HISTORICAL DEBT: A CRITICAL ISSUE IN FINANCING POLICY ON UNEMPLOYMENT INSURANCE AND PENSION UNDER ECONOMIC TRANSITION

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Abstract

This paper examines problems in financing pension and unemployment insurance under China's economic transition. Before the economic reform, the state government provided social safety programs that were financed through an economic plan. Contributions to these social programs were implicitly transferred to the State through profit of state-owned-enterprises (SOEs). The economic reform shifts financial responsibility of these programs from the government to enterprises. Because many SOEs are unable to finance pension and unemployment insurance, middle-aged and retired SOE employees lost benefits from those programs although they contributed before the economic reform. This created a historical debt. This paper shows that historical debt is the key to solve financing problems in unemployment insurance and pension. Without wealth redistribution through both central and local governments, a large number of middle-aged and retired SOE employees would become victim of the economic reform.

Introduction

Since 1978 when economic reform began, China's economy has been growing rapidly. From 1981 through 1990, the annual average increase in Gross Domestic Product was 10.1%; from 1991 through 1995, the average increase was 11.6% (China National Statistics Bureau, 1996: p. 30). Although reform has improved considerably the average standard of living, it also profoundly changed the country's industrial structure. State-Owned Enterprises (SOEs) have declined in productivity while other types of

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enterprises (private, collective, foreign investment) have grown dramatically (Tian, 1997: pp. 219-231). Among the enterprises registered at township or higher government levels, SOEs accounted for 72% of total output in 1985, but only 47% in 1995. During the same period, the total share of output by enterprises with foreign investment, including investment from Hong Kong and Taiwan, jumped from almost zero to 16.5% (China National Statistics Bureau, 1996: p. 30).

Implications under such a sharp change in economic structure are far beyond the boundary of economic reform. The political legitimacy has shifted from communist ideology to economic performance (Wu, 1999: p. 1). The unemployment and social security programs discussed in this paper reflects one of many aspects affected by changes of political legitimacy. Under the old socialist regime, financing social safety programs was built into the central planned economy. The political legitimacy was very simple: everyone contributed to the State and the government would take care of everyone through a centrally planned economy. When the political legitimacy is shifted, financing policy for social safety programs was completely changed. The middle-aged and older generations suffered substantially from such a sharp policy shift.

The major policy change in financing social safety programs is shifting financial responsibility from the government into enterprises. Because enterprises owned by private, collective, or foreign investors are new and have much younger employees than SOEs, this policy shift created a heavy burden to SOEs. According to *Xinhua News*, in Shanghai, for every 100 yuan paid to an employee by SOEs, the SOEs must pay 46 yuan for fringe benefits including pension contributions, unemployment insurance, health insurance, housing fund contribution, public transportation restructuring, etc (Zhong and Luo, 1997: p. 1). Management of the government and SOEs in Shanghai is the most efficient in the nation. If SOEs in Shanghai can barely support the social programs, other SOEs across China may not be able to afford such a system at all.

Under the new economic policy, many SOEs are in financial insolventy and unable to support social safety programs for their employees (Li, 1998: pp. 4-7). A large number of middle-aged and older employees are laid off and many retired SOE employees are left without pension (Yang, et al., 1998: p. 213). These people become a vulnerable cohort under the economic reform and fall into poverty under the rapid economic growth. The economic reform and new financing policy in social safety programs, in fact, created a historical debt. Contributions made by these people under the planned economy from 1950 through 1980 are not reflected in the new financing policy for social safety programs. Middle-aged and retired SOE employees strongly feel that they are robbed by the policy shift (Deng and Zhang, 1998: p. 2).

This paper discusses the basic problems of financing unemployment and pension insurance in urban China. It focuses on effects of wealth redistribution under the policy change in financing these programs on middle-aged and retired SOE employees. It points out that it is necessary for both central and local governments to jointly finance social safety programs to eliminate the impact of the historical debt created by economic transition on the middle-aged and retired SOE employees.

