needed urgently to restore the viability and credibility of the system. Using lessons from the recent pilot programs, a set of reforms that could help improve financial sustainability include: gradually increasing the statutory retirement age to 65 for both men and women; reestablishing the actuarial balance in individual account pensions by amortizing the account balance based on average remaining life expectancy at retirement, rather than using the current low factor of 120; raising the contribution rate for small businesses and the self-employed to the same level as other workers; and adopting a more transparent and predictable method for indexing pension benefits. It will also be important to find a more equitable formula for sharing the ‘legacy cost’ of the pension system. The legacy cost is likely to require subsidies through fiscal transfers at various levels of government or even higher contributions from current and future contributors, while a mature pension program can be financed by insurance contributions (World Bank, 2006a).

Going forward, China will also need to improve the investment outcome of its pension reserves. Higher returns can help achieve higher pensions with lower contribution rates and fiscal subsidies. However, the Liaoning pilot showed that investment returns have been low, so individual accounts have generated low wage replacement rates. To help boost returns, the transparency of fund management needs to be improved while strengthening internal controls and further developing investment regulations. Over time, improved regulation and supervision of the investment industry should allow for investment of pension funds in a wider range of instruments. Financial sector reforms could also lead to higher returns on invested funds. Since the development of the financial market will take time, however, one option for the near term is to issue special government bonds to help compensate for low returns to individual account savings. These bonds, which could be purchased by pension fund managers on behalf of individual members, could be indexed to GDP growth or wage growth to provide the returns needed to fund pensions from individual accounts (World Bank, 2006a).
Another priority area for pension reform is to improve administrative efficiency and financial management. To strengthen program management, reform efforts could focus on: improving the legal basis for social security administration to allow for effective enforcement of contribution payments and collection of arrears, strengthening enforcement of compliance with pension contributions, reorganizing the pension administration and improving administrative processes and procedures, and improving the information system by developing common databases and fostering electronic exchange of information among local agencies and with the national tax authorities. To improve financial management, measures could include: establishing a full treasury cash management system, accelerating the deposit of funds into interest-bearing accounts, exploring ways to pool financial resources more effectively, and improving transparency by disseminating information on the revenues and expenses of the system and the composition of its investments (World Bank, 2006a).  

II. Unemployment Insurance

Overview of the UI System

As described in Chapter 1, China’s progress in economic reforms has given rise to the major challenge of developing programs to support the millions of urban workers laid off in the process. Many of these workers have had difficulty finding new employment in the formal sector and have either turned to the informal sector for work or left the labor force altogether. One of the most significant instruments to help ease the transition for laid-off workers has been unemployment insurance (UI), which has evolved significantly over the past two decades.

China first introduced its UI system in 1986, although the system differed considerably from those found in most other countries. At that time, the Chinese system provided income and other support to redundant workers through their former SOE employers. The UI program covered only the SOE sector and was financed by employer contributions, interest earnings, and government subsidies, without any employee contributions. Benefits were calculated using the individual worker’s average monthly wage and were paid out according to length of service and other criteria. Although the UI framework was modified several times in the first decade of implementation, the role of the UI system remained limited during this period due to the slow pace of SOE reform and low levels of unemployment.

The acceleration of economic reforms in the late 1990s brought renewed attention to the UI program. To handle the large number of workers being laid off from SOEs, the Government required that all SOEs establish Re-employment Service Centers to provide a transition for workers to move into other employment or the UI program. As described in Chapter 1, these xiagang workers were eligible to receive living support and reemployment assistance from their enterprises for up to three years. Notably, their

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38 For more a more in-depth discussion of pension reform options, see World Bank, 2006a.
39 See also the Policy Note on “China: Improving Unemployment Insurance” (May 2007), which accompanies this Synthesis Report.
benefits were financed by the enterprise and government as well as by the UI system, which contributed one-third of the funds. As subsequent economic reforms ended the requirement that SOEs take care of their former workers, the UI system was again modified accordingly. By 1999, when the latest “Regulations on Unemployment Insurance” were introduced, the features of the Chinese UI system had become much more similar to those found in other countries.

The most recent development related to UI was the adoption of the binggui policy in 2000. This policy shifted the burden of supporting retrenched workers away from SOEs by merging the Re-employment Service Centers with the UI program. Laid-off workers would no longer maintain a relationship with their former employers through the Centers but would instead be covered directly by the UI program. By the end of 2005, 17 provinces had effectively completed binggui, and only about 1 million people remained in Re-employment Service Centers compared to a peak of 7.01 million in 1991. Over the same period, the number of people receiving UI increased from about 600,000 to 6.8 million (World Bank, 2007b). With these changes, China’s UI program has slowly evolved from being a transition measure for mass layoffs to becoming a regular UI program.

The current UI system aims to provide a basic level of income protection to the unemployed as well as help them gain new employment through related active labor market programs. The most recent regulations move away from a unifying national UI standard to a more decentralized approach, allowing provinces to set their own benefit levels, duration, and other parameters. One major change from previous policies is the extension of UI program coverage beyond SOEs to include all urban workers, with the exception of civil servants. The UI program also covers rural contract workers employed by urban enterprises, but it does not apply to rural farmers and workers. It also does not cover special groups such as ‘school leavers,’ in contrast to some OECD and transition countries where such groups might receive UI benefits, albeit at a lower level.

In another departure from the past, responsibility for UI contributions in China is now shared between employers and employees. Employers contribute 2% of their total payroll to the system, while employees contribute 1% of their wages. Only rural contracted employees recruited by urban enterprises and institutional organizations are exempt from paying UI contributions themselves. Unless a provincial UI program faces a serious financial problem, the central government does not assume any financial responsibility for the UI program. Local governments cover the administrative costs of program operations but normally do not finance the UI program directly. If a UI fund lacks sufficient funds to pay out the current year’s expenditure, the UI reserve fund accumulated from previous years, sale of government bonds, and UI pooled adjustment funds should be used to cover the deficit.

Unlike in other transition and OECD countries, UI benefits in China are not earnings-related. The Chinese UI program has a flat benefit level determined by local authorities, with regulations only requiring that it be higher than those used in minimum living standards schemes for urban residents but lower than the local minimum wage.
Additional benefits include medical subsidies for those receiving UI cash allowances and minor benefits for survivors in the event of a beneficiary’s death, and UI funds may also be used to subsidize vocational training and job matching services. The duration of benefits varies according to the applicant’s years of contribution: a person who has contributed for less than five years may receive benefits for up to 12 months, a person who has contributed for five to ten years may receive benefits for up to 18 months, and a person who has contributed for over ten years may receive benefits for up to 24 months. As shown in Table 3.3, China’s maximum benefit period is long compared to the European transition countries, which have typically reduced the maximum potential benefit duration to 12 months (Vodopivec, Worgotter, and Raju, 2005).

Table 3.3: Comparison of UI Benefits - China and Other Transition Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Maximum duration of benefits</th>
<th>Relation to individual’s gross earnings</th>
<th>Minimum and maximum benefit levels (as % of minimum wage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>1999</td>
<td>24 months</td>
<td>None</td>
<td>higher than level under minimum living standards scheme for urban residents lower than local minimum wages</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1998</td>
<td>12 months</td>
<td>60% (average of last six months’ wage), plus additional 15% upon completion of retraining</td>
<td>85% 140%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1998</td>
<td>6 months</td>
<td>50% first 6 months 40% following 6 months (60% if retraining)</td>
<td>none (but 70% of min. living standard if not employed before) 150-180% of min. living standard</td>
</tr>
<tr>
<td>Estonia</td>
<td>2001 (effective 2003)</td>
<td>12 months</td>
<td>50% in the first 100 days, 40% thereafter</td>
<td>40% of the average wage 150% of the average wage</td>
</tr>
<tr>
<td>Hungary</td>
<td>1997</td>
<td>360 days</td>
<td>65%</td>
<td>90% of minimum old-age pension 180% of minimum old-age pension</td>
</tr>
<tr>
<td>Latvia</td>
<td>1993</td>
<td>6 months</td>
<td>90% of minimum wage (70% for new entrants)</td>
<td>70% of minimum wage 140% of minimum wage</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1993</td>
<td>6 months</td>
<td>70%, later reduced to 60% and 50%</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>1997</td>
<td>18 months</td>
<td>flat rate amount paid at 378,2cz</td>
<td>None None</td>
</tr>
<tr>
<td>Romania</td>
<td>1998</td>
<td>9 months</td>
<td>50-60% for 9 months</td>
<td>76-92% 210%</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1997</td>
<td>12 months</td>
<td>60% first 3 months, 50% following 9 months</td>
<td>None 150%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1998</td>
<td>24 months</td>
<td>70% first 3 months, 60% following 3</td>
<td>100% 300%</td>
</tr>
</tbody>
</table>

Source: For China, Chen (2004) and for transition countries, Vodopivec, Worgotter, and Raju (2005); presented in World Bank, 2007b.

To be eligible for benefits, an individual must: (i) have contributed to UI for at least one year, (ii) been separated from their employer involuntarily, and (iii) be registered as unemployed and willing to work. To maintain their eligibility, UI beneficiaries must be actively seeking, capable of, and available for work, as well as willing to accept suitable job offers. A beneficiary loses eligibility under a number of conditions, such as gaining re-employment, emigrating to another country, becoming eligible for basic old age pension, or refusing to take jobs recommended by the designated local government authorities. To meet eligibility requirements, beneficiaries must report monthly to the UI institutions regarding their job search efforts and participation in training.
Challenges in Design and Implementation

Under increasing pressure to provide support to a larger number of workers, China’s UI system now faces several important challenges and policy dilemmas. First, despite the considerable expansion of the UI program since 1999, coverage and participation remain limited (Table 3.4). Although the number of contributors rose from 98.5 million in 1999 to 106.5 million in 2005, the proportion of workers enrolled in the program in total urban employment fell steadily from 44% to 39% over the same period. Thus, only 14.1% of the labor force was covered by UI in 2005 (World Bank, 2007b). Moreover, UI coverage is more prevalent among richer segments of the population (World Bank, 2007a). Since UI coverage is limited to urban enterprises and institutional organizations and their employees, a large number of workers remain outside the system. Assessments of the UI system in Liaoning province found that private sector coverage is poor due to non-compliance by employers, partly by hiring workers without labor contracts (Chen 2004, Abrahart 2005).

