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The Role of Social Security in China's New Development Pattern

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1. China's heavy tax burden and unreasonable social security structure inhibits the improvement of residents' consumption levels

In the international experience perspective, economic growth, the establishment of a sound social security system, and higher social security expenditures are all conducive to reducing people's perceived uncertainties, narrowing the income gap, and expanding the size of the middle-income group, thereby releasing consumer demand. However, if social security benefits are already at a high level, higher taxation is needed to support the continued improvement of benefits, at which point increasing social security expenditures would constrain people's consumption to a certain extent. In the United States, which has low taxes and low welfare levels, people's consumption expenditures account for the highest proportion of national income. This is followed by Japan and the United Kingdom, which have medium taxes and moderate welfare levels. In Norway, which has high taxes and high welfare levels, this proportion is relatively low.

As for the large-caliber calculating methods used in determining China's macro tax burden, academic circles have not reached any consensus. The main point of disagreement lies in the revenues from land assignment fees. When the International Monetary Fund (IMF) calculates large-caliber government revenue, it does not include revenue from land use rights, and in China, the Ministry of Finance's calculation of general government revenue also follows this standard. Yan Kun and Yu Shuyi (2008) believe that the revenue from the assignment of land use rights belongs to the costs of

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enterprises, so it should be counted as general government revenue. Lü Bingyang et al. (2020) believe that, out of consideration of equal costs and benefits, general government revenue should include the revenue from land use rights assignments minus cost expenditures. China's macro tax burden for 2019, calculated according to these three different calibers, was 27.2%, 34.5%, and 29.9% respectively. Regardless of which caliber is used, China's macro tax burden, in comparison with OECD countries, is not light, and it even exceeds the tax burden level of OECD countries at the same level of development. However, the proportion of China's expenditure on social security is far lower than that of OECD countries, and the structure is not reasonable; it has not effectively played a role in improving the security level of low-income groups and narrowing the income gap throughout society. In 2019, China's public social security expenditure accounted for only 11.8% of its GDP. This value is even lower than that of the United States, and to some extent this leads to a lower proportion of people's final consumption in GDP. By optimizing the structure of fiscal and social security expenditures, it would be possible to increase people's consumption level without increasing the overall financial burden. China may be able to reach the proportion of residents' consumption of Norway, which has high income and high welfare levels, and it may be able to reach the proportion of consumption of Japan, which has tax levels closer to those of China. This is exactly why the CPC report to the 20th National Congress (2022) called for "increasing the income of low-income earners and expanding the middle-income group," and "increasing the strength of adjustments to tax revenue increases, social security, and transfer payments."

From the fiscal revenue perspective, China has a rather heavy macro tax burden, and indirect taxes are the mainstay, which is not conducive to narrowing the income gap, and it also inhibits consumption, especially in low-income households. In recent years, although China has achieved remarkable results in reducing taxes and fees, and the proportion of indirect taxes has continued to decrease, the proportion of indirect taxes still remains at a high level, accounting for more than 50% of tax revenue. Even the European Union (EU), where value-added taxes are the mainstay, has a lower proportion of indirect taxes than China. For the convenience of comparison, the

following only compares the ratio of consumption taxes and value-added taxes to total tax revenue. In 2019, China's consumption tax and value-added tax accounted for 47.4% of tax revenue, while in the same year they accounted for 27.6% in France and 32.8% in the UK; the OECD average was 32.6%. Tax systems whose mainstays are value-added tax tend to restrain consumption, and they are regressive, meaning that they have a corrosive effect on income distribution. However, given China's current tax environment, it would be difficult indeed to increase the proportion of direct taxes.

Meanwhile, from the fiscal expenditure perspective, China's expenditure on social security is at a relatively low level, and the expenditure structure is unbalanced. After more than twenty years of development, China has established a relatively complete social security system, with pensions and medical care basically covered. However, only urban workers have a relatively high level of security, and medical insurance, for both urban and rural residents, plays a rather limited role in eliminating worries and releasing consumption. As for pensions (endowment insurance), there are large disparities among the benefits offered by government agencies and public institutions, the employees of enterprises, and urban and rural residents. In absolute terms, in 2020, the average monthly pensions of government agencies and institutions, enterprise employees, and urban and rural residents were 5,767 yuan, 2,906 yuan, and 174 yuan per person, respectively. There are large gaps among the three. Relatively speaking, the replacement rate of pensions for government agencies and institutions can reach 80% to 90%, while the replacement rate for enterprise employees is only about 45%, and the endowment insurance for urban and rural residents is not even enough to meet the minimum living standard. As for medical insurance, the actual medical insurance reimbursement rate for employees of government agencies and institutions reaches 90%, while the actual reimbursement rate for the more than 1 billion urban and rural residents' medical insurance subscribers is only about 50%. In comparison, the United States' social security expenditure is relatively low; it is used mainly to provide protection for low-income groups, while middle- and high-income groups mainly purchase commercial insurance to meet their protection needs. This not only releases the consumption potential of low- and middle-income groups, but also meets the