Unemployment Insurance

Communist Ideology and Socialist Unemployment

The communist party was developed during the industrial revolution in the 19th century. Marx and Engels observed the industrial revolution in 1840s in England (Engels, 1845 [1987], 1885 [1971], and Marx and Engels, 1953) and developed the communist ideology for a better society (Marx and Engels, 1848 [1992]). Marx and Engels pointed out that under the capitalism, workers were forced to "sell themselves piecemeal" to the bourgeoisie; they "live only so long as they find work, and … find work only so long as their labour increases capital … [They] are consequently exposed to all the vicissitudes of competition, to all the fluctuations of the market" (Marx and Engels, 1848 [1992], p. 9). Under the influence of their theory, a group of socialist countries were established and capital was nationalized and shared by all citizens. The theory predicts that under such a new production relation, labor productivity would be greatly improved and a fast growing economy will be shared equally by all.

In theory, a socialist state provides all citizens with an equal opportunity of working (universal employment), and thus provides everyone with social insurance through universal employment. The theoretical basis of a socialist economy is to let the state allocate resources in production, including human resources. In theory, therefore, unemployment should not exist under a centrally planned economy. But since the planned economy can not compete with the market economy, most socialist countries have reformed their economic systems and introduced market mechanisms. As a result of market adjustment, unemployment appears.

Current Financing Plans to Assist SOE Layoff

Establishing an unemployment insurance program cannot solve unemployment in major industrial cities. In many such cities, SOEs laid off 10% to 30% of the total SOE labor force (China Daily, 1998, Zhong and Luo, 1997: p. 1.). Because SOE layoffs are so extensive, simply pooling SOEs with other enterprises to finance unemployment insurance is equivalent to asking other enterprises to rescue the SOEs. Also, in the planned economy, much of the profits of SOEs were disbursed to other parts of the country via the central government. Now, these SOEs are facing market pressure and need significant adjustment to survive. Should the entire country share the cost of such adjustment?

Current government policy calls for local unemployment insurance programs to assist the unemployed in urban areas. According to the State Council, in 1994 employers paid 0.6% of their total wages for unemployment insurance. If a fund has a surplus or shortage, the local government has the authority to adjust the premium. The maximum rate, however, cannot exceed 1% of total wages (Deng, Zhu, and Song, 1997: pp. 250-264). The redistribution effect of this financing policy is to ask sound firms (both SOEs and non-SOEs) to subsidize weak SOEs. The level of the subsidy depends on the proportion of SOE layoffs in the local area. The higher the proportion of SOE layoffs, the heavier the burden to local business firms.

This financing policy can create unfair competition between enterprises with different levels of unemployment insurance payments. For example, a firm in Shenyang (an old industrial center dominated by SOEs) cannot compete with a similar firm located in Shenzhen (a newly developed coastal industrial region with almost no SOEs). Even if the former is more efficient, because it has to pay more to support the large number of SOE layoffs.

Using local insurance in response to SOE layoffs also increases the gap among regional economies. If economic development in a city is slow, the proportion of SOE layoffs will be higher and the burden to local business heavier. Because firms located in regions with little economic growth will have greater financial burdens than firms in other regions, they cannot compete. This will further slow economic growth and lead to higher levels of unemployment. In addition, heavy taxation will wash out the advantage of low labor cost and discourage investment from other regions and foreign countries.

The current financing policy for unemployment insurance has at least two practical problems in major inland industrial cities where SOE layoffs are extensive. First, the current premium is not nearly enough to cover unemployment benefits. If insurance pays 60% of average local wages to the unemployed and employers pay the maximum amount of premium (1% of their total wage) this only covers 1.7% of all employees. According to the newspaper, *Zhongguo Gongshang Shibao*, SOE layoffs in Shanghai, Shenyang, Fujian, Zhengzhou, and Chengdu account for 14%, 23%, 27.5%, 14.8%, and 20-30% of total employees respectively (Zhong and Luo, 1997: p. 1). Second, compliance rates in these cities are low. Many SOEs have no money to pay for unemployment insurance at all. Based on statistics provided by the Labor Bureau, the national average compliance rate in 1994 was only 88.7% (World Bank, 1996: p. 11). In fact, SOEs that laid-off a large number of employees are also the ones that can not afford unemployment insurance, which makes the insurance program more like a rescue program.