Table 3.4: National-level Statistics on Unemployment Insurance

<table>
<thead>
<tr>
<th>Year</th>
<th>Contributors at year-end (million)</th>
<th>Beneficiaries receiving the benefit at least part of the year (million)</th>
<th>Beneficiaries at year end (million)</th>
<th>UI program coverage rate (%)*</th>
<th>UI program recipiency rate (%)** among beneficiaries receiving the benefit at least part of the year</th>
<th>UI program recipiency rate (%)** among beneficiaries at year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>98.5</td>
<td>2.7</td>
<td>1.1</td>
<td>44</td>
<td>47.2</td>
<td>19</td>
</tr>
<tr>
<td>2000</td>
<td>104.1</td>
<td>3.3</td>
<td>1.9</td>
<td>45</td>
<td>55.4</td>
<td>31.7</td>
</tr>
<tr>
<td>2001</td>
<td>103.5</td>
<td>4.7</td>
<td>3.1</td>
<td>43.3</td>
<td>68.8</td>
<td>45.6</td>
</tr>
<tr>
<td>2002</td>
<td>101.8</td>
<td>6.6</td>
<td>4.4</td>
<td>41.1</td>
<td>85.3</td>
<td>57.1</td>
</tr>
<tr>
<td>2003</td>
<td>103.7</td>
<td>7.4</td>
<td>4.2</td>
<td>40.5</td>
<td>92.7</td>
<td>52.5</td>
</tr>
<tr>
<td>2004</td>
<td>105.8</td>
<td>7.5</td>
<td>4.2</td>
<td>40</td>
<td>91.1</td>
<td>50.6</td>
</tr>
<tr>
<td>2005</td>
<td>106.5</td>
<td>6.8</td>
<td>3.6</td>
<td>39</td>
<td>80.8</td>
<td>42.9</td>
</tr>
</tbody>
</table>

Notes: * UI program coverage rate is the ratio of number of employees covered in the program to total urban employment.
** UI program recipiency rate is the ratio of number of benefit recipients to the number of urban registered unemployed.

Second, the level of UI benefits remains quite low, providing only a very modest level of income protection to beneficiaries. At the national level, the China Labor Statistical Yearbook indicates that UI benefits paid as a percentage of average urban on-work wage was 11% in 2005. Assuming that the average wage of recipients before becoming unemployed amounted to 75% of the overall average wage, UI benefits provided a wage replacement rate of only 14.7% in 2005 (World Bank, 2007b). This replacement rate is much lower than those of developed countries and also other transition countries, where replacement rates typically range from 45% to 70% of average gross earnings (World Bank, 2004c). Beyond the UI program, if their household per capita incomes are still below local minimum living standards while receiving UI benefits, unemployed workers can apply for the minimum living allowance as urban residents (Box 3.1).
Box 3.1 The Dibao Program

Although the urban minimum living standard guarantee program or dibao is not strictly a labor market program, it has been developed as a last-resort layer of unemployment protection. In principle, all residents with hukou and with income per capita less than a local dibao standard (‘dibao line’) are eligible to receive cash transfers equal to the difference between the dibao line and that income per capita. In addition to cash and in-kind benefits, a dibao certificate often provides preferential access to certain social services, such as free or reduced-fee schooling, health care, utilities, and housing. Some provinces also try to incorporate workfare-type mechanisms into the program or encourage employment, for example by limiting the number of times able-bodied beneficiaries can refuse a job offer, permitting them to retain benefits for some time after they find new employment, or disregarding small income changes.

The central government became involved in financing dibao in 2001, allowing the program to be rolled out nationwide and expanded to a greater number of unemployed individuals and other beneficiaries. Until 2001, the number of dibao beneficiaries remained under 4 million or less than 1% of the total urban population. With fiscal support from the central government, the program grew rapidly to cover 22.3 million individuals or 10 million households by the end of 2005. Beneficiaries included over 4.3 million xiagang workers as well as 4.0 million unemployed individuals, who comprised the largest group of dibao beneficiaries. During the same period, the number of UI beneficiaries was only 6.8 million (China Statistical Yearbook 2006 and China Civil Affairs Statistical Communique 2006).

Third, in most areas of the country, enforcement of eligibility requirements remains quite weak, particularly for municipalities with high levels of unemployment and low administrative capacity. One reason cited for weak enforcement is that when the benefits are so low, UI officers may side with beneficiaries and tolerate ‘hidden employment’—registered xiagang or unemployed individuals receiving UI benefits and working at the same time. UI offices in different cities apply different standards for evaluating eligibility under these circumstances, with some ignoring additional earnings if income earned is below minimum wage. Enforcement has been more stringent in areas such as Shanghai, which uses advanced information systems to cross-check claims and undertakes regular auditing to reduce fraud. However, even in municipalities that enforce the requirements, hidden employment can be difficult to detect given its oftentimes informal and irregular nature. Various sources and survey results suggest that between 50-90% of the urban registered unemployed are engaged in hidden employment (World Bank, 2007b).

Fourth, the incentives to maintain a connection to the labor market are quite weak under the current UI scheme. Although UI policies recognize the value of labor market programs in promoting reemployment and allow for up to 10% of UI funds to be allocated for labor market programs, expenditures on vocational training and employment placement programs have been low, particularly for provinces with UI fund deficits. In terms of continued eligibility requirements, the current UI regulations place greater emphasis on disqualifying events such as military service and emigration rather than on ensuring continued connection to the labor market among beneficiaries (World Bank, 2007b).
Fifth, concerns have been raised over the financial sustainability of the UI system. The financial performance of UI funds varies widely across the country according to the level of unemployment and other factors in each area. Some UI funds were pushed into deficit after the adoption of binggui in 2000, which sharply increased the number of unemployed and therefore the number of UI benefit recipients. Financial sustainability is also threatened by benefits leakage, with the UI system providing benefits to some individuals who do not meet the initial or continued eligibility requirements. In addition, employer contributions have been reported to be irregular in some areas, particularly for SOEs in arrears. Compliance among employers, for UI as well as other social insurance obligation, is uneven since the incentives for non-compliance are high. For example, employer contributions for the five main social insurance programs are estimated to be 30-34% of the wage bill (World Bank, 2007a).

Policy Issues for Consideration

A number of policy options could be considered to address the challenges outlined above, drawing upon the benefit of international experience and UI policy simulations conducted within China. First, to expand program coverage, greater emphasis is needed on improving incentives for workers and employers to participate in social insurance programs. The establishment of individual accounts could make participation more attractive, giving workers assurance that they will later benefit from their contributions and increasing the accountability of employers to individual workers. Chile, for example, has adopted a UI program that combines social insurance with self-insurance, using individual accounts and a common solidarity fund (Box 3.2). Broadly similar programs also exist in Colombia and Mexico, while Indonesia is currently considering the introduction of individual severance/unemployment insurance accounts.

Box 3.2 Chile’s Unemployment Benefit Program

In 2002, Chile introduced an innovative new unemployment insurance program that combines social insurance with self-insurance. Contributions, paid by both workers and employers, are split between individual accounts and a common solidarity account which is partly financed by the government. By making contributions, employers reduce their severance payments obligations, so the new unemployment insurance program is partly replacing severance pay. The program is effectively a funded program, with individual account funds being managed by a free-standing administrator selected through competitive tender.

To stimulate reemployment, the program requires that benefit recipients first draw from their own accounts. Withdrawals from individual accounts are triggered by separation from the employer, regardless of the reason. Withdrawals from the common fund are triggered once individual accounts are depleted, if the claimant satisfies the usual conditions of continuing eligibility under unemployment insurance such as not working, being available for work, and searching for a job. However, withdrawals from the common fund are limited to two every five years. Benefits are linked to past earnings, with a declining schedule.

Regarding the level of UI benefits, it could be argued that benefit levels should be raised to enable recipients to better smooth their consumption levels and provide greater income security. Improving the consumption smoothing properties of the UI system may require changing from a flat-rate benefit system to one that replaces a certain percentage of individual earnings. At the same time, however, it should be recognized that having a low benefit level reduces the moral hazard problem found in UI systems of countries with relatively high replacement rates. If benefit levels are perceived to be high, insured workers may reduce their efforts at work when employed and reduce their job search efforts while unemployed and receiving UI benefits (World Bank, 2007b). In their analysis of data from the China Urban Labor Survey, Giles, Park, and Cai (2006b) found that the ability to receive unemployment subsidies—either a xiagang subsidy or UI payments—lowered the probability that a retrenched male worker would be reemployed within a year by 34%.40

To eliminate leakages in the UI system and improve financial sustainability, initial and continuing eligibility requirements could be strengthened. Some progress could be achieved by improving the administration of services, for example by linking various social security information systems, providing greater specificity regarding job search standards, and strengthening coordination between UI benefit administration offices and reemployment service offices. More information is needed on the employment, training, and job seeking activities of beneficiaries to reduce leakages to individuals who are ineligible for UI benefits. However, as argued in World Bank (2004d), it should be recognized that efforts to strengthen monitoring of continuing eligibility requirements may be counterproductive at this stage of China’s development. If benefits remain at their current low levels, stronger enforcement would have limited payoffs and would tax the already limited capacity of UI offices. If benefit levels are raised and the capacity of UI offices is improved, enforcement of continuing eligibility requirements will be a higher priority. Further analysis is needed to determine whether and when measures to eliminate hidden employment should be strengthened (World Bank, 2007b).

Another question is how the Chinese UI system can be used to improve incentives for maintaining a connection to the labor market. In other countries, demonstrated attachment to the labor market is a fundamental condition for continued eligibility. Some countries require registration with the employment service or employer contacts on a weekly basis as proof of continued attachment to the labor market. Transition countries such as Poland require that UI benefit claimants be willing to participate in vocational training or public works programs. Within China, best practice cities such as Shanghai require that unemployed workers seek work at the employment service center at least twice a month and attend at least two training courses, otherwise benefits are terminated. Such measures have resulted in improvements in UI benefits administration as well as helped reduce benefit leakages (World Bank, 2007b). Requirements need to be monitored continuously to ensure that they foster job-seeking behavior among unemployed workers.

40 Giles, Park, and Cai (2006b) found that unemployment subsidies did not have any statistically significant impact on the reemployment rate of female workers, which they attribute to decisions to exit the labor force that are independent of the availability of unemployment benefits. They found that family demographic characteristics have a significant influence on the reemployment probabilities of women.
The impact of such requirements also depends on the level and quality of employment services which may also need to be improved, as discussed in Chapter 5.

