

Policy Implications of Informality in Chinese Labor Market

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Abstract

In this study, the informality of labor market in China is explored. We follow the evidences to analyze the relation between informality, structural economic changes and large economic shocks. While the residency policies of the late 1950's led drastic problems in labor market and made migrant workers a significant part of informal employment, we claim that the aggressive growth policies are the major cause of structural breaks in labor market. In order to achieve faster growth rates by fostering the international trade, the government has accelerated the industrialization process. In this regard, the fast urbanization and regulation of the internal migration are the main effects of these structural changes on markets as well as the causes of the informality in labor market. The 2008 crisis has been enforcing China to change existing economic policies, including the ones related labor market. Our analysis leads us to discuss potential policy changes that require rearrangements of government's regulations. We conclude that regulations should be less in number but should be strongly supported by efficient institutions.

Keywords: Institutions, informality, labor market, international trade, regulation

INTRODUCTION

China, the once closed giant country has experienced a rapid economic growth, and gained worldwide capitalist ambitions. The strong political system, vast natural resources and abundance of skilled labor in China have transformed it into a modern global factory. A lot of structural changes affecting the social, cultural and economic life are following the big transformation of trade openness decision of 1978. China seems like to be a role model for other developing countries with its shockingly increasing income per capita (from \$540 in 1995 to \$7380 current US\$ in 2014), life expectancy at birth (from 70 in 1995 to 75 in 2014), and primary school enrollment rates (from 104 in 1995 to 126 in 2014)¹. However, the cost of this growth is felt in many respects. This study offers an analysis on one of these changes, increasing informal employment. It aims to analyze the causes of informality and discusses its effects on economy. Especially after the 2008 crisis, the increase of informal employment brings new policy challenges. The analysis in this paper emphasizes the importance of effective regulation and the requirement for strong institutions. The study is limited with finding the reliable data on informality in China. Accepting the difficulties in finding the correct measures, this study examines the literature for evidences to analyze the extent of informal employment in China. In that respect, the study may appeal to readers who have

interests on regulations and development policies, the effects of trade and fast urbanization as well as Chinese economy.

The structural changes of the Chinese labor market cover a variety of issues such as labor market participation, part time employment, the working hours, work efforts and wages. Indeed, labor markets of transition and developing economies have some common characteristics such as labor market informality resulting from the decline of the state sector, and rapid structural change and urbanization which is accompanied by large internal rural labor migration to urban areas. Without differentiating the productivity and legalistic definitions that exist in the literature (Husmanns 2004 and Saavedra et al. 1999), we follow the definition of informality given by International Labor Organization in 2002. In that sense, informal employment has features such as lack of protection in the event of non-payment of wages, compulsory overtime or extra shifts, lay-offs without notice or compensation, unsafe working conditions and the absence of social benefits such as pensions, sick pay and health insurance.

The economic crises put enormous pressure on the system to respond and adjust to an unexpected decrease in labor demand. These crises challenge the economy to acquire knowledge on how to respond to adversity and to question how economic growth can cure poverty. In

¹ Source: <http://databank.worldbank.org>

this study, we aim to understand how fast growth and significant economic downturns in the rest of the world pressures on the labor markets.

The Chinese Labor Market

The annual GDP growth of China which makes it a model for other transition and developing economies has been significantly greater than the world's average over last 50 year. (Figure 1) The significant share of exports in GDP strongly suggests the trade as the main engine of Chinese economic growth. (Figure 2) The unemployment rates that had uprising trends in late 1990's have been decreasing between 2003 and 2010. (Figure 3) However, unemployment was 4.6 percent in 2014.

