

**The Razor's Edge of China's Gradual Reform: A Perspective of Labor's  
Misalignment with Industrial Development**

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China has achieved rapid economic growth in recent decades thanks to its market reforms which enabled it to develop an export-oriented labor-intensive manufacturing sector. A huge amount of rural labor moving *smoothly* into urban areas, engaged in manufacturing productions especially in the non-state sectors, have contributed to the successful structural changes. Along with this labor mobility, China has adopted gradualist approach in reform partly because the power was shared among those who supported market and those who supported state plans. Therefore, China's reform path was a result of compromise between these two groups. Many of the unique things in China's market reform, including township enterprises without clear ownership and the double-track pricing systems, were the result of China's special political environment rather than the economic system.<sup>1</sup>

After 34 years of economic reforms and fast growth, China has become a great economic power, overtaking Japan as the second largest economic entity, overtaking Germany as the world's largest exporter, and overtaking the U.S. as the world's largest industrial producer. China may become the world's largest economic entity measured by GDP as early as 2018. However, below the surface of China's success and glory, there are many challenges and constraints that the country has to face in the coming decades, such as widening income inequality, state monopoly, continuing rural-urban divide, sluggish progress in poverty elimination, to name a few of the challenges. And as for sustaining labor-intensive production, an effective and more market-friendly employment system has to be implemented. If labor market fails to be fully integrated in national industrial structure, then the slowing down or even a stop of economic growth is inevitable. This is the problem the paper is addressing.

In the following, we will first review reform process in China with particular evaluation of the effect of reform in the past decades. And then we will look at the reform issues in labor market emphasizing the problems of over-employment and hidden unemployment. In the third section, specific problem of labor market fragmentation is discussed, pinpointing the necessity of continuing reform in employment systems. In the fourth section, we raise the issue of decentralization of government power and try to figure out how labor would fit in it. We will close the paper with a brief concluding remark.

### **Institutional Evolution of the Chinese Economy**

In the Third Plenum of the 11<sup>th</sup> Chinese Communist Party Central Committee (CCPCC), held on December 18, 1978, Deng Xiaoping and his senior supporters took decisive control of the CCPCC. This plenum marked a major turning point in China's reform and development. After a decade of turmoil brought about by the Cultural

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<sup>1</sup> See, e.g., Jeffrey Sachs, Wing Thye Woo and Xiaokai Yang, "Economic Reforms and Constitutional Transition," *Perspective* (Overseas Young Chinese Forum), 1(5), (April 2000) ([http://www.oycf.org/Perspectives2/5\\_043000/economic\\_reforms\\_and\\_constitutio.htm](http://www.oycf.org/Perspectives2/5_043000/economic_reforms_and_constitutio.htm)).

Revolution (1966-1976), the new direction set at this meeting was toward economic development and away from class struggle. The course was laid for China to move toward the ambitious targets of the Four Modernizations in the sectors of industry, agriculture, science and technology and national defense.

In brief, the institutional evolution of the Chinese economy since 1978 has followed a gradual path and could be outlined in the following six phases:<sup>2</sup>

1. Centrally planned economy (before 1978);
2. Economy regulated mainly by planning and supplemented by market (1978-84);
3. Planned commodity economy (1985-87);
4. Combination of planned and market economy (1988-91);
5. Socialist market economy with *state* ownership as the main form (1992-97); and
6. Socialist market economy with *public* ownership as the main form (1998- ).

Generally, the third phase—planned commodity economy was known to be based loosely on the Hungarian model of market socialism. It followed the guidance set in 1984 CCPCC which had reversed the previous path of central planning and market regulation. Nevertheless, the state continued to own the bulk of large and medium-sized enterprises and to regulate the production and pricing of a number of strategic commodities, but the market mechanism was permitted to play an increasing role in the pricing and allocation of goods and services and in the allocation and remuneration of labor in some non-strategic sectors. In the ideological struggles between the radical reformers and the conservatives, there appeared a new term “socialist commodity economy” from 1988 to 1989,<sup>3</sup> but this was replaced by the main theme in Phase 4, combination of planned and market economy, immediately after the Tian’anmen Square incidents of May-June 1989. Phase 4 was extremely important insofar as it legitimated the abolition of the traditional mechanism of central planning in favor of the market mechanism. Right after the Tian’anmen incident there was a power shift in economic decision making from the reformers to the conservatives. This led to a temporary halt on China’s economic reforms and its rates of economic growth.

