LABOR

THE STORY SO FAR

From the birth of the People's Republic of China in 1949 to 2015, China's working-age population grew by 600 million people: it is little wonder economic output expanded. Today, the size of the workforce is shrinking, so improving both its quality and mobility is critical for longer-term competitiveness. The share of Chinese people living in cities is also slated to rise to 60% by 2020, up from 36% in 2000, increasing fiscal pressure on local governments to deliver social services while adding huge additional economic growth potential. China's 2013 Third Plenum called for labor policy reforms to boost job creation and entrepreneurship, discourage discrimination and labor abuse, improve income distribution, fund social security and pensions, and enhance health care and education.

- In July 2014, Communist Party authorities issued an opinion that called for relaxing the burdensome restraints on individuals who wished to move and change their residency (the household registration, or *hukou*, system). This new policy eased controls for those wishing to move to smaller cities while leaving in place more restrictive measures for bigger cities. Policymakers also planned to set up a nationwide residency permit system to ease and standardize the process of relocating.

- In December 2015, the central government established that anyone living in one locality for six months could apply for a residency permit and thus gain access to basic social services. The measure softened the division between rural and urban *hukou* and laid the basic foundation for the eventual abolishment of the *hukou* system.

- In August 2016, the State Council recommended fiscal support to incentivize urbanization and provide social services based on the newly established residency permit system. The volume of support and its effectiveness in aiding urbanization are still unclear.

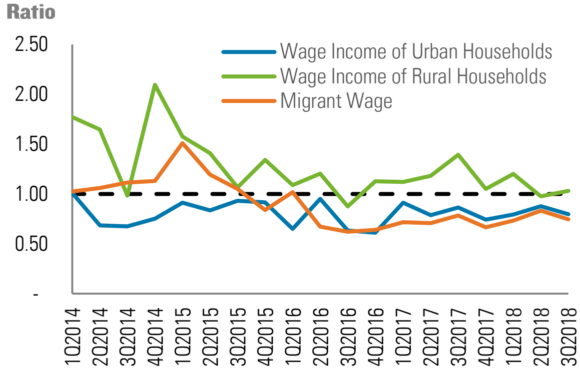
- The State Council announced that it would share more social expenditures with localities at the start of 2019. Local governments have long shouldered a disproportionate share of overall government spending while suffering from weak sources of revenue. This measure should help bridge the gap and shore up funding for important social services.

METHODOLOGY

*To assess progress in China's labor policy reforms, we chart wage growth for the less-empowered segment of China's workforce, those most likely to bottleneck the country's productivity potential:*migrant workers*. Working away from home in temporary and low-skilled jobs, and with little access to urban social services, migrant workers supported China's growth miracle but find themselves increasingly vulnerable to structural changes. Our primary indicator charts the growth rate of migrant worker wages relative to the GDP growth rate. Wage growth below GDP growth suggests falling productivity, inadequate workforce policy support, or both. The wage/GDP growth trend for other segments of the workforce is included. Divergence in income gains between segments can lead to social unrest, as can downward trends impacting all segments simultaneously. Our supplementary indicators look at job creation, labor market demand and supply conditions, urban-rural income gaps, and social spending relevant to labor outcomes.*

QUARTERLY ASSESSMENT AND OUTLOOK

Primary Indicator: Wage Growth Relative to GDP



Source: National Bureau of Statistics, Rhodium Group.

- Our assessment of labor and shared welfare reform is negative—even more so than in the previous quarter—as Beijing did not sustain improvement from the last review period and labor conditions will likely further decline.

- Migrant and urban wage growth weakened compared to GDP, alongside mounting labor shortages across the country, and a decline in government social spending.

- Beijing modestly reduced employee-related expenses for companies, as well as the costs of early education and basic medications for households. These will help improve social welfare at the margins, but they will do little to address the larger sources of labor market dislocation and inequality.