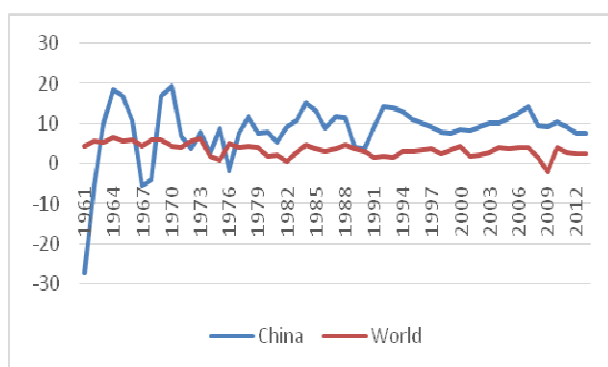


Figure 1 Annual Growth Rates since 1961

Source: <http://databank.worldbank.org>

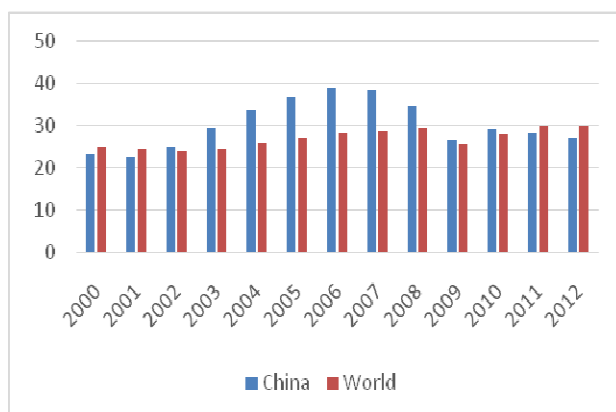


Figure 2 Exports of Goods and Services as percentage of GDP

Source: <http://databank.worldbank.org>

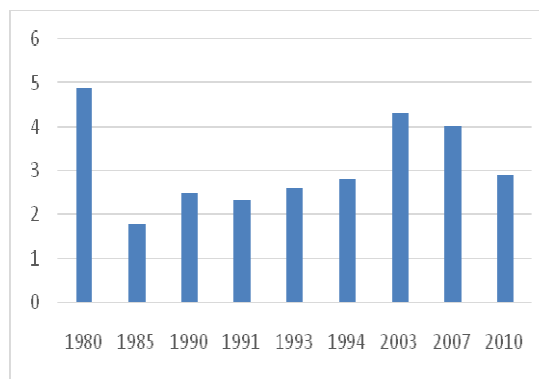


Figure 3 China's Total Unemployment (% of total labor force)

Source: *China Labor Statistical Year Book, 2014*

Park and Cai (2011) offer four complementary explanations to define missing workers: First, many missing workers are the ones who work in private sector but poorly are monitored, including self-employed workers who are not recorded with or certified by an official association. Second, most of the missing workers might be migrant workers who are hired on an informal basis or are self-employed and attempt to escape from paying taxes. Third, retired workers or re-employed workers who are dismissed and likely to be hired on an informal and temporary basis, even they are hired by government departments or state-owned companies. Fourth, many of the missing workers may work in the third rank where economic output has been statistically underestimated.

The urban labor market in China was varied and diversified in the late 1990s. The reduction of collective and state sectors was one of the most noticeable changes. The state-owned enterprises had actually reached their maximum number between 1990 and 1994. Official employment statistics show that the state-owned enterprise sectors declined from 1995 to 2000 so that 15 percent of the urban labor force and 31.5 million jobs had been lost. The collective sector had even begun falling earlier causing 16.5 million job losses lost from 1995 to 2000. As a result, employment in the state and collective sector fell from 76 percent in 1995 to 41 percent in 2000 and to only 27 percent in 2005. The employment increased notably in the private sector and limited liability corporations. The other workers who can be called missing workers since they reflect differences in the numbers of workers reported through different statistical reporting systems witnessed the fastest rate of growth, by 24 percent per year. 10.8 percent of the Chinese population did not get a residence permit to legally reside in their country, according to the information in a 2000 census which is thought to be a more accurate statistic of long-term

migrants. Therefore, migrants in urban areas are probably undercounted in labor force surveys and annual populations of China. Moreover, these migrants are more likely to work in the informal sector. In that case, estimates fall short in explaining the informal employment. Informal employment is characterized by a lack of stability or security. It is often temporary and usually includes the lack of a formal contract, no social insurance benefits and no other worker protections. (China Statistical Yearbooks, various years)