Finally, to strengthen the sustainability of the UI funds overall, greater efforts must be made to enforce pooling of funds. The UI guidelines stipulate that funds should be pooled at the municipal/city level. Provincial-level adjustment funds may also be collected by the transfer of 4% of all UI contributions within the province. These adjustment funds can then be used to supplement city or district pools that are experiencing deficits. However, as in the case of the pension system, the level of pooling remains low. As an incentive for pooling, provincial-level adjustment funds could be given only to those municipalities who have achieved single pools. Incentives for higher-level pooling could also be explored. Currently, only Beijing, Shanghai, and Tianjin have achieved provincial-level pooling (World Bank, 2007b). A higher degree of pooling would not only enhance the insurance aspects of UI, but by being redistributive in nature, it would also help reduce inequities among provinces and municipalities. However, higher levels of pooling could lower incentives to collect local contributions, making enforcement critical. Local governments who have sufficient resources to fund their own social insurance programs may also dislike the redistributive nature of pooling.
CHAPTER 4: FOSTERING LABOR MOBILITY AND INTEGRATING MIGRANT WORKERS

For China to fully tap the potential of its workforce and ensure that labor supply can move to where demand is greatest, further progress will be needed in removing barriers to migration. As noted in Chapter 1, the efficiency of the Chinese labor market is reduced by regulations and practices restricting worker mobility between jobs and between rural and urban areas. Although significant progress has been made in dismantling these barriers, some significant institutional impediments remain. Even when workers are successful in migrating, they oftentimes face discriminatory treatment in the receiving area. This chapter summarizes some of the policies that have been adopted to improve mobility between rural and urban areas and help integrate migrant workers, lays out remaining challenges, and suggests areas for further attention.

Recent Migration-Related Policies

Recently, a wide and lively debate has taken place in China over hukou reform. The emerging consensus appears to be that such reform requires a gradual and phased de-linking of hukou registration from access to social benefits and services. This process is expected to move more quickly in small- and medium-sized cities than in Beijing and other very large urban centers. Indeed, 12 provincial areas, including Hebei, Liaoning, Shandong, Guangxi, and Chongqing, have launched trial reforms to help bring an end to the differentiation between rural and urban residents. A number of large and medium-sized cities such as Zhuhai, Nanjing, and Xi’an have also relaxed their criteria for granting hukou to migrants (Cai 2002). Larger cities such as Beijing, Shanghai, and some cities in Guangdong province are moving more slowly but have also loosened some of the restrictions that previously hindered people from changing their hukou. Heilongjiang province has recently initiated trial reforms in its household registration system and aims to have them fully implemented by the end of the year. In many smaller cities, the hukou system exists in name only (Zhao 2003).

In a recent development, the Ministry of Public Security has submitted an ‘Opinion of further reforming hukou management policies’ to the State Council, which seeks to relax the conditions under which hukou status may be changed, at least in some core areas. Some specific policies are expected to be issued within the next year based on the experience of the 12 provinces that have implemented the trial hukou reform. These developments are likely to help facilitate the movement and integration of rural migrants into urban areas.

New policies have also signaled a renewed commitment to helping rural migrants integrate into urban areas. Reforms in 2001 allowed migrants in small towns and cities who have fixed, legal housing, a stable occupation, and a regular, legal source of income to apply for permanent residence. The central government also prohibited the imposition of ‘illegal’ fees on non-local hukou workers. Responding to public outrage in 2003 following the death of a young educated migrant in police custody, the State Council
abolished a long-standing law allowing coercive detention and deportation of unregistered migrants. China also launched a national crackdown on wage arrears in 2003, spurred by Premier Wen Jiabao’s visit to a migrant worker family in Chongqing. In the construction sector, for example, some municipalities have issued regulations requiring that real estate developers deposit money before groundbreaking to ensure that workers can be paid even if a project runs into problems (People’s Daily, March 2007). In 2004-05, the Government took further legal measures to eliminate discriminatory treatment of migrants in access to employment, which are now at various stages of implementation. The 2004 Pan-Pearl River Delta Regional Labor Cooperation Framework, for example, created migrant employment systems, dismantled barriers to recruiting migrant workers, and established trans-provincial employment services (ILO, 2006).

The 2006 State Council Opinion on rural migrant workers (State Council, document #5, 2006) has taken the most far-reaching stance to date, recognizing the significant contributions made by rural migrants to the country’s development and underscoring the importance of safeguarding their rights and interests. To address the problems of low wages and defaults on payments, the State Council opinion mandates the establishment of a system to guarantee and monitor salary payments for rural migrant workers. It also lays out various measures to discourage payment defaults, for example imposing special account management on employers with a history of default, withholding construction licenses from construction units that have insufficient project funds allocated for salaries, and toughening penalties for employers. In addition, the opinion stipulates that wage rates for rural migrant workers should be standardized and raised to provide equal pay for equal work compared to other employees. Furthermore, migrant workers should receive staff leave, holidays, and overtime pay according to law.

The Government has also recognized the importance of improving the ability of migrant workers to gain better employment opportunities. The Government has been giving significant attention to extending public employment services to rural migrants in urban areas, and it is proactively collecting and channeling job information to rural areas and providing opportunities for rural migrants to develop employable skills. For example, the Government has introduced an ambitious Rural Workforce Transfer and Training project, also known as the ‘Sunshine Project,’ to support basic and vocational training for potential migrant workers (Box 4.1). The Ministry of Agriculture has also launched the Blue Certificate training project to help improve the quality and skills of rural migrants entering TVEs. In addition to formal government-supported training, some projects and enterprises provide specific training to the rural migrants they hire so they can perform their work duties, but little information is available on this type of training (World Bank, 2007d).
Box 4.1 The ‘Sunshine Project’ for Rural Migrant Workers

To help prepare rural migrants for work in urban areas, the Government introduced the Rural Workforce Transfer and Training Project, or ‘Sunshine Project,’ in 2004. In the course of the project, which runs from 2004 to 2010, introductory or basic training is to be provided to 60 million potential rural migrants, of whom 35 million will then receive vocational or technical skills training. The project also aims to provide training to 250 million rural migrants who are already working in urban areas. Several government agencies are involved, including the Ministry of Agriculture, Ministry of Construction, Ministry of Education, Ministry of Finance, Ministry of Labor and Social Security, and Ministry of Science and Technology.

Three types of training are provided under the project: (i) basic training, which teaches potential migrant workers about their rights, relevant laws and regulations, basics about urban living, and job search skills; (ii) vocational or technical skills training, focusing on professional skills in areas such as housekeeping, catering and restaurant services, construction, and manufacturing; and (iii) on-the-job training to update the skills of migrant workers already working in urban areas. Training duration ranges from 15 to 90 days.

As of early May 2007, the project had provided vocational training on skills in construction, manufacturing, and services to 8.8 million rural workers, with a Government investment of 1.25 billion yuan (160.3 million USD). The government’s training subsidy has increased since the beginning of the project, rising from 100 yuan per person in 2004 to 171 yuan per person in 2006. The cost of training is to be shared among central and local governments, current/potential employers, and the trainees.

Although the implementation experience and impact of this program to date have not yet been assessed, the limited information available suggests that results have been mixed. In some cases, it appears that migrant workers who received the vocational training achieved higher annual incomes than those who did not receive training. However, the extent to which the training itself contributed to higher incomes is unclear. Furthermore, feedback suggests that quality assurance has not been strong, and the Central and Western regions of the country have had more difficulty providing adequate financial support for the program.


The State Council opinion also calls for improved access to various benefits for migrant workers, such as medical insurance for major diseases and suitable pension insurance plans that can be integrated into insurance for urban employees and/or transferred between locations. In addition, it requires governments in receiving areas to bear the responsibility for providing children of rural migrant workers with equal opportunities to access compulsory education. Finally, to help protect migrant workers’ rights and interests, the opinion mandates that employers ensure migrant workers are represented in employees’ representatives conferences and guarantee their right to join trade unions according to law.

**Challenges in Implementation**

Although rural migrants have benefited from the gradual relaxation of *hukou* policies, China’s migrant workers continue to be in a vulnerable position. As described in Chapter...
1, these workers have not yet been integrated fully into urban areas and in many respects remain second-class citizens relative to their local urban counterparts. They face a multitude of problems, including: low wages and delayed payments, long working hours, inferior safety devices, high incidence of occupational illness and accidents, difficulties in getting employment and training, and obstacles in securing housing (State Council, 2006). One study found that the proportion of migrant workers in the urban labor market working six days a week is two times higher than local urban workers and 58% higher among those working 7 days a week (Du, et al, 2006). Migrant workers are also subject to the risk of arbitrary actions by local authorities in the name of preserving social order and public safety (Fleisher and Yang 2003). Their vulnerability is heightened by lack of access to welfare services, health care, and legal aid.

Although the policies described earlier in this chapter represent a large step forward, the critical question is whether and how these policies will be implemented by each locality and employer. The implementation of State Council guidelines and other regulations is left to local city governments, and many municipalities are still reluctant to eliminate hukou restrictions. As mentioned above, large cities such as Beijing, Shanghai, and Guangzhou have been slow in undertaking reforms (Cai 2002). The increased number of residents would necessitate an expansion of public services and facilities, placing more demands on already limited local resources. When Zhengzhou, the capital of Henan province, decided to relax its qualifications for permanent residence, the migrant population increased ten-fold to 150,000 in only three months. Social disorder led the local authorities to reverse the decision (ILO, 2006). Employment policies in large cities are often restrictive, controlling migrant worker intake through quotas and occupation-specific restrictions requiring permits and documents for which they must pay (Chan 2006).

Numerous reports point to evidence that policies aimed at improving the status and situation of migrant workers are not being implemented in practice. Studies have found that central policies such as the 2003 State Council directive instructing local governments to provide education to migrant children, which are not backed by additional funding, lag in implementation.\footnote{See, e.g., CECC (2005) or Knight, Song and Jia (1999).} One study concluded that even if rural migrants gain some benefits from acquiring urban hukou, such as in education, they are still asked to pay a substantially higher fee compared to other workers (Chan 2004). Moreover, policies such as the urban dibao program described in Chapter 3 continue to exclude migrant workers by design. Local urban governments are reluctant to expand these programs to migrants due to the costs involved and because it could spur a large inflow of migrants who might become dependent on such assistance (World Bank, 2007a). The World Bank is currently undertaking a study, jointly with the Ministry of Labor and the Chinese Academy of Labor and Social Sciences, to assess the extent to which State Council directives are being implemented in practice and in what form. The study will also examine the effectiveness of the policies that have been put in place thus far and major constraints to their implementation.
Another continuing problem for migrant workers is lack of social insurance coverage. Although the Labor Law allows for all urban workers to join social insurance programs, coverage rates indicate that very few migrant workers benefit from them. Surveys in several cities showed that few enterprises pay pension contributions for the rural migrant workers they employ (Zhang 2003). As noted in Chapter 1, coverage rates for pension, unemployment, and health insurance among migrants are about one-seventh of those for local urban residents (Figure 4.1). A related problem stems from the decentralized management of social protection programs. Programs are implemented and administered at the local level, and entitlements are not transferable to other municipalities. This arrangement acts as a disincentive to workers who have contributed to the system and who would lose benefits from changing jobs or locations. At the same time, some migrant workers are reluctant to pay part of their salaries into a social insurance scheme from which they may only see only limited benefits (ILO, 2006).