THIS QUARTER'S NUMBERS

Despite several new policies advanced in 3Q2018, our indicators suggest that authorities did not improve labor's share of income in the economy in line with 2013

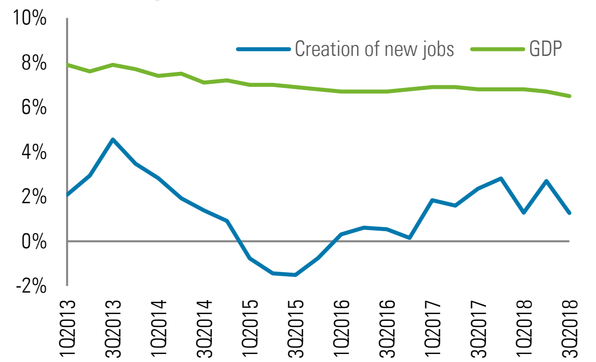
Third Plenum goals. Growth in migrant wages as a ratio of GDP growth, our primary indicator of Beijing's success in encouraging labor mobility and employment opportunities, declined from 0.83 to 0.75. In other words, migrant worker wage growth was 25% lower than GDP growth in 3Q2018. The wages of urban workers, the largest section of the labor market and particularly important for the health of consumption, were also weak, dropping from 88% to 80% of GDP growth – even in an era of moderating GDP. Stronger rural wages would indicate that policies were helping to equalize the development gap between cities and the countryside. However, rural employment income only saw a small recovery in 3Q2018, which did little to offset the consistent slowdown over the previous six quarters.

Supplemental indicators suggest a disconnect between job supply and the availability of qualified candidates. New employment continued to grow more slowly than real GDP, with the pickup of 2.7% year-on-year in 2Q2018 declining to 1.3% in 3Q2018 (see **Job Creation**). Weaker employment did not result from a lack of job openings, but rather the inability or unwillingness of applicants to assume those positions. For cities across China, the ratio of job openings to job applicants spiked, with all three regions seeing nearly the highest imbalances on record (see **Labor Demand-Supply Ratio**). In an efficient market, persistent labor shortages should cause wages to rise, and there were tentative signs of improvement in the previous two quarters. The decline in wages in 3Q2018, however, suggests structural problems. There are two likely contributors. The first is *hukou* (household registration) restrictions, which still prevent qualified applicants from relocating to fill new jobs. The second, related contributor, is that candidates in local labor markets lack the skills required for available positions.

Data show that the government is not spending enough to address these challenges, as fiscal expenditures are actually weakening (see **Social Spending**). Government social spending as a percentage of GDP declined in the first half of the year, a trend that continued in 3Q2018. Education spending dropped compared to 3Q2017, a concerning development given the increasing demand for skilled workers. Spending on social security, employment, and health and family planning declined in both year-on-year and quarter-on-quarter terms. Weaker spending is in part due to the ongoing campaign to cut local government and corporate debt, which has also caused companies to lay off workers and reduce wages. The unfortunate result of these two outcomes is that 3Q2018 government assistance was pared down precisely as the need for such assistance grew. The slowdown in transfer income received by urban households reflects this, growing by the slowest level in five years at 8%. If authorities do not act to bolster government spending, risks to the labor market, consumer spending, and the broader economy will increase.

Supplemental 1: New Job Creation

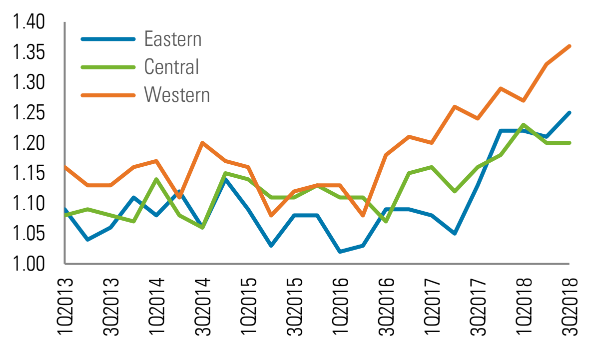
Year-over-year growth



Source: Ministry of Human Resources and Social Security, National Bureau of Statistics.