The beginning of the 1990s witnessed the sudden collapse of the socialist camp in Eastern Europe and the Soviet Union. China’s immediate reaction was a policy of re-centralization, but the CCP soon realized that its legitimacy could be sustained only through economic growth brought about by further reforms. Amid the political deadlock between the reformers and conservatives concerning how to combine the planned and market economic systems, Deng Xiaoping made his famous southern

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<sup>2</sup> Rongxing Guo, *How the Chinese Economy Works*, 3<sup>rd</sup> revised ed. (London: Palgrave Macmillan, 2009), p. 100.

<sup>3</sup> The terms was first publicized in bold headlines in China’s official newspapers, such as *People’s Daily* and *Workers’ Daily*, in early 1988.

tour to Guangdong Province in early 1992 which had tipped the political balance at the CCPCC and the central government. This resulted in China's official declaration in October 1992 of its intention to build a "socialist market economy" as well as a calling for faster reforms and economic development.

In the early 1990s, some of the policies applied to the coastal special economic zones (SEZs) were extended to a list of inland regions and cities along the Yangtze River and, as a result of normalization of China's diplomatic relations with the former USSR, to the border cities and towns adjacent to Russia and other neighboring countries. Furthermore, many inland cities, which did not qualify for this special treatment, established numerous economic and technological development zones (ETDZs) inside their regions. However, the high economic growth following the wide-ranging pro-development reforms also led to two-digit inflationary pressures that occurred in 1993. Facing with an overheating economy, the Chinese government announced a series of banking and financial reforms in 1994, which were aimed at eliminating some of the structural inefficiencies in the financial sector.

The 15<sup>th</sup> National Congress of the CCP, held in 1997, witnessed a historical breakthrough in terms of the reform in ownership structure of the national economy. The three aspects of the adjustment were: i) to reduce the scope of the state sector and to withdraw state capital from industries that were not considered essential to the national economy; ii) to seek various forms for materializing public ownership that can generally promote the growth of the productive forces and to develop diverse forms of public ownership; and iii) to encourage the development of nonpublic sectors of the economy such as the individual business sector and the private sector and to make them important components of a socialist market economy.<sup>4</sup>

China's commitment to the creation of a market-oriented economy has been the central plank of its program of economic reform, and considerable progress toward this end has been achieved through gradual withdrawal of the government from the allocation, pricing and distribution of goods. Along with the forward movement of market-oriented reform, the government relaxed control over the non-state-owned economy, and many non-state sectors developed rapidly. When Deng Xiaoping was on his inspection tour in south China in January and February 1992, he expounded his basic view on plan and market: "It is not more plans or more markets that essentially distinguish socialism from capitalism. Planned economy does not mean socialism; capitalism has planning too. Market economy does not mean

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<sup>4</sup> Jinglian Wu, *Understanding and Interpreting Chinese Economic Reform* (Singapore: Thomson/South-Western, 2005), p. 86.

capitalism, and socialism also has markets.”<sup>5</sup> The meeting of the Political Bureau of the Communist Party, held in March 1992, pointed out clearly that both plan and market were economic methods and emphasized that socialist commodity economy should be actively developed. After formal announcement by the 14<sup>th</sup> National Congress of the Communist Party in October 1992 that “The goal of economic system reform is to set up a socialist market economy”,<sup>6</sup> the long debate about the relation between plan and market were basically brought to an end.

However, internal debates did not stop and the appearing new theme was about how to evaluate the effect of the reform of the past decades, which is also the main theme of this paper. In 2004 when Larry Lang, a professor at the Chinese University of Hong Kong, criticized the reform in a speech he gave in Fudan University on August 9 that “state-owned enterprise reform, which lasted for more than 20 years, was only a banquet to carve up state-owned assets”.<sup>7</sup> The scope of this dispute widened rapidly from reform of the state-owned enterprises (SOEs) to nearly all significant and sensitive economic and social problems, including healthcare reform, educational reform, regional disparity, the urban-rural gap, the income gap between the rich and the poor, and social security. Lang argued that solving the problems of allocating property rights of SOEs does not solve all problems of state enterprises. The SOEs should be reformed, but the focus ought not to be on privatization. Property right reforms ought to consider first the interests of the nation and of ordinary people.