Some Chinese scholars have suggested to use some of the funds obtained from selling the assets of SOEs to assist the unemployed (Hu, 1997: p. 3). The rationale behind this suggestion is that profit created by SOEs during earlier years includes contributions for various social benefit programs. Therefore, workers laid off by SOEs should obtain some money from state owned assets. In 1994, the State Council decided that assets of bankrupt SOEs should be used to assist workers prior to paying any debt. This financing method can reduce the burden of local firms in those major inland industrial cities. But, government revenue from state assets will decline accordingly. Government revenue comes from two major sources: taxes and the return on state assets. When state assets shrink, government revenue will decline unless taxes are increased. The redistribution effect of this financing method depends on who gets the money from selling state assets and how the revenue decline is covered. Usually, funds raised from selling state assets do not go to local governments. When the funds are used for unemployment, government banks are more likely to be the losers because most bankrupt SOEs have a considerable amount of debt accrued from government banks. Therefore, financing assistance to SOE unemployed by selling state assets will indirectly spread the burden to other areas through government banks or other channels.

Policy Considerations

The current unemployment insurance program will be viable and its financial status will be sound only if the SOE unemployed receive financial assistance from the central government. As discussed earlier, SOE layoff is the result of structural adjustment due to the transition from a planned economy to a market system. It is very hard for local governments to handle such large-scale economic adjustment alone. The key question is whether all provinces can agree to the establishment of a national program to assist SOE layoffs. A program financed through the central government can also have negative effects if it is not properly managed. Sending money to cities with large numbers of unemployment may encourage local governments to do nothing but wait for financial aid from the central government, and the number of layoffs may increase when more funds flow in. In additional to other factors, management efficiency and financial capability of local governments are major determinants of economic development. Hence, a multi-dimensional program is needed to assist SOE layoffs during the economic transition.

Many believe that the lack of a functional social insurance program is a major obstacle to SOE reform. This impression is enhanced by many newspaper reports. For instance, Jianqin Zhong and Jun Luo (1997: p. 1) reported statistics from the Ministry of Labor showing that during the 9th Five-Year Plan, 15 million state employees will be laid off. When this is added to the current SOE layoffs (estimated at 15 millions), the total number of SOE layoffs during the 9th Five-Year Plan will be 30 million. This estimate ignores the possibility that the number of layoff may be reduced if the management structure of SOEs is successfully reformed. A typical example is the well-known Wang Yitang event reported by Zhong Guo Ning Nian Bao (1997: p. 2). A county-owned cement factory replaced 12 directors and still lost money. Finally, the county contracted with a private entrepreneur, Wang Yitang, who was once a farmer, and gave him complete control of the factory's management. The factory made a profit of 700,000 yuan in the first year and 2.5 million yuan the next year. He did not layoff any worker and did not even change regulations. He just fired the previous director and 8 associate directors, and strictly enforced existing regulations. Of the 415 factory employees, only about 20 people left the company. They had been previously paid without actually doing any work. This example suggests that if reform is successful in SOEs, actual layoffs may be reduced.

People often think that the lest productive employees are laid off first. Based on the economic theory, if the marginal return of a worker is less than his or her marginal cost, the worker is an extra employee because the firm's profit will be increased if this worker is laid off. Because most SOEs are inefficiently operated, reform may significantly improve their efficiency, increase workers' productivity (marginal return), and reduce the number of unemployed. It should also be kept in mind that those who are laid off first may not be the least productive. It has been observed that the relationship with supervisors is an very important determinant of layoff. If reform goes in the right direction, profit should be used to decide which employee should be laid off first.