Supplemental 2: Labor Demand-Supply Ratio

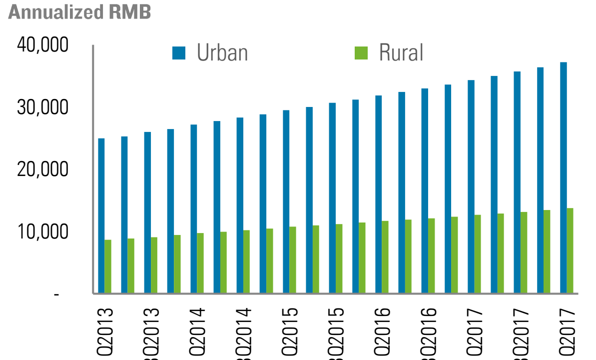
Job openings per applicant



Source: Ministry of Human Resources and Social Security.

Supplemental 3: Rural-Urban Household Income

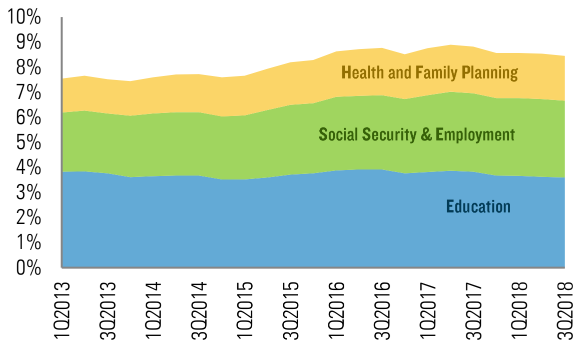
Annualized RMB



Source: National Bureau of Statistics.

Supplemental 4: Government Social Expenditures

4qma, percent



Source: National Bureau of Statistics, Ministry of Finance.

POLICY ANALYSIS

Beijing made only modest changes to labor-related policies, which did not significantly address growing employee-related costs for companies or the affordability and accessibility of important social services. The most important policy development was a State Council announcement on December 5 that would seek to stabilize employment by providing vocational training, subsidizing entrepreneurship, and refunding 50% of funds that companies pay for unemployment insurance. The last measure is meant to ease the growing financial burden on small- and medium-sized firms, which now face a more thorough collection of social security contributions.

Chinese companies are required to pay only 1% of their employees' salaries as unemployment insurance. Other costs are much steeper: contributions for pensions, for example, must equal 19% of salaries. Credible estimates from domestic think tanks argue that government would need to reduce social security contribution costs by 6 to 9 percentage points to offset the impact of enhanced collection methods. However, local governments desperately need more revenue (see Fiscal Affairs) to make up for the shortfall in social security funds. In the short term, this is an unresolvable dilemma, which is a major factor in our negative assessment. Beijing will have to decide whether to ease the contribution burden on companies, which will allow for stronger employment and wages, or to ensure sufficient funding of the pension system, which will help sustain this program in the long term. The current policy mix prioritizes the latter and, if left unchanged, will weaken labor conditions in 2019.

Ensuring affordable access to early education is vital for both child development and the productivity of China's future labor force. In pursuit of this goal, Beijing issued preschool regulations aiming to increase the share of kindergartens following government pricing guidance to 80% by 2020 from less than 60% this year. While this policy will likely achieve its goal of reducing tuition costs, it will also limit private fundraising for these schools. It is unclear how policymakers plan to make up the difference in funding, given the declining level of spending on education over the past year.

In another move to lower costs of living, officials approved a plan to centralize the procurement of basic medications. While good intentions may have been behind this move, the policy will more likely have a negative impact on healthcare services. Intervention to improve consumer bargaining power may reduce prices in the short term, but at the long-term expense of the industry's efficiency. The plan will cover 11 cities that account for up to 50% of China's total demand for basic medications, and some medications saw price reductions of up to 90%. The extent of this reduction and central control over the bidding process will likely decrease the willingness of domestic and foreign companies to invest in pharmaceutical markets.