On the other hand, pro-market reform economists argued that markets must be fostered and cultivated as long as China has taken the road of market economy unswervingly. The emerging agents with different interests must be supported by carrying on property right reform. A loss of state-owned assets (or a reduction in their value) is possible in individual cases, but is impossible for the aggregate. The reform should not be stuck in debates about whether the assets are state-owned or private owned. As long as reform contributes to increasing national wealth in aggregate it is worthwhile to continue.<sup>8</sup>

It should be noted that within a decade, the central government exercised effective control over only 5.4% of all the SOEs in terms of number (although these

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<sup>5</sup> Cited in Xibao Guo and Ping Zhang, “Thirty Years of Disputes on China’s Economic Reform”, in Ying Ma and Hans-Michael Trautwein, eds., *Thoughts on Economic Development in China* (London: Routledge, 2013), p. 225.

<sup>6</sup> Guo and Zhang, “Thirty Years of Disputes on China’s Economic Reform”, p. 225.

<sup>7</sup> Larry Lang, “Greencool: Revel in the Grand Banquet of Privatization”, Speech at Fudan University, Shanghai, August 9, 2004. See also Joseph Fewsmith, “China under Hu Jintao”, *China Leadership Monitor*, No.14 (Spring 2005) ([http://media.hoover.org/sites/default/files/documents/clm14\\_jf.pdf](http://media.hoover.org/sites/default/files/documents/clm14_jf.pdf)).

<sup>8</sup> See, e.g., Wu Jinglian, “Rethinking the Reform of the Past 25 Years, and Clearing the Direction of Advance in the 21<sup>st</sup> Century,” paper for the annual conference of the Chinese Economists 50 Forum; cited in Guo and Zhang, “Thirty Years of Disputes on China’s Economic Reform”, p. 226.

large SOEs generated 34.8% of China's industrial output).<sup>9</sup> Decentralization of control rights created more opportunities for local officials and SOE managers to appropriate the rents created by local monopolies and other political interventions. Furthermore, the presence of these assets with decentralized control rights would attract local predators, such as various government regulators and tax collectors, who used to be kept away by the central government. Because SOE managers now in control of these assets were politically less powerful than local state agents, the latter could demand various illicit payments from SOEs without fear of political retribution.<sup>10</sup>

One of the most serious criticisms of China's progress in economic reform concerns the persistent fragmentation and distortion of the country's internal markets. Both Chinese and foreign observers attribute such fragmentation and distortion to so-called local protectionism—administrative barriers to trade and investment that are erected by local authorities. Alwyn Young demonstrated that the devolution of economic power to local government during China's economic transition is responsible for both the fragmentation of markets and the rising output growth. To the extent that localities are better suited to control the local economy than the central government, aggregate output will increase because of decentralization but not the abandonment of control. The fragmentation of markets in China is evident in massive industrial duplication, inefficient allocation of factor inputs, local trade wars, and the emergence of regional autarky.<sup>11</sup>

Fragmentation also affects the factor markets. An IMF study suggests that China's capital markets remain highly fragmented. Cross-regional capital mobility within China in the 1990s was comparable to the cross-national capital mobility in developed market economies.<sup>12</sup> In the labor market, local governments protect their local residents from competition posed by migrants by forcing firms to favor local residents in their hiring and by increasing the costs of migrants seeking employment through the imposition of fees, the requirement of residence permits, and the need for certifications of skills. Before we ponder further, let us turn to the labor market reform.

### **Labor Market Reforms**

Among labor issues, employment is the foremost one. Employment refers to

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<sup>9</sup> *Jingji Yanjiu Cankao*, July 24, 1998, p. 9.

<sup>10</sup> Minxin Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge, Mass.: Harvard University Press, 2008), p. 140.

<sup>11</sup> Alwyn Young, "the razor's edge: Distortions and Incremental Reform in the People's Republic of China," *Quarterly Journal of Economics*, 115 (November 2000), pp. 1091-1135.