Another factor that should be considered when reducing the number of SOE employees is the overall cost to the society. When a worker is laid off, the government has to assist the worker and his family. In this case, even if the worker's marginal return is less than his marginal cost, it is better for both the state and the worker if he can continue to work as long as the lost is less than the cost of unemployment compensation. Of course, in the long run, resources are better allocated if layoffs lead workers to more productive areas.

Another important feature of SOE layoff is its historical background. SOE unemployed concentrate in the middle-aged generation that grew up under the planned economy. Most of them have been assigned to the same job since they started working. When they suddenly lose their jobs, they do not know where to go, what to do, and how to find another job. Industrial workers used to be treated as the leading class. Because losing a job means losing social status, many unemployed workers are deeply depressed.

SOE layoffs and slow economic growth often go together in large industrial cities. Without financial capability, none of the present social programs will be available. It is true that SOEs are not efficiently organized and cannot compete with other types of enterprises, but SOE employees worked very hard to follow each economic plan and contributed a great deal to the nation's economy before the economic reform. And during that period, economic planning, including resource allocation and income distribution, was controlled by the central government. Therefore, SOE layoffs are the cost of national economic reform, rather than a local problem. Should the entire country share the cost? The question has to be answered by the society.

Pension Insurance

Dynamics of Pension Finance

To understand the problems of pension reform, one has to understand the dynamics of pension finance. There are two basic principles for financing pension programs: individual accumulation and pay-as-you-go. Individual accumulation takes the form of mandated personal saving. Regardless of personal preference, all citizens are required to put aside a certain amount of money while they are young and able to work. In the beginning, one's contribution depends on the number of years left before retirement. To obtain the same level of benefit, people who are closer to their retirement have to contribute more. Therefore, a pension completely financed by individual accumulation is feasible only for young people who can gradually increase the coverage as time goes by. The pay-as-you-go system is a quick-fix method to initiate a pension program. Unlike individual accumulation, pay-as-you-go does not require accumulation; it simply pays the retired by taxing the working population. Therefore, it can immediately cover the entire retired population.

A special feature of pay-as-you-go financing is that almost all adults benefit from the new program, especially those who are close to age 65 or older and no one is worse off. The system would reach its stable status after the cohort of age 21 die. Then, the new system financed by the pay-as-you-go method would become the same as the one financed by individual accumulations. Because most adults are better off and no one is worse off, a pay-as-you-go pension plan is easily accepted in a democratic country.

However, if the government wants to change from a pay-as-you-go pension plan back to the original one financed by individual accumulation, the redistribution nature would be just the opposite. During the transition to individual accumulation, all adults, especially older people, will lose and no one will benefit. Older people do not have enough personal savings and would have to reduce consumption considerably. The aggregate impact on the economy would be that consumption decreases and saving increases. When the entire working generation dies, the system would reach stable status. The implication of changing from pay-as-you-go to individual accumulation is that the public debt owed by the next generation to the current generation would not be honored.

Reform and Policy Consideration

The financing method used for the previous pension program in SOEs is equivalent to the pay-as-you-go plan outlined above. The principle of the current reform of pension finance is to transfer from that system to individual accumulation. As pointed out in the previous section, this change involves the problem of public debt. The currently retired and employees in middle age or older have contributed a great deal of their lifetime income to support the people who retired before them. Now they will have to take care of themselves. To ease this problem, the current reform includes a social pooling plan to pay the currently retired with savings acquired from the young.

There are three basic problems under the previous pension system in SOEs. First, unlike other pay-as-you-go systems, the previous pension finance does not have a clear accounting of the contributions, distributions, and balances. Pensions are distributed through the payroll account and retired persons receive their pensions from the company they last worked for before retirement. When SOEs accept financial self-responsibility, they also have to pay the pension of people who retired from them. As a result of the financial self-responsibility principle and the old payment method, the previous pension finance after the economic reform becomes a company-based pay-as-you-go system. If a company loses money, it cannot pay any pensions. If a company is very old and has a large number of retired employees, the working employees in that company will have very heavy burden for their pension program.