**Policy Issues for Consideration**

A key issue is how to bring local governments and employers into compliance with existing policies, which is particularly difficult given the high degree of decentralization in China. The *hukou* system continues to serve as an instrument for controlling the flow of labor and restricting access to social protection programs. Such barriers not only affect migrant workers themselves and contribute to widening inequalities but also act as disincentives for others to migrate, thereby reducing labor market integration. The removal of these barriers and other discriminatory practices would help facilitate labor mobility between urban and rural areas and reduce the vulnerability of migrant workers (Box 4.2).
Box 4.2: Efficiency gains from removing restrictions to labor mobility

The Chinese labor market still shows significant fragmentation across regions and sectors. Although labor mobility has greatly increased in the last two decades, the remains of the hukou system have acted to reduce internal mobility between rural and urban areas, within the rural sector, between small and big cities, and between regions. These constraints on labor mobility have had significant growth and welfare effects.

Evaluating the gains from lifting these mobility restrictions is a complex exercise. Nevertheless, a number of recent papers give partial estimates of these effects. For example, World Bank (2005a) used simulations to estimate the potential gains from greater labor mobility out of the agricultural sector. Using 2001 as the baseline, the study showed that moving 1%, 5%, and 10% of the labor force out of agriculture into other sectors added 0.7%, 3.3% and 6.4%, respectively, to China’s total GDP. The same study showed that the benefits of greater mobility between the rural and urban sectors would be highest for the central and western regions, hence improving not only efficiency but also equity.

Using a different approach, Au and Henderson (2006) show that migration restrictions across cities as well as restrictions on rural-to-urban migration have left many cities undersized, with unexploited economies of scale and resulting in large productivity losses. They estimate that increasing the size of a prefecture-level city that is 40% below its optimal size to its efficient size will raise output per worker by 20%, while increasing the size of a city 50% below its optimal size to its efficient size would increase output per worker by 35%. Doubling the size of non-prefecture level cities would also lead to large efficiency gains as output per worker would increase by 11%. Au and Henderson (2006) argue that restrictions on migration and restrictions on the movement of rural firms have also reduced spatial agglomeration of rural industry, resulting also in productivity losses in the rural sector. They estimate that the gain in output per worker from doubling the size of TVE employment could be as high as 23%.

Source: authors using World Bank (2005a); Au and Henderson (2006).

In terms of hukou policy reforms, China is unlikely to eliminate the residential registration system entirely in the near future since it provides an instrument for controlling the flow of labor and coordinating rural and urban development. However, further loosening of migration restrictions and various reforms may erode the value of urban hukou to the point where the distinction is no longer relevant. Some proponents of hukou reform argue that there should be a process to gradually de-link hukou from residence and employment benefits, so that it remains simply as a record of residence.

Other measures, in addition to hukou reform, can help facilitate worker mobility. Continued efforts are needed to improve the flow of information on job opportunities from urban areas to rural areas. An effective migration management system should be able to monitor migration trends and patterns, promote safe channels of migration, and analyze the absorption capacity of receiving areas to provide timely and accurate information on the supply of and demand for migrant workers (ILO, 2006). As noted in Chapter 1, first-time migrants currently rely on family and personal networks to find employment, which perpetuates their presence in the informal sector. Job search assistance and placement services, which are discussed in Chapter 5, could be extended further to migrants and potential migrants to give them access to a wider range of
employment opportunities. At the same time, measures to improve the education and skills base of potential migrants can improve their employability for better-paid and higher-skill jobs in urban areas. The basic life skills courses which have been provided under the Sunshine Project can also be developed further and made more widely available to help migrants manage the transition to a new locality. In addition, as suggested in Chapter 2, greater efforts to educate migrant workers on their rights may help boost compliance among employers and reduce abuses.

Another policy option for improving worker mobility is to make social insurance benefits portable between different areas and municipalities, as stated in the new Labor Contract Law. If they could take their accounts with them, workers may feel less compelled to remain at the same job when a better opportunity becomes available. For portability to work effectively, the administration of social insurance programs would need to be strengthened and better integrated across provinces and municipalities to ensure that contribution and account records are transferred as workers move.

One example of an effort to improve portability was the pensions pilot program in Liaoning province, described in Chapter 3. An explicit objective of the pilot was to improve the portability of pension benefits, which it accomplished by making individual accounts fully funded. Individual savings accounts could therefore in principle be transferred when workers moved between different pooling areas within or across provinces. Authorities reported that there were no major problems when such transfers of pension rights took place (World Bank, 2006a). This experience could be scaled up and replicated in other parts of China.
CHAPTER 5: FACILITATING REEMPLOYMENT AND ADDRESSING SKILLS GAPS

The emergence of unemployment and the large inflow of new labor force entrants have been placing increasing pressure on China’s labor market. As described in Chapter 1, many laid-off workers have had difficulty finding new jobs, particularly in the formal sector. While numerous programs have been created to help these workers maintain a connection to the labor market and upgrade their skills, the effectiveness of such programs is not yet clear. At the same time, new graduates are also facing difficulty finding suitable jobs as they enter the workforce. Reports point to a disconnect between the knowledge and skills provided by the education and training system and those demanded by employers. Closing the skills gap will be critical to helping these young workers find employment, which will in turn help China maintain its competitive edge in global markets by boosting the productivity of its massive labor force. Policymakers are looking to various active labor market policies (ALMPs), as well as academic and vocational education reform, to help address these issues. This chapter describes the major initiatives that have been undertaken to facilitate reemployment and address skills gaps, highlights the challenges that have arisen in implementation, and proposes some issues for further analysis to help shape future policymaking in these areas.

I. Facilitating Reemployment for the Unemployed

Overview of ALMPs

Beyond providing UI benefits to help alleviate the immediate financial impact of unemployment for laid-off workers, the Government has adopted a number of policies and programs aimed at helping these workers find new employment. Laid-off SOE workers face particular problems in finding reemployment because they have been shielded from competition with other workers and may lack the necessary skills and knowledge to compete for jobs. The Government’s approach to active labor market policies (ALMPs) has therefore focused on both helping these workers find new job opportunities, whether in the formal sector or through self-employment, and on upgrading their skills so they can meet the demands of employers in the more open and competitive labor market. 

42 See, for example, McKinsey Global Institute, “Addressing China’s Looming Talent Shortage” (October 2005).

43 In the Chinese context, the term ‘active employment policies’ encompasses all policy measures aimed at creating employment, which is a much wider definition compared to the one traditionally used elsewhere. Employment policies in China include several categories: (i) macroeconomic policies that promote economic growth, as the main generator of employment; (ii) policies assisting the laid-off and unemployed to get reemployed; (iii) policies aimed at enhancing the match of labor supply and demand; (iv) macro-control policies to reduce unemployment; and (v) social security policies to support the laid-off and unemployed (Yang 2005). This section focuses on the second and third categories, which fall within the traditional definition of ALMPs.
China’s ALMPs have gone through several stages of development in the past two decades. In the initial wave of economic reforms, the primary objective of labor market policies was to address the large displacement of workers from SOEs. Although the policies were mainly passive in nature, providing welfare support to laid-off workers, some major ALMPs were adopted to help reduce unemployment. The use of Labor Service Enterprises (LSEs), for example, was one of the most important labor market policies in the early 1990s. These quasi-state enterprises, which were first created to absorb the millions of people returning to urban areas after the Cultural Revolution, were viewed as a means of absorbing the surplus labor that was expected to be generated by SOE restructuring and retrenchment. The LSEs were new cooperative businesses mostly created by SOEs, which provided start-up capital and unused production capacity and which used the LSEs to test new products and enter new markets. Around 200,000 LSEs existed in the 1990s, employing about 9 million workers.

In the late 1990s, the Government implemented a ‘Re-employment Project’ under which the Reemployment Service Centers (RSCs) were created. As noted above, the RSCs not only served as a social safety net for laid-off workers but also provided reemployment assistance. The RSCs were charged with implementing ALMPs such as job search assistance and counseling, training, support for self-employment initiatives, and tax breaks for enterprises employing displaced workers. These responsibilities for reemployment assistance were finally shifted away from SOEs with the introduction of the binggui policy.

The ‘positive employment policy,’ which is the Government’s latest framework for labor market policies, was introduced in 2002. The policy continues to focus mostly on assisting unemployed SOE workers, in particular older workers—referred to as the ‘4050’ group because they include women over 40 years of age and men over 50 years of age—since they have lower reemployment prospects. The policy also encompasses special programs for migrant workers, as described above; women workers; people with disabilities; and youth. The Ministry of Labor and Social Security (MoLSS) has primary responsibility for overseeing the policy, but the programs are run mainly by the public employment service (PES). The PES operates on a number of levels through a national policy office; provincial policy offices; provincial, city, district, and sub-city level Labor Service Bureaus; employment exchange centers; and neighborhood employment stations (Abrahart, 2005).

The ALMPs established under the ‘positive employment policy’ can be classified into five groups:

(i)  *job placement services*, which offer free job matching and labor market information to the registered unemployed and laid-off SOE workers.

(ii) *employment training programs*, including pre-employment and reemployment training as well as skills testing services.

(iii) *subsidies for employers* to hire retrenched workers.

(iv) *self-employment generation*, giving tax breaks and other assistance to laid-off workers who become self-employed.
(v) *public works programs* such as public construction projects and subsidized community positions.

**Job placement** is the key service offered by PES offices. The PES reportedly succeeded in placing over 15.8 million workers in 2003 (MoLSS 2004). The PES offices have seen a large increase in the number of job seekers over the past few years; although the number of PES offices increased slightly between 1999 and 2003, the number of registered job seekers and people assisted doubled over the same period as shown in Table 5.1. On average, each PES outlet covers a population base of 30,000 people between the ages of 15 and 64. Each office has an average of 1,000 unemployed registrants and receives a similar number of vacancies (Abrahart 2005). By the end of 2003, around 26,000 job placement agencies were operating in China, of which 18,000 were public job agencies. Private employment agencies operate mainly in the coastal cities and in areas with a high concentration of migrant workers.