<sup>12</sup> Genevieve Boyreau-Debray and Shang-Jin Wei, "Can China Grow Faster? A Diagnosis of the Fragmentation of Its Domestic Capital Market", IMF Working Paper WP/04/76 (May 2004) (<http://www.imf.org/external/pubs/ft/wp/2004/wp0476.pdf>).

employment of new labor force and re-employment of the unemployed, and China had to create jobs for its new labor force and to provide training for the unemployed. There were several weaknesses in the pre-reform period about its labor force. Firstly, labor resources in pre-reform China were not allocated by market mechanisms but by state plans. As massive imbalances existing between China's material resources and labor resources, it was hard for the central planners to make timely and proper labor arrangements, or it was hard for the government to achieve "full employment" efficiently. It was an internal defect of the system: the government had promised to make everyone employed on one hand, and it lacked the ability and support to efficiently address labor oversupply on the other hand. Consequently, the government had achieved a distorted full employment, namely creating five jobs for work that could be done by three people. In addition, it had to prevent rural surplus labor from entering cities. Therefore, China had created serious "over-employment" and "hidden unemployment" problems.<sup>13</sup>

Secondly, China's Planned management of labor only terminated unemployment superficially with persistent unemployment pressure. A unified labor program is unable to match qualification, competency and willingness of individuals with their allocated positions. Therefore, employers were unable to find the right employees to fulfill their labor demand and, as a result, they could not optimize internal resource allocation while labors had no freedom in choosing their jobs and no obligation to create new employment opportunities, so that their enthusiasm for work and initiative were depressed in a lifelong permanent employment system. Furthermore, the rigid labor system hindered China's overall economic development, causing economic and social stagnation as well as accumulating hidden unemployment.

Thirdly, the planned economic system was unable to address frictional or structural unemployment. China's old employment system had serious defects. First, it separated the urban and rural labor markets with a rigid household registration system. The rural labor force, which accounted for more than 70% of the total, was chained to the land and peasants were denied the right to move freely. As massive imbalance existing between China's material and labor resources, it was hard for central planners to make timely and proper labor arrangements, failing to achieve full employment efficiently. Third, in a centralized permanent employment system, wages were decided by government and employers had to provide welfare and social security coverage for employees. Therefore, workers lacked motivation and incentives to work hard and employers were not able to decide the number on their

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<sup>13</sup> Yuan Zhigang, *Yinxing Shiyelun* (On Hidden Unemployment) (Shanghai: Lixin Accounting Publishing House, 1998).

payroll or whom they want to employ. Fourth, due to lack of timely information, the central planner was unable to ensure a sustained reasonable labor structure. Fifth, a plan-based labor system also intensified the centralization of ownership structure and employment channels, worsened distortions in industrial and employment structure, and encouraged uncontrolled population growth to some extent.<sup>14</sup>

In the late 1970s, the plan-based employment system became increasingly unsuited for China's economic reform. As the pressure on employment mounted, Beijing found it nearly impossible to create jobs for China's expanding urban labor force, including millions of educated youth returning to the cities. With economic liberalization, many people lost their jobs partly because the hidden redundancies in China's state sectors. As a result, it was imperative for Beijing to start thinking about reforming the employment system and adopting proactive measures. In 1980, the Communist Party allowed people to find jobs on their own which, without doubt, was a great breakthrough in China's labor system. The new policy completely changed the traditional view that the government should provide jobs for everyone and opened up a new pattern of multi-channel employment in China.

As the market-oriented economic system accelerated, China's labor system reform also deepened. Beginning from 1984, a series of labor regulations were issued to reform wage and employment systems in public as well private sectors, to establish more flexible labor relationship, and to provide more suitable social security and labor protection measures.<sup>15</sup> In July 1994, the 8<sup>th</sup> National People's Congress endorsed the China Labor Law. It is China's first labor law to suit the socialist market economy in terms of regulating labor relations, protecting the legitimate interests of workers and promoting economic development and social progress. The subsequent reform measures were to address labor relations in foreign companies, orderly flow of rural labor force, group labor contracts, labor standards, etc.<sup>16</sup>

Generally speaking, China's employment system reforms could be summarized into three aspects. Firstly, the rural labor force is no longer chained to farming and rural residents have taken jobs in various sectors of urban and rural areas. Since the implementation of the "household contract responsibility system" in rural areas, a large number of rural surplus laborers have moved from traditional farming into non-agricultural sectors, at first in local township enterprises and then manufacturing bases in coastal areas. In 2001, the total rural labor force in China was about 480

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<sup>14</sup> Wang Yanzhong and Zhao Xi, "China's Employment System Reform", in Li Tieying, ed., *Reforming China: Experiences and Lessons* (Singapore: Enrich Professional Publishing, 2011), pp. 315-17.

<sup>15</sup> Cf. Wang and Zhao, "China's Employment System Reform", pp. 321-22 for detained description of China's labor regulation reforms prior to 1994.