differentiated demands of middle- and high-income groups, and promotes the development of the insurance industry and related industries. Our situation is different. Employees of government agencies and public institutions and the employees of monopoly state-owned enterprises, which are mainly supported by public financing and resources, enjoy relatively high social security benefits, while low- and middle- income groups, especially rural residents, receive significantly lower levels of social security benefits. This structure of social security expenditure largely inhibits the role of fiscal and social security expenditures in boosting domestic demand. On the one hand, middle- and high-income groups receive relatively high social security benefits, and their marginal propensity to consume diminishes. On the other hand, low- and middle-income groups have low incomes, low social security benefits, and insufficient ability to expand consumer spending.

2. Equalizing basic social security requires efforts from many angles

The CPC report to the 20th National Congress pointed out: “We must improve the income distribution system ... build a coordinated system of primary distribution, redistribution, and third distribution ... intensify the adjustment of taxation, social security, and transfer payments.” The initial distribution system is still the foundation, so it will take a long time to complete the reform. To improve income distribution in a relatively short period of time, we need to start with redistribution, i.e., expand the adjustments to taxation, social security, and transfer payments.

Judging from international experience, redistribution is an important means of adjusting the income gap, and the redistribution policies of OECD countries have played an effective role in doing this. In 2019, the redistribution policies of some OECD countries alleviated the income gap. Although in some countries, such as Costa Rica, South Korea, and Turkey, the Gini coefficient’s improvement was relatively weak, most OECD countries improved it rather strongly. In fact, in 65% of them, it improved by more than 30%. Belgium’s redistribution policy was particularly effective: its Gini coefficient decreased by 47.42% after redistribution. If the Gini coefficients of OECD countries are simply averaged, the Gini coefficients of primary income and

redistributed disposable income are 0.469 and 0.313 respectively. This means that the redistribution policy has reduced the Gini coefficient of OECD countries by 33.20%.

Among policies that influence the effects of redistribution, taxation and social security are the two pillars that improve income distribution. It is true that there are differences in the improvement effects of taxation and social security systems in different countries, but many studies still show that the social security system is the most important system affecting improvement of the Gini coefficient. Lindert (2021) used cross-country data to show that social security expenditures are positively correlated with the degree of improvement in the Gini coefficient—that is, the more expended on social security, the greater the improvement in income distribution. Wang et al. (2012), by studying the contribution rate of different transfer payment projects in OECD countries, pointed out that social security and transfer payments can explain 80% of the improvements in the Gini coefficient. This conclusion holds true even for the United States, where social security spending is low. Lindert (2021) studied the average tax rates of income and property taxes in the United States from 1910 to 2010, social security expenditures, and the sequence of changes in the Gini coefficient. The results showed that it was the increase in social security expenditures that led to an increase in the level of social redistribution. Wang et al. (2012) also analyzed the degree of improvement of the Gini coefficient in the United States, and found that transfer payments and social security contributed 60% of the decline in the Gini coefficient. In other words, social security plays an important role in the process of adjusting income.

So, does China's social security policy play a role in regulating income distribution? Many scholars have carried out research on this, and the results show that social security has improved income distribution to a certain extent, but its improvement effect is limited, that it has failed to effectively narrow the income distribution gap, and even that some institutional arrangements have actually widened the income gap. Based on survey data on six provinces compiled by CASS in 2012, Wang Yanzhong et al. (2016) showed that social insurance (the largest part of the social security system that includes basic endowment insurance or pensions, basic medical insurance, unemployment insurance, etc.) reduced the Gini coefficient by 6.4%.

However, this effect is mainly reflected in the non-agricultural household registration group. Social insurance has reduced the Gini coefficient of the non-agricultural household registration group by 12%, but in the sample of persons with agricultural household registration, i.e., farmers and migrant workers, the effect of social insurance was very small. Li et al. (2020) used four rounds of China Household Income Survey (CHIPs) data to break down the Gini coefficient, and the results showed that endowment insurance has become an important source of household income inequality. For families with elderly people in particular, pensions can account for more than 50% of the Gini coefficient of household incomes. Research by Yang Sui and Zhao Xiaoman (2022) shows that in recent years, China's transfer payments have significantly increased the effects of reducing the Gini coefficient of rural incomes, but the urban-rural division (or identity division) in the social security system has led to a very obvious difference in the transfer income of urban and rural residents. All of the above studies pointed out that although social security within the system has played a certain role in improving income distribution, the differences and divisions between the systems have reversed the effects of adjusting the income distribution.