<table>
<thead>
<tr>
<th>Year</th>
<th>Average staffing</th>
<th>Vacancies lodged</th>
<th>Registered jobseekers</th>
<th>Vocational guidance</th>
<th>Placements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>2.8</td>
<td>11,242,000</td>
<td>15,930,000</td>
<td>7,949,000</td>
<td>8,844,000</td>
</tr>
<tr>
<td>2000</td>
<td>3.0</td>
<td>15,094,000</td>
<td>19,917,000</td>
<td>10,048,000</td>
<td>9,752,000</td>
</tr>
<tr>
<td>2001</td>
<td>3.2</td>
<td>18,768,000</td>
<td>24,395,000</td>
<td>11,576,000</td>
<td>12,291,000</td>
</tr>
<tr>
<td>2002</td>
<td>3.2</td>
<td>22,502,000</td>
<td>26,842,000</td>
<td>13,402,000</td>
<td>13,543,000</td>
</tr>
<tr>
<td>2003</td>
<td>3.1</td>
<td>38,320,000</td>
<td>30,602,000</td>
<td>16,110,000</td>
<td>15,860,000</td>
</tr>
</tbody>
</table>

Source: Ministry of Labor and Social Security

The Government has been making efforts to improve its job placement services by strengthening the public labor information system. Since 1999, local labor bureaus in major cities have been required to collect and release labor market information. A significant investment has been made in computerizing the PES network, and over 100 cities have launched labor market information websites connected with city and district employment services. Over 90 cities release quarterly analysis reports of labor supply and demand by job category. In addition, the Institute for International Labor Studies under the MoLSS is developing a set of indicators that can be used to alert policymakers of significant changes in the labor market. These measures have helped improve the efficiency and efficacy of China’s employment service, although further efforts are needed to link networks at various levels and enhance their effectiveness (ADB, 2006).

Another important initiative in the job placement area has been to try to facilitate migration flows in response to labor market demand. Around 1,000 rural labor flow and employment monitoring stations have been established in 100 counties and cities throughout the country. These stations analyze the flow of and demand for rural workers and regularly release the information (ADB, 2006). However, the employment services network is concentrated in urban areas, and potential migrants have few resources available to provide labor counseling and advice before they migrate (ADB, 2006).
In the area of training services, the primary focus has historically been on reemploying retrenched and unemployed workers. Following the success of a pilot reemployment project initiated in 1994, the Chinese government launched the ‘Three-Year Ten Million Plan’ in 1998. The program, which aimed at retraining 10 million retrenched workers for reemployment, retrained over 13.5 million workers in the first three years. Around 65% of the workers found jobs afterwards, although the extent to which this reemployment can be attributed to the training itself is unknown. In the second phase of the program, around 15 million workers were retrained between 2001 and 2003 (MoLSS 2004).

Most recently, reemployment training has been provided by employment training centers, which are part of the local labor and social security system. In 2003, China had over 3,300 of these centers which graduated almost 6 million people that year. Training is also being delivered through community-run vocational training centers, which numbered over 19,000 and graduated over 5 million people in 2003. These community-run centers focus on training for the informal sector and are generally designed for workers with low levels of certified skills. At both types of centers, most courses are less than six months in duration. Although the reemployment rate among those who enrolled in these courses was reported to be 63% in 2003 (Yang, 2005), it is difficult to determine the extent to which the training contributed to this outcome and whether those workers would have found reemployment even without the benefit of training.

To address the current mismatch between supply and demand for skills in China, greater emphasis is being placed on using training services to enhance skills for employment. Several programs were adopted in 2002 to improve employment qualifications and competencies, including the ‘Plan for Strengthening Vocational Training to Improve Employment Qualifications,’ the ‘National Project for Training Highly Skilled Personnel,’ and a program for training 500,000 new technicians in three years (Yan, 2006). Particular emphasis was placed on new techniques, materials, and technology, with the goal of meeting private sector demand for laborers with specialized skills.

In addition, the category of training services includes the operation of skills testing centers, which provide certification for workers who have gained skills on the job. China had 7,252 of these centers operating in 2003. Around 7.36 million out of a total of 8.8 million candidates obtained job credentials through these centers in 2004, representing an average passing rate of 83.7% (Abrahart, 2005). Most centers are hosted at vocational schools or training centers affiliated with the MoLSS, non-MoLSS vocational schools or higher learning institutes, and entities affiliated with other line ministries. Some private firms also conduct skills assessments, particularly in service-related occupations. In addition, international vocational qualifications and specialized certificates issued by foreign organizations and multinational firms are being introduced into China. These international certificates are well-recognized by the market. In contrast, the domestic certificates appear to have had little impact on employability, especially in large cities where labor markets are relatively more developed (World Bank, 2007d).

Very limited information is available on the implementation of the subsidies for employers to help generate employment. The program offers incentives such as wage
subsidies for newly hired workers as well as social insurance subsidies, tax deductions, and loan guarantees to small- and medium-sized enterprises for hiring retrenched workers. The retrenched workers must account for at least 30% of annual new recruits and have contract durations of more than three years. Under the program, LSEs that are independent from the primary business of their parent SOEs—meaning that they have independent accounting and do not use the core assets of the parent SOE—are also exempt from corporate tax if retrenched workers amount to at least 30% of their annual new recruits.

**Self-employment generation** among unemployed and laid-off workers is being supported through a number of financial incentives. Unemployed and retrenched workers who become self-employed are exempt from business, income, city, and building taxes. They can also receive remittances for administrative charges related to registration, certification, and management of their start-up businesses. In addition, different levels of government have established guarantee funds for small loans, which all banks are to provide to retrenched workers seeking to start their own businesses. The size of the loans cannot exceed 20,000 yuan, and the maximum reimbursement period is two years. The interest rates, fixed according to the loan interest rate issued by the People’s Bank of China, are to be subsidized by the state. Very few of these loans have been given to date, and lack of interest among the unemployed has been attributed to the low loan ceiling and cumbersome application procedures which reduce the incentives to apply.

Another program in this category is business start-up training for unemployed or retrenched workers who want to become self-employed. The program was first piloted in Beijing, Shanghai, and Suzhou in 1998 and has since been expanded to 100 cities. Around 280,000 people received this training in 2003, of which about half have started their own businesses or become self-employed (MoLSS, 2002). In some localities, voluntary business guidance groups, in which experts provide business advice to entrepreneurs, have also been formed.

Finally, **public works programs** have been used as an ALMP, particularly to absorb older retrenched workers. In 1998, the Government required that regions establish special funds for laid-off workers to participate in public projects, mainly in construction. Public works programs also include subsidized community positions, which are low-level positions of community value and include jobs such as street cleaners and traffic control officers. The use of public works programs has been limited to date, but the number of participants is on the rise. Community programs had about 30,000 places in 2003, jumping sharply to 520,000 places in 2004. Although the ‘4050’ group of workers receives priority for such positions, the Government has also issued policies encouraging university students to participate in the development of western China through volunteer service, supported by a monthly living allowance (Yang, 2005).

**Challenges in Evaluating Program Effectiveness**

As highlighted throughout the discussion above, information constraints make it difficult to assess the effectiveness of the various ALMPs in China. Detailed data is not available.
to determine how successful the PES and other employment services providers have been in job placement. Very little is known about turnover rates or types of jobs lodged and about whether the jobs filled matched the educational backgrounds and skills of the workers. The extent to which workers would have found similar or even more suitable jobs without assistance from such providers is also unknown.

One study conducted in Beijing suggests that job placements through PES offices are low relative to other mechanisms, with most unemployed workers finding employment opportunities through friends and relatives. The study estimated that almost 90% of jobs found by retrenched workers in the city were for casual labor positions which are often unstable (Yang, 2005). International experience also shows that placements made by a PES are oftentimes for short-term work, for example in public works programs or for temporary and casual work, and that the proportion of jobs actually found through the PES are much lower than those reported by the PES itself (Abrahart, 2005). Although these findings cannot be generalized, they do imply that further analysis is needed on job placement data.

As in the case of job matching services, the impact of training services is difficult to evaluate. Beyond number of courses offered and number of people trained, little information is available on the outcomes of such training in terms of enhancing employment prospects for workers. One of the few in-depth evaluations to be conducted was a 2004 World Bank study of training programs in the cities of Shenyang and Wuhan. The assessment showed mixed results and found that neither city was able to demonstrate the unequivocal value of the programs in economic terms, at least at the macro level (World Bank, 2004a). A more detailed description of the results is provided in Box 5.1.

**Box 5.1 An Evaluation of Training Programs in China**

In 2004, the World Bank conducted an evaluation of training programs in Shenyang and Wuhan. In each city, two samples were taken of workers who were laid-off in mid-1998. One sample was comprised of workers who had participated in training programs, while the other sample, the control group, was comprised of workers who had not participated. The samples were surveyed in mid-2000 about their employment situation. For each city, respondents in the two samples were compared in terms of two outcome variables: their employment status at the time of the survey and, for those who were employed, their monthly earnings.

Although results differed between the two cities, neither demonstrated the unequivocal value of the programs. In Shenyang, workers who had been trained were no more likely to find employment at the time of the survey than those who had not participated in training, although those who were employed were likely to have slightly higher earnings. In Wuhan, training increased the likelihood of employment among workers whose highest education level was junior high school but had no impact on those in other education groups. Furthermore, the earnings levels of those who were employed were the same whether or not they had participated in training.

The study suggests two explanations for the differing results between Shenyang and Wuhan. First, people trained in skills that are in demand are more likely to find employment. Wuhan, which had a relatively stronger economy, would have more skills in demand than Shenyang. Second, Wuhan’s training programs were better designed compared to those in Shenyang, with longer programs and more practical content. Workers in Wuhan also had stronger support from employment services, as indicated by the much higher proportion of workers from Wuhan going through Reemployment Service Centers.

Given the current information constraints, drawing detailed or definitive policy conclusions from China’s experience with ALMPs is extremely difficult. The extent to which ALMPs have contributed to reemployment of beneficiaries needs to be studied further, supported by monitoring and evaluation systems that would allow for such an assessment and help gauge cost effectiveness. What percentage of participants succeeded in finding employment after receiving the assistance/training? What types of employment did they find? How do these outcomes compare to those of workers with similar backgrounds who did not receive the assistance/training or who received different types of assistance/training? Is there a significant difference in outcomes depending on whether a public or private provider was used? Given the mixed results found in the limited evaluations conducted to date on ALMPs, such information is needed to determine whether such programs have a positive impact and should be continued. Although better data collection mechanisms and more in-depth program evaluations will require investment, they will be cost-effective in the long run by informing decisions on where the limited resources for labor market programs should be channeled for greatest impact.