<sup>16</sup> Wang and Zhao, "China's Employment System Reform", pp. 322-23.

million, more than a third of them have taken non-agricultural positions in industrial production, construction and service sectors. Many of them have moved to other provinces. All in all, the rural employment structure has undergone fundamental changes.

Secondly, urban workers no longer enjoyed the traditional “iron rice bowl” privileges and had to face job market competition. The labor system reform in China’s SOEs began in 1987, and the reform was aimed at changing the rigid employment system and the promise of lifelong employment which had been in place for decades. At the same time, part of the rural labor force has moved into cities since the 1980s, intensifying job competition in urban areas, even though they usually have taken jobs that local residents were unwilling to do.

Thirdly, the state sector is no longer the only channel for employment. The proportion of the state-owned economy in overall employment fell sharply. An increasing number of newly-added labor and rural migrant workers have taken jobs in the private sector. As the share of the state-owned economy in the whole economy fell, so did its role in China’s employment. For example, from 1978 to 2001, the share of SOEs in urban employment fell from 78.3% to 31.9%, and the share of the urban collective economy in employment fell from 21.5% to 5.4%. The private sector in urban areas, on the other hand, created 62.7% of jobs in Chinese cities starting from a zero base.<sup>17</sup>

### **China’s Fragmented Labor Market**

With China’s market economic reforms, it has gradually established and improved a labor market, but serious fragmentation existed. The pattern of fragmentation was different in different phases. In the first phase, from 1978 until roughly 1984, China’s labor market was separated into an official urban labor sector and a rural labor sector. There were also some separations within the urban areas. Due to household registration control, labor movement virtually did not exist with clear separation between the urban and rural labor forces. Urban residents were covered by a centralized state employment system and they were assigned to government agencies, SOEs and collectively owned businesses. Urban residents had good job security with stable wages and other earnings for basic living necessities as well as social welfare such as housing, medical care, education and childcare. In this period, the contract responsibility system in rural areas allowed farmers greater freedom in farming their own land, leading to rapid increase in their incomes. At the

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<sup>17</sup> Cai Fang, “Sichang Peizhi Laodongli, Zhengfu Cujin Zaijiuye [Market Allocated Labor, Government Promotes Re-employment]”, a speech at the Fenghuang Television, December 31, 2005 ([http://blog.voc.com.cn/blog\\_showone\\_type\\_blog\\_id\\_39547\\_p\\_1.html](http://blog.voc.com.cn/blog_showone_type_blog_id_39547_p_1.html)).

same time, the private economy in both urban and rural areas was still in its infancy. The rural labor market was completely independent of the urban one. Although farmers increased their incomes significantly over the period, they were denied access to social security coverage.

The second phase was from 1985 to 1991, during which China did not have a fully competitive labor market or rural labor market. In 1986, the State Council issued the Provincial Regulations on Labor Contracts in State-Owned Enterprises, and many similar rules were issued in subsequent years which gave companies greater autonomy in recruitment. At the same time, as China has not made any fundamental reforms to its household registration system and its social security system remained under-developed, urban residents employed via the state employment system enjoyed lifelong job security while immigrant workers in the same state companies had to suffer lower wages and little social security coverage and no guarantee of job security.

The third phase in 1992-1997 witnessed a continuation of the fragmented labor market. In 1993, China allowed state firms to lay off workers. Therefore, the lifelong job security for urban residents was removed. On the other hand, the private economy and the mixed-ownership economy in urban non-state sectors grew rapidly, and their share in overall urban employment increased from 0.2% and 0.9% in 1992 to 1.1% and 1.6% respectively in 1997. In rural areas, non-agricultural sectors grew rapidly after 1992 and non-agricultural employment there accounted for 3.1% and 5.9% in 1992 and 1997 respectively.<sup>18</sup>

The fourth phase began in 1998 when the labor markets in both urban and rural areas became fully competitive. After several years of reforms, the SOEs were now independent business entities with modern corporate structures and have gained decision-making power on the size and salary levels of the workforce. The government also conducted a “streamlining” of the civil service system and ended the guarantee of lifelong job security for government employees, at least superficially. In subsequent years, companies were required to provide workers with maternity insurance, industrial injury insurance, pension insurance, unemployment and medical care insurances. However, there were discrepancies between the primary and secondary labor markets. In the primary labor markets, mainly those in large and capital-intensive companies, workers received decent salaries with good chance of promotion and sound working environment. But in the secondary labor markets, often those in small- and medium-sized and labor-intensive manufacturing firms, salaries were lower than in the primary markets with little chance of promotion and poor working conditions. Workers in self-employed businesses, which are few, can be

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<sup>18</sup> Wang and Zhao, “China’s Employment System Reform”, p. 331.

classified as in secondary labor markets. On the other hand, employment in rural non-agricultural as well as traditional rural households was unstable with low wages and little social security coverage. Furthermore, there are not only discrepancies between primary and secondary labor markets and between urban and rural areas, but there are also barriers in labor movement between provinces.