The second problem with this system is the rapid growth of non-state-owned enterprises. Before economic reform, SOEs accounted for 99% of industrial production. From 1985 through 1995, production of foreign and joint owned enterprises grew from 0% to 16.5% (China National Statistics Bureau, 1997: p. 30). Most foreign and jointed owned enterprises are new and hire young people. As the ratio of retired to working employees in SOEs increases along with the shrinkage of SOE production. Thus, the burden on SOE employees is incrementally heavier than before. The third problem is the increasing proportion of the aging population. Due to family planning and an increase in life expectancy, the ratio of the retired to the working is rising significantly. Pay-as-you-go financing will place a heavy burden on future generations as the population grows older.

Of the three problems, only the last one is related to the pay-as-you-go financing method. It is caused by the aging population rather than by economic reform. Even the aging problem can be solved by gradually increasing accumulations in the pension fund. For instance, the U.S. pension system is financed by pay-as-you-go. Realizing the problem caused by an aging population, the Congress passed a law in 1983 that increased pension taxes and extended the retirement age from 65 to 67. Its financing method is still pay as you go and no dramatic change is needed. Because China's pension program only exists in SOEs and government agencies, however, more than 80% of the population still depends on family to support the elderly. Therefore, the problem of the aging population will not be as serious as in a country with a universal pension program.

To solve the first two problems of the previous pension program, retired employees will have to be separated from enterprises. If the pension financing pool is based on a community such as a city, the entire working population should be included to finance the system. A program such as that can be financed by a community-based pay as you go method. However, the current policy in State Council Document 6 of March 1995, provides two basic plans for local authorities to choose from. Both plans involve individual accounts and social pooling, although they are organized in different ways.

The first plan, designed by the State Commission for Economic Restructuring of Economic Systems, emphasizes individual accounts. All new workers will use individual accounts for their pension and a social pool would be responsible for pensions for those already retired and current workers not fully covered by individual accounts. Contributions into individual accounts would be approximately 16% of total wages and would consist of three parts: (1) an individual contribution of 3% of total wages; (2) an enterprise contribution of 8% of each worker's wages; and (3) an enterprise contribution of 5% of the average local wage (World Bank, 1996: pp. 96-99).

The second plan is based on the previous model developed by the Ministry of Labor, which focuses more on social pooling than on individual accounts. The basic pension insurance premium would be paid by both enterprises and workers, according to a proportion to be decided by local governments. Part of the pension funds will be contributed to individual accounts. For those whose payment period is longer than 10 years, the pension will be granted as follows: (1) social pension which equal 20-25% of local average wage, (2) premium pension which is about 1.0-1.4% of basic wage figures, and (3) all money in individual accounts (World Bank, 1996: pp. 100-102).

In principle, both plans combine social pooling with individual accounts so that the pension finance will be eventually transferred into individual accounts. Rather than reducing the burden on SOEs, this policy, in fact, doubled the SOEs' financial responsibilities. In additional to providing pensions for retired workers, SOEs now have to contribute to individual accounts. In most industrial cities, enterprises contribute from 20% to 30% of total wage and workers contribute 3% to 5% of their own wage (World Bank, 1996: pp. 9-10). If 16% of total wages is deposited into individual accounts, the social pooling will not be enough. In this case, many local insurance programs use the money in individual accounts to pay those currently retired. Individual accounts thus soon become empty accounts.

The major advantage of individual accounts disappears when they become empty. First, there will be no return from individual accounts. The promised interest from individual accounts will have to be paid by future contributions. Moreover, individual accounts will reduce personal savings because workers feel that they have already have their pension saved. Also, There will be less saving flowing into investment, which in turn may slow economic growth and increase the burden on future generations. With empty individual accounts, the financing method of pension insurance is equivalent to a pay-as-you-go system.