Kuruvilla et.al. (2011) report that the employers' contribution to payroll taxes for unemployment insurance, medical insurance, pensions etc. was almost 36.5 percent of wages in Shanghai, in 2004. If economic activity can be hidden from authorities, then taxes can be avoided. This is especially true for the self-employed or for small, private enterprises. In this regard, employees in China have a strong incentive not to sign labor contracts with workers and not to denounce other employees like themselves. Since the on-going process of monitoring working conditions is not successful and employers are not willing to register their employees, informal employment increases continuously.

Migration and Hukou System

The changing economic structure and rapid industrialization has been accompanied by massive migration rates in China. Although the Chinese government has tried to control the internal mobility of the population by enforcing a registration policy, named Hukou system, Chan (2013) points the volume of rural-urban migration between 1979 and 2009 as the largest in human history. Hukou system restricts the migrants to live in cities without local household registration. Those who are lack of Hukou status local cannot access to educational resources, social welfare programs and formal jobs. (Liang and Ma, 2004) However, it is not easy to claim that the system was successful. 40% of the total urban labor force was estimated as migrant workers by 2006.² Cai and Wang (2010) suggest that there exist a sharp occupational segregation between migrants and local residents. The share of migrant workers in public sector is low and most of the migrant workers are self-employed. Although the Hukou system, starting at 1958, aimed to provide support to agricultural production as well as industrial sector in cities by restricting the number of migrants who were allocated with jobs, housing and other necessities by government, the migrants were influenced by positive factors in

cities, such as expected earning opportunities, personal development aspirations and urban lifestyle, or negative factors in rural areas including labor surplus and difficult living conditions. Indeed these factors had positive impact on women's decision to migration and to join the workforce formally or informally. Rural-urban migration in China can be depicted in two ways: First type of migration is related to macro and socio-economic structure; essentially a movement from the interior to coastal towns or from western areas to eastern areas. Secondly, most migrants move from rural areas where farming is practiced to urban areas for non-agricultural activities.

There were an estimated 229.8 million rural migrant workers in China according to national statistics, by the end of 2009. 145.3 million rural migrant workers worked outside of their hometowns for over six months and 84.5 million worked within their hometowns for six months. 70 percent of migrant workers work in China's eastern regions with two thirds of them working in large cities and half of them moving between rural and urban areas. Rural migrant labors are an important and integral part of industrial areas in China. (IPLE Project Group 2007, mini-census data.)

Informal employment of permanent residents in urban China

Chinese economy has been evolving for almost 30 years and the labor market is transforming from one state into another. Today, there is no third party to organize the relation between employer and employee in China. (Park and Cai, 2011) It is accepted as a way to achieve a stable employment structure. The labor law enacted both in 1993 and in 2008 shows the importance of the contract. An employee has the right to end the labor relation if his employer does not provide the worker with a social insurance according to the labor contract law in 2008. However, the law does not work in practice. Although the employer rejects payment for the social insurance for the employee, it is common that a job with a formal contract stays stable. Employees want neither to lose their jobs, nor to deal with legal processes.

Due to the lack of enforcement by government, employers and employees decide on whether or not to participate in social insurance plans in their self-interest. It is not surprising that rural migrants have little positive motivation to participate in a social insurance plan, because the scope of social security provided and risks covered are generally restricted to local residents.