### **How Labors Fit in Decentralization?**

A Salient feature of China's economic reform is the decentralization of control rights (over the cash flow from operations of state-owned assets) from the national authorities to provincial/local authorities. Intended as an incentive to improve the efficiency of these assets, the decentralization of control rights fundamentally changed the system of property rights in China. To be sure, the process of decentralization of control rights was gradual. In 1984, the central government decided that the control rights of SOEs were to be delegated from the ministries and provincial authorities to major industrial cities where SOEs were located. Such control rights included, most critically, the rights to determine wages, benefits, and bonuses, as well as the use of capital, thus making local governments and SOE managers effective owners of assets. The central government, however, retained its control rights over large SOEs in critical sectors such as power generation, telecom, petrochemical industries, machine tools, and coal production.<sup>19</sup>

Within a decade, the central government exercised effective control rights over only 5% of all the SOEs in terms of number (these large SOEs generated 34.8% of China's industrial output).<sup>20</sup> The trend of decentralization of property rights accelerated in the 1990s as the Chinese state further delegated power to manage the state's most important asset—land. The power to sell long-term land leases allowed a large number of state agencies, mostly at the local level, to profit from sweetheart deals with their friends. These deals resulted in sudden loss of an incalculable amount of revenues for the state because the initial lease terms were significantly undervalued to let the awardees to quickly make an easy and large profit.<sup>21</sup>

China's internal capital markets are segregated as well due to local interference which has impeded the flow of domestic capital and transfer of corporate control. Local authorities habitually limit outflow of capital and restrict investment from outside firms and their acquisition of local firms.<sup>22</sup> Chinese enterprise managers report widespread practices of local protectionism. A nationwide survey of 3,539

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<sup>19</sup> Pei, *China's Trapped Transition*, p. 139.

<sup>20</sup> Jingji Yanjiu Cankao, July 24, 1998, p. 9; cited in Pei, *China's Trapped Transition*, p. 140.

<sup>21</sup> Pei, *China's Trapped Transition*, p. 140.

<sup>22</sup> State Planning Commission, "Dapo Difang Shichang Fenge Jianli Quanguo Tongyi Shichang [To End Regional Market Segregation and Establish an Integrated National Market]", *Jingji Yanjiu Cankao*, 27 (2001), pp. 5-7.

managers conducted by the official Development Research Center (DRC) in 2002 showed that local protectionism was prevalent in all provinces. Respondents singled out Henan, Shanghai and Beijing as jurisdictions with the most discriminatory policies against nonlocal firms, followed by Hubei, Shandong, Hebei and Hunan. Local protectionism was found to have nothing to do with the level of development—the poorer agrarian provinces in the central region were as rampant as the more industrialized coastal provinces. The survey also found that local protectionism was costly for Chinese firms. 34% of the managers reported that such practices affected their operations “a great deal or quite significant”, and 35% reported a “fair impact”. Only a third said such practices had small or negligible impact. Local protectionism appeared to hurt the firms in the poorer western and central provinces more than those in the more prosperous coastal regions, except for Shanghai, Beijing and Shandong. The sectors most seriously affected were tobacco, pharmaceuticals, petroleum refining, printing, food processing, plastics, and electrical machinery. The least affected were textile and garments, synthetic fibers, and electronic communications equipment. Ironically, SOEs, which heavily relied on other provinces for markets and raw materials, were more negatively affected than private firms, which were small in size and did little business in other localities. The least affected were foreign (including Hong Kong and Taiwan) firms, apparently because they relied more on international market for exports and imports.<sup>23</sup>