Since few evaluations of China’s ALMPs have been conducted, reviews of international experience could offer some insights into various policy options. Although evaluations by the World Bank and OECD of ALMP experiences in other countries are largely inconclusive and the results are mixed, international comparisons yield some general conclusions about the value of ALMPs and particular approaches that may contribute to successful outcomes. The World Bank reviewed a large number of evaluations of ALMPs, covering the OECD countries as well as some transition and developing economies, and found the following:

- Employment services generally have a positive impact and are cost-effective. They are normally associated with positive results, particularly in the context of employment growth, although they do not appear to be effective for youth. Their effectiveness in countries with a high degree of informality is questionable. However, more evaluations are needed to draw definitive policy conclusions.

- Training activities appear to have little impact for retrenched workers and the long-term unemployed, although the evidence is inconclusive. Training targeted at young people generally has no positive impact on youth employment and has had negative effects or negative rates of return in developed countries. In European countries, the results are contradictory: while specific programs appear to have disappointing effects, they are the only labor market programs that show a positive aggregate impact on labor market outcomes.

- Self-employment or micro-enterprise development seems to be effective when tightly targeted and implemented on a very small scale. The key issue with providing self-employment assistance is finding ways to improve access to credit for participants.
Public works are effective as poverty programs but not as programs to alleviate long-term unemployment. In European countries, programs that involve the direct creation of public sector employment seem to be less effective than training.\footnote{See World Bank (2004b), Abrahart (2005), and OECD (2000) for more detailed discussion of these findings.}

Given the limited number of evaluations that have been conducted on ALMPs and the unique features of the Chinese context, it is difficult to draw specific implications from these results for the design of China’s ALMPs. However, one consistent message is that ALMPs need to be targeted carefully and executed on a smaller scale. The World Bank and OECD note that ALMPs: involve deadweight losses, in supporting something that might have happened without the programs; have displacement effects, providing employment to one person at the expense of another in the employment queue; and have substitution effects, since one person ends up losing a job to make room for someone who has been assisted. Therefore, particular care is needed in deciding whom to support with these programs. The programs should be focused since they involve specific-purpose activities for particular target groups, which require a high degree of management and control (Abrahart, 2005).

In terms of prioritizing China’s ALMPs, Abrahart (2005) suggests that a key objective is to develop effective employment services. The PES could be charged with registering the unemployed, undertaking job brokerage and associated functions, identifying targets for programs, and handling mass redundancies. It could also help place workers abroad, as in Bangladesh where public training institutions train people for overseas jobs or in Thailand where a network of government-sanctioned private agencies facilitates overseas placements. However, to handle these responsibilities, the capacity of the PES would need to be expanded significantly. In 2003, PES offices had only about three staff members each, with each staff member handling 315 registrants on average. Workloads continue to rise, and it appears unlikely that PES offices have sufficient staff capacity to handle time-intensive tasks such as assisting hard-to-place workers or providing intensive job counseling (Abrahart, 2005).

Regardless of how China decides to prioritize its various ALMPs going forward, an important consideration will be how to finance these programs. Currently, most labor market programs are funded primarily through the UI program. They therefore vary widely from region to region according to the economic and employment situation in each area and depending on whether UI pools are in surplus or deficit. Areas such as Liaoning province, where the UI fund has been in deficit, are spending very little on their labor market programs. Abrahart (2005) suggests that training and subsidy programs as well as financial assistance for self-employment should continue to be financed from the UI system and be treated as replacements for cash transfers offered as unemployment compensation. However, the PES and public works programs could be financed from general revenue to help ensure a more sustained flow of resources. Overall, the proportion of ALMP expenditures is quite low in China, amounting to less than 0.4% of GDP. In contrast, most OECD countries have allocated approximately 2% of GDP to their labor market activities, although expenditures vary widely across countries (Yang,
By international example, given China’s GDP per capita and population size, it might be reasonable for China to spend 0.5% on ALMPs. At this level, expenditures on ALMPs would be around US$25 billion, with international experience suggesting that about one-third would be on the PES (Abrahart, 2005).

II. Addressing Skills Gaps

Overview of the Education System and TVET System

From a labor market standpoint, education and vocational training are critical determinants of workforce capacity since they equip future labor force entrants with the skills and knowledge needed to become productive workers. The degree to which the education system and technical and vocational education and training (TVET) system can provide the skills demanded by the labor market has implications not only for the employment prospects of individual workers but also for the competitiveness of the economy. Furthermore, the continued flow of large numbers of youth with dim job prospects and insufficient qualifications into the labor market could bring the risk of social instability. Therefore, although detailed analysis of the education system is beyond the scope of this report, it is discussed briefly here in relation to labor market entry.45

Modern education reform started in 1986 when the Government enacted the Law of Compulsory Education, which extended basic education to include three additional years of junior secondary and diversified senior secondary education. China has also decentralized responsibilities for education, giving provincial and local governments more authority. The majority of public education funding comes from local governments, particularly at the county level. Counties and townships together account for 70% of public spending on education (World Bank, 2007d).

China’s education reforms have largely proven to be successful, and China has made impressive progress in boosting educational attainment. By 2003, 51.4% of the population aged 6 and above had attained secondary education and 5.5% had attained tertiary education. From 1990 to 2004, the gross enrollment rate for junior secondary level rose from 67% to 94%, senior secondary from 22% to 47%, and tertiary from 3% to 19% (World Bank, 2007d). In addition, China has been tapping into distance- and internet-based learning to expand its education capacity. It now has the world’s largest system based on radio and TV universities, and by 2005, over 4.25 million graduates had earned higher education diplomas from China’s Radio and TV University, accounting for 12% of total higher education graduates (World Bank, 2007d).

Beyond universalizing compulsory education and expanding higher education, the Government is giving greater attention to vocational education as a means of improving employment prospects among youth and addressing skills gaps. A recent National Conference on Vocational Education, convened by the State Council, emphasized the importance and urgency of promoting vocational education and defined objectives and

45 For a broader discussion of education and training in China, see World Bank (2007d).
milestones for the coming years (Box 5.2). With the introduction of market-based economic reforms, China has made significant efforts to modernize and restructure its TVET system, making it more demand-driven, flexible, and a source of quality training for youth as well as older workers. Horizontal pathways between general and vocational training and vertical pathways between secondary and post-secondary education for vocational students have been improved, and the Government’s current TVET policy is consistent with international trends and best practices (World Bank, 2007c).

A large number of students and workers benefit from the TVET system. Over 20% of youth between the ages of 16 and 19, or 15 million students at the senior secondary level, are enrolled in the TVET system. In addition, 7 million students are enrolled in vocational colleges, while another 75 million workers receive short-duration training. Placement rates of graduates are high, although it may reflect a very tight labor market for skilled workers and technicians rather than high quality of skills obtained (World Bank, 2007c).

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<th>Box 5.2 Promoting Vocational Education in China – Objectives and Goals</th>
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<td>A high-level National Conference on Vocational Education, convened by the State Council in 2005, laid out the principles and objectives for developing China’s vocational education system. It defined four main focus areas: (i) adjusting the education structure by shifting emphasis to vocational education; (ii) promoting institutional and system reforms and forming a multi-faceted education scheme; (iii) improving the quality and levels of vocational schools and making them employment-oriented; and (iv) greatly developing rural-focused vocational education, improving the professional skills and abilities of rural workers to transfer to different jobs. It emphasized that the vocational education system should have strong links to the labor market and enterprises to serve the needs of a market economy.</td>
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<td>The conference also set ambitious targets to be achieved by 2010, including:</td>
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<td>• Increase enrollment in secondary vocational schools to 8 million students—compared to 5.5 million in 2004—so enrollment in higher vocational education will account for over half of total higher education enrollment.</td>
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<td>• Increase the number of secondary vocational program graduates to 25 million and the number of tertiary program graduates to 11 million.</td>
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<td>• Boost the number of trained labor force members to over 100 million and improve the quality of the labor force through various modes of vocational training.</td>
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<td>• Upgrade vocational education conditions, improve the quality of teachers, and enhance the effectiveness and efficiency of vocational education.</td>
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A job preparation training scheme, launched in 2000, is also being implemented to enhance the employability of young people in rural areas. This program, run by the Ministry of Labor and Social Security (MOLSS), provides rural junior and senior high school graduates who are unable to continue their education or want to transfer to non-agricultural/urban activities with vocational training and education for one to three years. The training courses focus on basic qualifications, professional knowledge and skills,
social practices, and job-specific curricula. The training format is a combination of full-time, part-time, and credit hours, as well as distance learning. In principle, training costs are shared by individuals and employers (potential or former), with some assistance from the government. Costs can be reduced or waived for students in financial difficulty. In 2003, around 1.26 million urban youth who were unable to enter schools for further studies received this training. It has been estimated that the employment rate of trainees is over 70% and that the average income of trained graduates is higher than those who have not been trained. However, training quality is reported to be problematic, and low-income families in rural areas have difficulty paying the training fees (Shi, et al, 2004).

**Challenges in Education and TVET**

Despite considerable progress in expanding access to education and TVET, the overall educational attainment of the Chinese population remains low compared to OECD countries. In 2001, the average years of education of China’s total labor force was 8.0, compared to 11.7 in OECD countries. Only 4.7% of China’s labor force had education at the college level or above, versus 24% among the OECD countries. Figure 5.1, which compares shares of population that have attained upper secondary education and above, shows large differences between China and the OECD average. China also lags behind other countries in the region in this regard; in 2003, the upper secondary graduation rate in China was only 31%, compared to 91% in Japan, 84% in Malaysia, and 59% in Thailand (World Bank, 2007d). Low educational attainment limits China’s ability to upgrade skills, redeploy workers from low productivity jobs to higher productivity jobs, and thus boost its competitiveness.

**Figure 5.1 Comparison of Educational Attainment – China and the OECD**

Furthermore, although basic education through ninth grade is compulsory, the education level of the labor force continues to vary widely across regions and between rural and urban areas. While some Eastern provinces are considering a 12-year compulsory education system, the Western region is still struggling to provide a 9-year basic system. The more prosperous coastal regions enjoy a great advantage in terms of education levels and resources available for education, both from the public and private sectors. As noted
above, county and township governments having direct financing responsibilities for compulsory education. Education services in each locality depend on fiscal status, so compulsory education is severely under-provided in poor rural areas. Per capita student spending for the primary level, which is closely correlated with GDP per capita, ranged from over RMB5,400 in Shanghai to just RMB520 in Henan province in 2003. Some local governments have had to increase school fees, worsening burdens on the poor, and many incur debt to fund school construction or renovation (World Bank, 2007d). These differences in education resources are manifested in large disparities in illiteracy rates. The national illiteracy rate was about 11% in 2003, with rates below 10% in most coastal regions and rates as high as 21-40% in the Western provinces (World Bank, 2007d).

