

A Modern Welfare State for China

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Background

- China's recent growth remarkable: over last 20 years, GDP growth on average about 10% per year. Almost an 8-fold increase.
- Investment-led growth, with massive structural transformation toward manufacturing and services, along with rapid urbanization.
- In comparison, Sweden---a success development story---accomplished a similar transformation over the last 100 years.
- A move from a centrally planned to a market economy---less than half of employment in state-owned enterprises today.
- China is still a developing country---still grows rapidly and is now at about 20% of US GDP/capita. The remaining gap is still large!

Needed

- An understanding of key issues for going forward:
 - remaining catching up expected to be harder and harder
 - need for continued and new structural transformation
 - rising inequalities, environmental challenges,...
- In this context, need to analyze details of recent growth
 - fortunately, very interesting recent literature on China also among Western scholars, using modern scientific methods
- Recent “manifesto” produced long list of major challenges and proposed improvements. One of them: building a welfare state.
- Here: purpose of welfare state, what type of system is desirable?
- European economies: more experience on welfare states than the US, with both positive and negative experiences to offer China!

The purposes of a welfare state: the traditional view

Mostly *ideologically based redistribution* from the less needy to the more needy. Progressive taxation.

Typical tools:

- unemployment insurance (UI; from employed to unemployed)
- social assistance (needs-tested; from rich to poor)
- social security (age-based; from working young to old)
- in-kind transfers (health, education, childcare for all...)
- possibly, various forms of regulation (wage compression, rent regulation, etc)

The purposes of a welfare state: the modern view

Similar policies. However, goal more *promoting economic efficiency*:

- provide insurance when it is hard to do so for markets
- make sure there is enough insurance so that workers and entrepreneurs are willing to take on risk
- promote increases in productivity where markets fail (encourage better matching in labor markets, seeking new sectors/regions,...)
- limit taxation/progressivity

Focus here on households---treatment of firms/entrepreneurs (e.g., financial markets) usually outside scope of welfare-state policies.

Unemployment

- Challenges: under rapid growth and continued structural transformation, many workers risk unemployment
- Key idea: if UI is available with decent replacement rate and duration, workers dare to move and change industries/occupations
- Challenge: make sure UI recipients search and retain skills
- Thus: some monitoring needed, offer (re)training subsidies to firms
- Special danger: avoid lock-in effects as human capital depreciates in a rapidly changing world (cf. “eurosclerosis” in the 1970s).
- Wage dispersion (avoiding severely binding minimum wage constraints) probably necessary to induce efficient hiring.

Social security, traditional way

- Major challenges ahead:
 - a rapidly increasing dependency ratio
 - large income/wealth gap between young and old, urban and rural regions
- Traditional western policy, since Great Depression in 1930s, a **pay-as-you-go** system:
 - current workers simply pay for current retirees' pension benefits out of taxes on labor income
 - implies large tax distortions, threaten to become very large with few workers per retiree (made more difficult with one-world policy)
 - increasingly unpopular in western world for this reason.
- Many countries: now adopted some form of **fully funded** system

Social security, new way

- In *fully funded* system:
 - workers save for their own retirement (often through a government-run pension fund)
 - often accompanied with incentives to save (tax breaks)
 - has the advantage of not requiring taxation
- However:
 - portfolio management difficult for inexperienced households (manage risk-return tradeoff)
 - system change difficult: “default on current old”?
- If rapid growth expected to continue in China, better install fully funded system gradually: currently working cohorts much poorer than future workers. Redistribute toward current cohorts!

Health, education, childcare

- Key channels for improving productivity---not just a redistributive tool or a “right”.
- Especially important to maintain minimum standards also across poorer parts of China, for men and women alike, and for all ethnicities. Avoiding segregation:
 - fully uses the country’s potential---the next economic, cultural, or political innovators and leaders can be born anywhere!
 - avoids social tension.
- Neglected in some countries (especially the US and increasingly in Sweden and in other European countries).
- Can give China an edge worldwide!

Regulations: some examples

- Wages, prices, rents: regulations to be avoided
- Private bankruptcy? Many European countries---like Sweden---do not allow it, but the US does.
 - Without allowing private bankruptcy, debts follow a person until they are paid back, so possibly the whole life. Provides good commitment to not take on unnecessary loans, but offers very weak insurance.
 - Private bankruptcy was a problem at the onset of the housing crisis in the US, when many defaulted as they were surprised by a collapsing housing market.
 - So tough choice! Limited private bankruptcy probably advisable, again to promote risk-taking.