The fragmentation of local markets create large distortions and inefficiencies, especially as local governments engage in investment activities that duplicate manufacturing capacities and generate negative returns. An analysis of regional industrial structures shows that duplication of capacity remains a core feature of the fragmentation of internal markets in China. For example, in 1989, the industrial structure of 22 provinces was 90% identical to that of China as a whole. In 1994, the industrial structure was 90% identical in 13 provinces and 80% identical in 21. The study suggests massive duplication of industrial capacities regardless of local comparative advantages. This characteristic persisted through the 1990s as most provinces continued to build up their own capacities to chase new demands. In 2001, 23 provinces manufactured washing machines, 29 made television sets, 23 produces refrigerators, and 27 assembled automobiles. Duplication will remain a structural feature of the Chinese economy without a fundamental change in underlying motivations for local governments. In envisioning their long-term industrial goals, 22 provinces listed automobile manufacturing as a pillar industry, 24 listed electronics as

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<sup>23</sup> DRC, “Zhongguo Difang Baohu Chengdu Yanjiu [A Study of the Degree of Local Protectionism in China]”, *DRC Diaocha Yanjiu Baogao*, 46 (2003), pp. 3-16; cited in Pei, *China's Trapped Transition*, p. 129.

a pillar industry, 16 listed machine-building and the chemical industry as a pillar industry, and 14 listed metallurgy as a pillar industry.<sup>24</sup>

The distorted and inefficient regional production patterns may have decreased the potentiality of the labor-intensive industrial development model, which China adopted so successfully in the past. Compared with the rest of the world, as China still enjoys incomparable advantage in its labor abundance, labor growth rate between 1990 and 2006 was remarkably lower than any comparable group, such as the lower-middle-income group, middle-income countries, and East Asian countries, and was just 0.9% higher than high-income countries. The labor force in low-income countries, particularly in Africa and South Asia, not only grew rapidly at an annual rate of 2%, but also increased in absolute numbers, challenging China's proprietary advantage in rich labor resources. Worse still is the fact that China already come to a turning point in its demographic structure (see Table 1).

**Table 1 Comparison of China with Other Countries in Labor Resources**

	Total Labor Force (in millions)		Annual Growth Rate of Population Above 15 Years Old (%)	Percentage of Women in Labor Force (%)	
	1990	2006	1990-2006	1990	2006
China	650.6	780.5	1.1	44.8	44.1
Low-Income Countries	694.0	995.4	2.3	35.1	35.0
Middle-Income Countries	1,258.0	1,582.6	1.4	41.7	42.0
Lower-Middle-Income Countries	954.4	1,208.6	1.5	42.4	42.0
Higher-Middle-Income Countries	303.7	374.0	1.3	39.5	41.5
Low-and-Middle-Income Countries	1,952.1	2,578.0	1.7	39.4	39.2
East Asia and the Pacific	858.7	1,074.1	1.4	44.1	43.5
South Asia	430.6	597.1	2.0	29.7	29.3
High-Income Countries	434.5	503.8	0.9	41.4	43.4

Source: World Bank, WDI, website of the World Bank, 2008.

As China is heading for more capital- and technology-intensive productions, it still needs to take heed for losing advantage in labor-intensive manufacturing. Provision for its huge population ample job opportunities of works is definitely crucial for it to sustain growth and competitiveness in the world market, where many countries are eager to capture a larger portion for their own prosperity, and political

<sup>24</sup> State Planning Commission, "Dapo Difang Shichang Fenge Jianli Quanguo Tongyi Shichang", pp. 7-8; Li Lüdong, *Zhongguo Xiandai Longduan Jingji Yanjiu* [A Study of Contemporary Economic Monopolies in China] (Beijing: Jingji Kexue Chubanshe, 1999), p. 150.

stability which is definitively important for CCP to maintain administrative power and, especially, the its ageing society. The over-capacity especially built within many state-owned companies has kept many human resources in increasingly idling productions and a privileged group of people, particularly those urban residents enjoying much better welfare measures, inside the institutions of shrinking proportion in GDP. Despite gradual reforms of household registration system (the *hukou* system), enabling more rural migrants to get into urban areas and reducing inter-regional income gaps, China's urban development is restricted by the rural-urban gap and inter-regional barriers as the flow which, in turn, exacerbates structural unemployment. In recent years, China had over 20 million urban laid-off and unemployed works in cities as a sign of structural unemployment.<sup>25</sup>

The unemployment pressure and inter-regional differences resulted in sudden emergence of "floaters", whose origins were non-local and work was heavily industrial, giving rise to the so-called "peasant workers flood" (*mingongchao*). According to National Bureau of Statistics, the number of inter-provincial workers was 120 million in 2000, 140 million in 2008, and 151 million in late 2009 (with 2008 numbers of total peasant workers being 225 million). Further, the majority of workers (70.4%) came from central and western China, and their destinations (66.7%) are the eastern coastal areas.<sup>26</sup> These migrant workers still face social exclusion in the destination to which they migrate. This is caused in part by the *hukou* system which divides the population into rural and urban, based on place of birth, and agricultural and non-agricultural, based on occupation. Given the geographical inequality in China, rights, statuses and opportunities are divided according to different categories of *hukou*. Hence migrant workers, despite the fact that they are engaged in non-agricultural works, are unable to enjoy the privileges and resources enjoyed by those with origins in urban areas where migrants work.