The improvement of social security systems started in 1980. Today, social pension is 70% of total social

² "Decent Work, Employment and Poverty Reduction in Urban China". Institute of International Labour Studies, MoLSS and the International Labour Organization. March 2006.

insurance accounts. (Dorfman et. al. 2013) Before the aggressive reform by the end of 1990s, state-owned enterprises were paying pension for their pensioned workers. Nevertheless, more and more state-owned enterprises stopped paying pension for their retired employee due to the financial difficulties resulting from the transition period. The Government has tried to encourage social insurance systems to replace the insufficient private pension system. Therefore, every province and municipality city was authorized to choose their pension system. In the majority of provinces, local authority was given the right to make decisions regarding their own pension systems, without the need for permission. This institutional act has caused a severe problem for migrants to join the social pension system, because an employee's pension system could not be easily transferred from one city to another. However, migrants who live in non-urban areas have much higher mobility in the labor market than the local residents. Therefore, rural migrant workers have preferred not to contribute to pension accounts and stayed out of the scope of protection provided by a contract. The entrepreneurs who started small enterprises and hired rural migrant employees to reduce the costs also had no incentive to contribute in pension system. Most dramatically, local authorities have tolerated them in order to appeal to the interest of enterprises and investors from other regions.

In fact, the pensions constitute two parts: workers add to personal accounts and enterprise adds to social accounts. About 20% of the total salary is the share of enterprise's contribution and about the 8% of the salary is the personal contribution. In other words, employers save 20% in wages and gain 8% in salary if they do not contribute the system. As a result, local governments also have a positive motivation to allow rural migrant workers to withdraw from social pension systems when they go away from certain work or places.³

Regional segregation of the social pension system is the main reason why there are differences between local resident employees and rural migrant employees. The significant difference in the magnitude and type of social insurance carried by the two subordinate groups of population cause a significant difference in defining and measuring the level of informal employment. As the state-owned enterprises left the markets, more than 60 million of employees were dismissed⁴. Government tended to incite social insurance funds to support these people. Although a survey of data whether a re-

employed worker have social insurance or not, is available in China Population and Labor Yearbook, the questionnaire is not clear enough to know whether it is government or the employers who contribute for the workers' social insurance cover.

Changing Family Structure and Employment in China

Several dramatic changes can be observed in family structures among working age in urban China between 1988 and 1995.⁵ For example, the proportion of female household heads has increased from 6.13% to 26.33%, while male household heads has increased from 2.78% to 23.96%. The proportion of children in the population has decreased. There was a small decline in the male employment rates of household heads. At the same time, there was a large rise in the male employment rate in terms of the spouse of the household head. As of 2014, under the current law, men retire at 60, women retire at 50 and the retirement age on the average is 53 where the average life expectancy is 75. However, two retirement systems, one formal and one informal can be observed: In the formal system, urban employees receive generous pensions and face mandatory retirement by age 60, and in the informal system, rural or urban, migrants or residents in the informal sector rely on family support in old age and have much longer working lives. (Giles et al., 2011)

China in International Trade

The effects of international trade on economic growth and productivity in particular, have been studied in the literature for several decades. Sun and Heshmati (2010) show that internationally active countries are likely to be more productive than closed countries. It is widely agreed on that international trade expands the markets so that firms who export products may increase their profits, increases the product variety so that consumers may attain higher quality and lower prices, bring the efficiency to the resource use so that the total output increases and accelerates the spread of the knowledge so that technological improvements are achieved in a shorter time period homogenously all around the world. The role of international trade on economic growth is empirically and theoretically proven. Cases of growth experienced by East Asian or Chinese economies are strong examples.

With Deng Xiaoping's open door policy in December 1978, China opened to the capitalist economy on such a large scale with a set of policies concerning foreign trade, foreign borrowing and direct foreign investment. The first step China took was to attract the foreign

³ See <http://www.chinalawblog.com/2013/11/china-employer-taxes-employee-taxes-are-we-having-fun-yet.html>

⁴ See the China Population and Labor Yearbook, calculations according to labor yearbook.

⁵ <http://data.worldbank.org>

investment by bringing economic zones in southern China with some incentives such as tax reduction of one or more tax rates and encouraging lower wages. In 2008, The World Bank data shows that 45 percent of growth was from exports. Total foreign trade in China was \$2.17 trillion which was only \$21 billion in 1978. Over these years, China made 21 percent contribution to global trade growth.