The TVET system faces similar challenges in equity and access. Student fees account for 47% of TVE funds in public training institutions. Annual school fees excluding room and board range from USD 310 to USD 700 in public training institutions and can be as high as USD 1,200 in better-equipped private institutions. Although financial aid covers about 15-20% of students, the needs are greater than the available funds. Very poor students cannot afford the high fees, thus limiting their access to TVET programs. Finally, a number of larger systemic issues have been identified in the TVET system, including: limited information sharing and collaboration between the MOE and MOLSS; lack of clarity on the role of the public sector in TVET, particularly in view of the growing private sector; and the need for more evidence-based planning and management of the TVET (World Bank, 2007c).

Another major issue in education and TVET is the continued disconnect between the supply of new labor force entrants and the demands of the market. The employment rate of college and university graduates has decreased as the time to first job has lengthened and starting salaries have been lower than expected. In 2004, of 2.8 million graduates—a 32% increase from the previous year—around 21% were jobless. Ministry of Education statistics indicate that by September 2005, of 3.4 million graduates, about 27% had not found jobs (World Bank 2007d). Factors such as poor course design and curricula, outdated training methods, lack of job market forecasting, and insufficient career guidance and counseling services have contributed to an overall mismatch of education supply and the demands of the labor market (World Bank, 2007d). This mismatch is underscored by dissatisfaction among employers regarding the quality and relevance of school education (Venter, 2003; McKinsey Global Institute, 2005).

The disconnect between the education system and labor market demand puts China’s future competitiveness at stake. In IMD’s World Competitiveness Report 2005, China ranked 53rd out of 60 countries on whether the educational system meets the needs of a competitive economy. While China is still relying mainly on labor-intensive manufacturing, it will need to upgrade its human capital to compete in an increasingly skills-intensive global economy. A significant proportion of China’s export producers are already shifting into more capital- and skill-intensive product lines, such as computer and electronic products, parts, and components. However, China continues to face a shortage of skilled labor. Technical workers, most of whom are junior technicians, account for only one-third of total industrial workers. Only 4% of technical workers are engineers
and advanced engineers, posing an obstacle to industrial upgrading (World Bank, 2007d). In the coastal areas, some firms report that they are unable to find the skilled labor needed to switch to more skill-intensive products and production technologies. Observers have also noted the need to improve the quality of exports in order to sustain strong export growth (World Bank, 2007e). Both of these shifts require a more skilled and better prepared workforce.

Notably, the recent expansion in China’s education and TVET systems has mainly been an increase in quantity rather than quality. Higher education courses are still too academic, and the new cohorts of graduates lack skills and competencies demanded by the market such as effective human resources management, intellectual property management, marketing, and strategic planning (World Bank, 2007d). The quality of TVET is also generally poor, due largely to the past history of underinvestment and low priority given to TVET. A study by the McKinsey Global Institute found that in 2003, China had about 8.5 million young professional graduates with up to seven years of work experience, plus an additional 97 million people who would qualify for support staff positions. However, according to interviews with human resource professionals who hire local graduates in low-wage countries, less than 10% of Chinese job candidates would be suitable for work in a foreign company. Likewise, the study found that although China has 1.6 million young engineers and one-third of university students study engineering, they focus more on theory and have little practical experience. As a result, only about 160,000 young engineers in China are considered suitable for work in multinationals, which is similar to the number in the United Kingdom (McKinsey Global Institute, 2005).

Quality concerns also extend to private sector providers of education and TVET services. In TVET, providers have been trying to offer more practical and market-driven courses through both classroom- and Internet-based teaching. Because of their flexibility, customization, and better linkages to the business sector in general, they have become an important component of China’s training system (World Bank, 2007c). However, these private sector institutions are not subject to accreditation requirements, and the existing set of regulations is subject to interpretation (World Bank, 2001). A quality assurance framework has not been developed at the provincial and school levels, and qualification and certification systems have not yet been established.

China not only faces the challenge of expanding access to education and TVET while improving quality, but it must also do so within large financing constraints. China will require a massive amount of resources to meet the enormous education and training needs of its population. Rough estimates indicate that about 80% of China’s 1.3 billion people need or are undertaking some type of education or training. However, China still faces serious financial shortages for various levels and types of education. Total education expenditure as a share of GDP was about 5.4% in 2002, including public spending, which is much lower than in developed countries and even lower than many developing countries. Ministry of Education statistics show that in 2000, the financial appropriation for primary and high schools was not enough to pay teaching staff salaries, with a shortage of RMB14.1 billion, and the shortage of public funding for nearly 200 million
primary and high school students was approximately RMB25.6 billion. The situation is even more severe for schools in rural areas (World Bank, 2007d).

Policy Issues for Consideration

The challenges described above point to a number of areas in which further efforts are needed to address the skills gap. One outstanding priority for China is to boost the educational attainment levels of its workforce, for example by ensuring that the national goal of universal basic education is attained. To improve equity in access and boost outcomes among disadvantaged groups, the Government may need to assist those poorer provinces and townships that have not been able to attain compulsory education. To do so, an effective taxation and fiscal transfer system needs to be developed. A nationwide assessment to identify the needs of different provinces, counties, and townships would help focus transfers and subsidies to poor areas (World Bank, 2007d).

Another clear priority is to improve the quality of education and vocational training to provide relevant skills for the new economy. Curricula will need to be revised and updated and teachers’ qualifications will need to be enhanced, working with the private sector to bring the curricula in line with the demands of the labor market. For TVET, provision of teaching equipment and facilities is another priority. Assessment tests can also be improved, placing greater emphasis on functional assessment rather than standard achievement, to give learners a role in tracking their learning, serve as motivators, and promote conceptual understanding. Likewise, the vocational qualifications framework needs to be expanded with the involvement of employing industries in developing qualification standards. Well-integrated systems for career information, guidance, and counseling services at the national and provincial or regional levels would also help ensure a smoother transition for new labor market entrants (World Bank, 2007d).

To meet China’s education needs, greater private and nongovernment provision of upper secondary and tertiary education should continue to be encouraged. Such arrangements will require the establishment of appropriate rules to provide sufficient incentives and transparency. Currently, many local governments control the operations of private schools and impose illegal taxes, fees, and fines while at the same time using public school facilities and resources to make profits. Policymakers could help create a level playing field by allowing publicly funded student loan programs to be used at private institutions, ensuring that the subsidies to publicly managed institutions do not crowd out private providers in the same fields, and adopting accreditation procedures, since most private education institutions are not officially recognized and their certificates are generally undervalued.

At the same time, better quality certification and assurance systems for private education and TVET would be helpful for measuring or enhancing the quality of services provided. Mexico and Chile offer two interesting and fairly successful examples of putting in place quality assurance frameworks. A comprehensive information system about the performance and offerings of public and private providers would also be useful in this regard (World Bank 2007d).
Greater attention will also be needed to equity issues as private education expands and as even public schools, mainly at the tertiary level, start to charge tuition. As out-of-pocket expenses for education increase, children from poor families may have difficulty continuing with post-compulsory education. Better financial aid instruments are needed for poor regions, families, and students. Such instruments could include revenue transfers for education purposes, scholarships, work-study programs, education vouchers, tuition reductions and waivers, and special loans. Although these instruments have been put in place in some areas, their effectiveness has been limited due to poor design or weak implementation. It will also be important to ensure implementation of the new policy on reform of the rural education financing system. The policy, issued by the State Council, abolishes school fees for rural compulsory education, provides free textbooks and financial aid for boarding for poor families, and guarantees funding for rural compulsory education. Such measures, if implemented properly, could help reduce urban-rural disparities in education (World Bank, 2007d).

Behind all these reforms is the need for sufficient financing, which depends on the amount of public expenditures for education as well as the allocation and efficiency of spending. Effective deployment of the limited resources available will require improving management and educational governance, reforming the curriculum and pedagogy, promoting incentive-based policies such as merit pay and fair competition between public and private providers, strengthening the links between the education system and labor market, and establishing an effective evaluation system to determine which approaches work best. In China as well as in other countries, more needs to be learned about the most cost-effective way to provide quality education to students. It would be useful for Chinese policymakers to study how countries that consistently attain excellence at lower cost organize their education systems. To ensure efficiency, an effective management information system is needed on academic and vocational education as well as on the labor market, collecting information on regulations and policies, fees, quality, accreditation, curricula, pedagogy, and skills demand and supply (World Bank, 2007d).
CHAPTER 6: CONCLUSIONS

In moving toward the development of a true labor ‘market,’ China has made great strides in its labor market policies and social insurance programs. At the national level, numerous policies have been put in place to protect the interests of workers, lower barriers to mobility, and develop the skills of the workforce. However, the success of these policies lies largely with local governments, given the high degree of decentralization in China. Implementation remains uneven across provinces and municipalities, in part due to severe resource constraints. The following chapter assesses the degree to which, with the help of policies and programs described above, China has achieved an efficient labor ‘market.’ It then summarizes some of the cross-cutting policy priorities for pushing China’s labor market development forward, drawing upon the discussion from the previous chapters.

I. Has China achieved a true labor ‘market’?

As described in the previous chapters, China’s labor market has changed dramatically over the past three decades, driven by the combined forces of industrialization, the movement toward a market economy, and integration into global markets. In the course of the transition, phenomena such as urbanization, unemployment, informalization, and widening wage disparities have emerged, bringing a host of new challenges for policymakers. China has responded with a range of policies, building a framework to govern how the new market should operate and developing social insurance programs to assist workers. The Government has also placed renewed attention on mobilizing the full potential of its labor force, with policies to reduce restrictions on migration for workers from rural areas and develop the skills of its workforce.