In the 2000s, restriction and control policies of both central and local governments led to increasing criticism and demonstrations. In 2003, the State Council published a circular to improve social services and management for migrant workers.<sup>27</sup> It seeks to improve the discriminatory policy environment for those peasant workers who enter the city to do work, preventing collection of duties and

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<sup>25</sup> See, e.g., Wang and Zhao, "China's Employment System Reform", pp. 338-40.

<sup>26</sup> Liu Kaiming, Tyler Rooker and Bin Wu, "Inequality between Migrants and Locals: Evidence from Export-Processing Factories in the Yangzi and Pearl River Deltas," in Bin Wu, Shujie Yao and Jian Chen, eds., *China's Development and Harmonization: Towards a Balance with Nature, Society and the International Community* (London: Routledge, 2013), p. 74.

<sup>27</sup> State Council General Office, "State Council General Office Notice Concerning Improvement of Services and Management of Migrant Workers [*Gouwuyuan Bangongting Guanyu Zhohao Nongmin Jincheng Wuging Jiuye Guanli he Fuwu Gongzuo de Tongji*]," 2003 ([http://www.gov.cn/zwjk/200508/12/content\\_21839.htm](http://www.gov.cn/zwjk/200508/12/content_21839.htm)).

protecting their rights. Yet the lack of a national social security system, including no national education, hygiene, sanitation, or housing systems, combined with the registration on free movement around the country and cities, means that each provincial and local urban government creates its own systems for labor management and regulation. Hence, discrimination and social exclusion continue on a massive scale across China.<sup>28</sup>

### **Concluding Remarks**

China's reform of the economic system amounts to a deep and radical change in society. To combine socialism with a market economy is an unprecedented experiment in China. It is a brave institutional innovation with inevitable divisions in ideologies as well as destinies and opportunities for different groups of people. Industrial productions, a key factor in China's rapid economic growth, are clustered around urban areas culminating in over-emphasis on urban employment but less effort in rural employment. Structural adjustment resulted in increasing unemployment, but with more concerns on unemployment in state sectors rather than the private sectors.

China has developed a fragmented industrial structure by means of decentralized government powers which resulted in massive industrial duplication, inefficient factor allocation, local trade wars and the emergence of regional autarky. Fragmentation also affected the labor market, where local governments protect their own residents against migrants from rural and other provinces by strict hiring regulations and raising costs of migrants seeking employment. The problem was exacerbated by the household registration system which has given rise to geographical inequality by dividing rights and opportunities according to different categories of *hukou*.

The institutional arrangements have resulted in different "forms" of citizenship among the Chinese people to generate interest groups and rigid mindsets. To deal with these problems, China has to address the urban-rural split to establish a unified national labor market and to give the market full play in allocating labor resources and creating equal employment opportunities for any kind of residents. In 2001 Zhejiang Province carried out a pioneering scheme to break the barriers between urban and rural employment for a unified labor market. This should be emulated by other provinces.

Flexibility seems to be the keyword for labor market reforms. Many non-traditional jobs, namely those different from conventional, typical and regular full-time ones, including jobs in private sectors as well as odd jobs in state sectors and self-employment jobs should be encouraged. No matter they are short-term

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<sup>28</sup> Liu, Rooker and Wu, "Inequality between Migrants and Locals," pp. 75-76.

workers, seasonal workers, on-project workers, dispatched workers or hourly workers, they all will more appropriately suit different job requirements and help reducing inefficiencies in manufacturing productions. Discrepancies between the primary and secondary labor markets, which are evidenced by different levels of wages and conditions of working environment, really need to be rectified to give workers equal dignities and living standards. More importantly, by reducing discrepancies not only in work categories but also between urban and rural areas, it would be more likely to have a well-functioning labor market to be fully integrated with industrial structures.