Taking the advantage of its massive population and labor force, and protecting its domestic industries from foreign competition, Chinese trade has been intensively focusing in export sectors. Unfortunately, although international trade creates a lot of surplus for the overall economy, the transformation of the resources from some sectors into others are not easy. Especially in the short run, import-competing sectors experience a lot of troubles. The resources are reallocated by the international trade. Whenever the reallocation is not subject to special constraints it does not create homogenous results. The income inequality may worsen in the economy. The Chinese labor force has been expanded rapidly. However, with extremely competitive and aggressive growth policies in labor market, informality and abuse of workers became inevitable. We claim that increasing demand on unskilled labor and high competition in labor supply and uncontrolled working environments created a pervasive labor market.

China has had advantages of international trade which have helped it to become a very important economic power in the world as a result. On the other hand, it has faced many serious problems like rising poverty and unemployment that resulted from fast growth.

CONCLUSION

On the basis of the above findings, we conclude that the Chinese labor market which is moving towards to a free market mechanism is more and more in need of strong institutions controlling working conditions. The percentage of the labor force that is employed in state-owned sector is decreasing. People increasingly work in secondary occupations and even look for a job after retirement. However, it seems that the process of change has not been completed. The majority of workers still find their jobs by means of government assignment. Workers work fewer hours in the state-owned sectors and get higher compensations. Wage differences among different professions in state-owned sector are less than that in the private sectors. Aggressive growth policies which enforce producers to extremely reduce the costs make the private sector more inefficient. Workers work much longer hours.

We claim that labor market reforms have to be supported by other institutional changes. The biggest difficulties in having a complete labor market is the large share of publicly owned sectors in the economy, lack of control mechanisms regarding the working environment, weak supports provided to rural areas and fast urbanization. It is crucial for the Chinese government to make more reforms on ownership structures. Such reforms should focus on possession of company's legal claims. Also it should withdraw from labor market interactions in small stages and over a long period of time, rather than suddenly.

The big difference between local residents and rural migrant is noticeable. Most of the employment can be seen as informal. In rural migrants, regarding social insurance standard, the share became greater in number and increase.

Economic development and wage increase can improve the conditions. However, rural migrants cannot deal with the institutional problems which enforce them to accept working in poor conditions; bad occupations or undesirable professions and make them to stay in urban areas for a long time as only migrants. The rural migrants refuse to make contributions to social insurance systems since they do not have positive expectation to benefit from the contribution. The rural migrants should be encouraged to integrate the urban life by the government. In addition to this, the social insurance's coverage level should be increased all over the country to encourage rural migrants to make contribution. The general development towards informality in China has changed since China's marketization reform started. Not only urban economic restructuring but also the rural migration is added to urban labor market informality. Nevertheless, it is not easy to measure informality because of data limitations. In an alternative way, the difference between total employment and unit employment published data by NBS could be estimated as informal employment which is recommended by Cai and Wang (2010). Nonetheless, there is no micro level national information or facts to measure the overall size of informal employment in urban labor market or to perceive the difference among its components.

The Chinese economy feels the effect of crisis more today by having the lowest growth rate of last 25 years. The authorities realize that the export dependent economy is not easy to manage regarding the possible demand decreases of trading partners. Offering only modest quality with lower prices will not be enough. Its economic ambitions forces China to transform its economy into full market economy. Population is aging

with single child policy. Having higher incomes and lower competition in labor supply, workers will not be ready to accept poor working conditions. Indeed many of skilled workers have already started to leave their countries. Therefore, we claim that it should be the priority of the Chinese government to reduce the informality in the labor market so that human capital may be accumulated and the producers may focus on producing higher quality goods with lower prices. Moreover, as the purchasing power of the workers increases, the dependency to the foreign demand can be expected to decrease as the Chinese government aims.

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