In this rapidly changing environment, it is important to take stock of China’s progress in labor market development to help inform policies and programs. How far has China come in developing a true labor ‘market’? To what extent does the labor market allow for the free flow of workers to areas and sectors where demand is greatest? The key function of the labor market is to allocate labor resources efficiently, namely, to ensure that people put their productive skills to the best use and so individuals are encouraged to make economically and socially optimal choices. How efficient is the labor market in China today? This question has implications not only for individual workers and employers but also for China’s overall competitiveness.46

46 Although testing the efficiency of the labor market directly is difficult, a variety of outcomes that are consistent with labor market efficiency can be examined. One method would be to estimate firms’ production function and assess whether they employ an optimal number of people. This method requires good firm-level data. Nationally representative firm-level data are not available at this time, but the recent wave of the Investment Climate Assessment survey which covers a large number of cities could be used for this purpose. Alternatively, the analysis of wages can try to determine whether workers are paid according to their individual productivity or whether non-productive and discriminative traits such as gender or party membership affect wages. Another indicator of growing efficiency would be declining differences in
Numerous studies point to evidence of the growing influence of market forces in China and greater integration of the labor market. For example, World Bank (2005a) observes a steady convergence in marginal productivity of labor across provinces at least until 1995, although not between agricultural and non-agricultural activities. Cai, Park and Zhao (2004) interpret increasing returns to education and their convergence to the level seen in other countries as a sign of market forces at work. Park et al (2005) also find strong evidence of converging returns to education between provinces and between ownership groups during the 1990s. Appleton, Song, and Xia (2005) find that returns to experience have decreased, indicating a move away from seniority-based pay. Biases such as gender, party membership, and sectors persist but seem to have leveled out to some extent. The relationship between firms’ profitability and pay also seems to have strengthened recently. Knight and Li (2005) report that between 1995 and 1999, the wage premium paid by profit-making firms increased from 21% to 41%. With regard to mobility, Dong and Xu (2006) note that excess job reallocation, a proxy for labor market turnover, increased significantly in China during the second half of the 1990s, suggesting that firms were actively replacing unproductive jobs with productive ones.

At the same time, studies have found evidence that China’s labor market remains segmented and does not yet function fully as a ‘market.’ As mentioned in Chapter 1, Dong and Xu (2006) conclude that the state sector still hoards labor surpluses, indicating that it is still shielded from the full forces of competition. Although labor mobility has increased, China has a very long average job tenure of 19 years compared to an average of 10.2 in OECD countries, and the overwhelming majority of urban workers have had only one employer (Knight and Yueh, 2004a; OECD 2006). These workers, found predominantly in the state sector, are reluctant to even consider a move to the private sector. Knight, Song and Jia (1999) find that non-migrant workers in the formal sector are paid much higher than their productivity while migrants are paid much below, indicating segmentation. Furthermore, returns to education continue to vary between groups. The education of migrants seems to be rewarded less (Knight and Li, 2006), although the situation appears to be improving (Cai, Du and Wang, 2006c). The findings noted above of significant wage premia for non-productivity-related traits such as party membership, as well as the persistence of differences between ownership groups and regions, also suggest segmentation. Studies such as Knight, Song and Jia (1999) or Drury and Arneberg (2001) find personal connections (guanxi) to be an important way of ensuring a job offer.

returns to schooling or other scarce traits across firms, sectors, or regions. Evidence of turnover to relocate workers to better-matched jobs would also be consistent with improving efficiency. Finally, job-specific information and personal connections (guanxi) would have more limited value in a competitive and efficient market than in a non-competitive one.

47 Coefficient of variation fell from 0.45 to 0.30 over 1978-2002 (World Bank, 2005).
48 Cai, Park and Zhao, 2004 qualify that not necessarily all of this increase is associated with labor market reform. Other factors, such as skill-biased technical change, could have also played a role.
49 Fox and Zhao (2002) report that voluntary outflow from the state sector is extremely low. Knight and Yueh (2004a) find that native urban workers have a strong preference for the state sector.
The general conclusion from these studies is that China has made large strides in developing its labor market, but the reforms are not yet complete and more remains to be done. On the demand side, the private sector appears very competitive, while the behavior of the average SOE is still not fully market-driven. On the supply and ‘matching’ sides, many structural and institutional impediments remain. As a consequence, China’s labor market remains fragmented and not fully integrated. Some of the reasons are policy-related—for example, differences in social protection between various segments of the labor market or lack of portability in social entitlements discourage people from moving between jobs. Other reasons are structural, such as structural skill mismatches, lack of full competition, and/or persistence of monopoly power in some sectors of the economy.

Although the Government has adopted a number of policies and programs to address these impediments, the reforms can be improved and further advanced. Chapters 2 through 5 highlighted specific policy priorities to help move China’s labor market development forward in several key areas. Drawing upon the points raised in these chapters as well as in the policy notes accompanying this report, some cross-cutting issues for attention are summarized briefly below.

II. Addressing Future Challenges - Cross-Cutting Issues

Building Capacity for Enforcement and Service Delivery

Across all areas, a key priority will be to build the capacity of the various government agencies and offices involved in implementing and enforcing labor market policies. The shortage of trained labor and social security inspectors makes it difficult to enforce labor market policies effectively. At the same time, the large numbers of laid-off workers and cohorts of new graduates entering the labor force each year are placing increasing pressure on employment services and training programs. The Public Employment Service is understaffed for its growing workload, even to provide a basic level of job matching services. Many public schools and vocational training centers, particularly in poorer areas, lack qualified teachers and the necessary equipment and facilities to educate students effectively. Capacity building, both in terms of quantity and quality, will be needed to enable the delivery of quality education and training programs. However, this capacity building will require increased public expenditures on labor market programs, which may be difficult.

Given the capacity limitations and resource constraints in the public sector, China will have to foster greater private sector provision of employment services and training. Private providers oftentimes have a comparative advantage in terms of being more flexible and better linked to the business sector in general. However, quality of services—both in the public and private sector—can be uneven, raising the need for strong quality assurance mechanisms. Qualification and certification systems are needed for employment services as well as education and training provision. In addition, issues of accessibility—particularly in terms of financial affordability—should be addressed. In
general, private providers charge higher fees which may preclude migrant workers and poor students from accessing their services, thereby exacerbating inequalities. To help alleviate this problem, government support to disadvantaged individuals could be considered.

**Strengthening Monitoring and Evaluation**

For all of China’s labor market programs, much stronger monitoring and evaluation is needed to inform policy decisions. In most areas, greater attention has been placed on setting up programs than on tracking progress and assessing their impact. However, information on employment outcomes and the cost-effectiveness of interventions is vital for determining what types of programs should be emphasized, where adjustments are needed, and how resources should be channeled. The evaluation of the UI pilot programs in Qingdao and Tianjin provinces, and of the Liaoning pension pilot, are two illustrations of how careful empirical analysis and evaluation can help identify proper policy interventions and improve upon existing ones. Such in-depth monitoring and evaluation is needed across a broad spectrum of labor market programs.

To enable meaningful assessments, monitoring and evaluation mechanisms must be put in place before programs start to be implemented. Collection of baseline data and the use of control groups are important for showing the impact of programs. The emphasis of program indicators should be on outcomes—such as percentage of workers successfully finding stable employment—rather than on outputs—such as numbers of workers trained. While gathering such information and conducting quality evaluations does require resources, such evaluations are critical for providing lessons learned and informing the design of future policies and programs.

**Ensuring the Financial Sustainability of Programs**

Given the limited amount of resources available at the national and local levels, ensuring the financial sustainability of labor market programs is a key concern. Although the Government has put numerous policies and programs in place, some local governments have been unable to implement them effectively due to severe financing constraints. The issue of financial sustainability of labor market and social programs is therefore related to the broader issue of fiscal decentralization and local government financing. As argued in a number of recent World Bank reports, in China’s highly decentralized fiscal system, large disparities in revenue-raising capacities across local governments translate into large disparities in public spending, with highly un-equalizing consequences within and across provinces and municipalities. Hence, there is a clear need to move toward a more equitable allocation of resources through comprehensive fiscal reform and further equalizing transfers.

In the more immediate term, financial sustainability of labor market programs can be addressed through a number of means. Measures to expanded coverage and ensure greater compliance with contribution requirements among both workers and employers would improve the financial outlook for social insurance programs. Reducing benefits
leakage and increasing the efficiency of programs would also strengthen financial sustainability. Another important measure for ensuring financial sustainability for pensions and UI is pooling of funds, which would allow local governments to tap into a larger pool of funding.

**Better coordination among agencies**

Greater integration and coordination across different Government agencies is critical for the success of labor market programs. Such coordination is important not only horizontally but also vertically, among the central, provincial, and local levels. In the education sector, for example, the Ministry of Education and Ministry of Labor Social Security are not the only actors involved. The Ministry of Personnel, National Development Reform Commission, and other agencies carry out learning programs and policies for various groups. Moreover, the private sector, trade unions, NGOs, and other institutions also provide training and certificates, which are not always integrated with those provided by the Government (World Bank 2007d). Therefore, strong coordination among government agencies as well as between the Government and the private sector and civil society is critical.

Across all areas, coordination could be greatly enhanced by the integration of databases and other mechanisms for sharing information. For example, in the case of UI, sharing information and data across the relevant social protection programs would help strengthen the enforcement of continued eligibility requirements. Stronger linkages with social insurance agencies and the civil affairs department, which is in charge of the urban *dibao* program, would also provide better information on beneficiaries. Information sharing systems would require unified planning and design as well as a sizeable initial investment, but the longer-term payoffs in terms of efficiency would be much greater.

**IV. Conclusions**

China has clearly made tremendous strides in its reform efforts and laid the groundwork for a well-functioning labor ‘market.’ It has put in place a labor market framework spelling out the rights and obligations of workers and employers, adopting regulations that are more consistent with international standards. Social insurance programs have been developed to help workers cope with old age, unemployment, and other shocks and life changes. Greater emphasis is being placed on increasing the mobility of workers, while continuing to help laid-off workers and new labor force entrants gain employment.

This report has proposed some areas in which further efforts are needed to address the remaining challenges. The previous chapters have suggested measures to further promote the integration of the national labor market and help develop sustainable and effective social protection instruments for workers. These efforts need to be coupled with measures to modernize the nation’s education and training systems so as to ensure the longer-term development of a skilled workforce. How well these reforms are tackled will in turn have implications for the well-being of workers, income distribution and poverty, social
stability, competitiveness in the global markets, and hence China’s long-term growth prospects.

It should be noted that labor market reform is oftentimes a long process, involving many stakeholders. Rapid changes can be hard to implement, particularly when they entail adjusting long-standing entitlements and are politically sensitive. Financial resource constraints add to the difficulty, and in a country as large and diverse as China, the challenges are exponentially greater. Under these circumstances, China’s current approach to labor market reform seems prudent: conduct regional pilots to test different approaches and gain experience before full-scale implementation. Sharing of experience across different areas of China as well as continued learning from the experience of other countries will also be important.
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