The World Bank has made feasible suggestions for reforming the pension system (World Bank, 1996: pp. 43-45). In 1996, a World Bank investigation team suggested that the pension system should consist of three pillars. The first pillar is completely financed by employers and controlled by the government. Its benefit is equal to the poverty level. Since many non-state-owned enterprises do not have retired employees, the World Bank team estimates that this part of pension would cost about 9% of total wages. The second pillar is mandated individual accounts jointly financed by employers and workers at 8% of individual's wage. This is only half of current contribution to individual accounts. Because the contribution to the social pooling is less than before, enterprises should be able to afford it. The most important feature for individual accounts is full accumulation. The entire fund in individual accounts should be fully invested in holdings with sound return. Individual accounts can smooth the financial problem caused by the aging population. With good returns, 8% of a worker's wage in 40 years can be a considerable amount of money for retirement. The third pillar is any complementary program provided by employers.

The World Bank plan has two important features. First, the first two pillars include all workers into the plan so that contributions to the basic plan (the first pillar) from enterprises with large numbers of retired workers are considerably reduced and become affordable to them. The second feature is that the benefit of the basic plan is reduced to poverty level, which also reduces the burden to all employers. The World Bank plan, however, does not consider how SOEs with serious financial problems will pay for the pension. Many SOEs are close to bankruptcy and have no money to pay any pensions. In many inland industrial cities, about 20% of SOE employees have been laid off and receive no pension from their enterprises. According to the World Bank report, in 1996, the compliance rate in Beijing and Tianjin is 95%, Shanghai is 90%, Shenyang and Changchun are 80% and 76.9% respectively, Chongqing is the lowest, only 70.2% (World Bank, 1996: p. 11). Therefore, even following the World Bank plan, local governments must subsidize the basic plan for some employees so that they can obtain at least poverty level of financial assistance when they retire.

Conclusion

This article discusses the relationship between financing methods and two common social safety programs: unemployment and pension insurance. Almost every social safety plan contains two features: welfare and insurance. If a plan is more like welfare, its collecting principle is often based on income, reflecting redistribution from the rich to the poor. If a plan is more like insurance, its premiums should follow the risk levels of individual workers. The riskier the person, the higher the premium. Many economic disasters are insured through the market and carried out by private insurance companies. Some events, however, cannot be insured through the market because charging insurance premiums according to personal risk level conflicts with the moral standards of society. A person with chronic medical problems is riskier than a healthy person. If following the insurance principle, sick people pay a higher premium, this creates a situation that is unacceptable in many societies. Hence, many governments either provide a national health insurance program, or strictly regulate private health insurance so that sick people are not excluded. As society's moral standard is closely related to a country's cultural and historical background, so is the financing principle of social safety programs.

The difficulty with China's social safety programs comes from a special historical background, which is the 30-year experience of trying to establish a socialist country. From 1949 through 1978, China's resource allocation in production, distribution, and social programs followed a central plan. Individual contributions to social programs such as pension and unemployment insurance were implicitly transferred to the state through profit of SOEs and benefits were carried out by state programs financed through government budgets. Therefore, it is very important for the government to back up the historical debt to the middle-aged and retired SOE employees in the new financing policy in such programs. This has been ignored in the last decade when SOEs started reform in the middle of 1980s.

The problem has become very intensive recently in many large industrial cities when the number of SOE unemployed is increasing dramatically. Together with corruptions in SOE management, inadequate assistance to the SOE unemployed and retirees becomes a major factor in political instability. The problem of historical debt in financing social programs has been realized by the central government recently. In 1997, the State Council had a special meeting on SOE lay off. A new financing policy on SOE unemployed request three sources to assist the SOE unemployed: 1) government, 2) enterprise, and 3) community. The government will assist the SOE unemployed through a government budgeted fund. For some cities where the proportion of SOE layoff is very high, the central government may help some. The community help comes from unemployment insurance programs (Gu, 1998: pp. 64-82). With such a policy, assisting SOE unemployed become more feasible and wealth redistribution due to the historical debt may be reduced.

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Biographical Sketch

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