Judging from history and international experience, if the income gap widens to a certain extent and persists too long, it will cause serious social conflict. China's Gini coefficient, which has been hovering around 0.47 for the past ten years, is much higher than the current level of 0.26-0.38 in developed countries. During a rapid economic growth stage, while the living standards of low- and middle-income groups continue to rise, there will be no serious conflicts. However, in a period of slowing economic growth and increasing external shocks, people's tolerance for inequality will decrease. This increases the possibility of forming social risks. At this stage, it becomes necessary to attach great importance to the income gap and social security issues, and it is particularly important to improve the equalization level of basic social security. However, if the "look only higher, not lower" principle of treatment applies, narrowing the social security gap between different groups would mean that financially there would be huge reform costs. At the same time, the current growth rate of China's fiscal revenue is far lower than the growth rate of its expenditure, so it would be difficult for

the government to “pay” for the reform. If we want to increase social security expenditures further, we need to find new sources of fiscal revenue growth. From the international experience perspective, developed economies such as the United States, Japan, and the countries of Europe generally first established their fiscal and taxation systems on direct taxes such as income tax and property tax before expanding their funding sources for social security system coverage through the collection of indirect taxes like value-added tax and consumption tax. In China, however, indirect taxes were the first major taxes that were levied; the proportion of direct taxes like income tax and property tax is much lower than that of the developed countries. As I have mentioned above, the proportion of indirect tax in China is still at a high level, and there is little room for future growth. Moreover, under China’s current social security system, the increase in the equalization level of social security brought about by increasing indirect taxes in order to raise the funds for social security is partially offset by the regressive nature of indirect taxes. Although many scholars believe that the existing fiscal and taxation system should be reformed and the proportion of direct taxes should be increased, at the current stage, it may be much more difficult for China to increase the collection of direct taxes to support expanded social security coverage than it was for the developed economies to raise supplementary funds through the introduction of indirect taxes. First of all, China’s current macro tax burden is not low, and there is not much room for tax increases. As mentioned earlier, China has just entered the ranks of middle- and high-income countries, but its tax burden is already close to that of developed countries. In China’s current tax collection and management system, the costs of direct tax collection are higher than that of indirect taxes, and the “tax pain” it causes is also stronger, so that adjusting the existing tax structure will be very difficult.

More importantly, it is very difficult to use income tax or property tax to establish an equalizing and universal social security system. The experience of various countries shows that when an income gap increases between the middle-income group and the low-income group—which together are the main taxpayers—the social security expenditure for the low-income group will decrease. An analysis of China’s current situation shows that the main group of taxpayers for income tax and property tax,

regardless of income (or property) decile or quintile, will be formal sector employees. For example, if the property tax were to be levied comprehensively, whether that tax is based on area, number or units, or property value, the largest group of taxpayers were definitely be formal sector employees, especially retired employees. International experience shows that this group reacts strongly to tax and fee increases. Therefore, there is great resistance to financing universal social security through the expansion of income tax or property tax. Even in Shanghai and Chongqing, where property taxes are already being levied, the increase in revenue is very limited, and nationwide implementation has not yet been put on the agenda.

3. Policy recommendations

Given the constraints caused by the difficulty of transforming the fiscal and taxation structure and maintaining a tight balance between fiscal revenue and expenditure, we may consider two ways to solve the problem of figuring how to boost domestic demand by universalizing social insurance and improving the level of equalization of social security:

(1) “Limit the high and supplement the low.” That is, restrict government agencies, public institutions, monopolistic state-owned enterprises, and developed regions from continuously improving security benefits, and require them to devote more funds to basic endowment insurance (pensions) and basic medical insurance for urban and rural residents and underdeveloped regions. This would also require us to continuously improve the overall planning level of social insurance, and at the same time limit local moral hazard and soft budget constraints through various means.

(2) Broaden financing channels and liberalize the development of commercial insurance. Provided that full basic social insurance coverage is ensured on a “limit the high and supplement the low” basis, release more of the demand among middle- and high-income groups for higher and better endowment and health security to commercial insurance, and free up funding to raise the level of social security for low-income groups. This approach would better achieve social harmony and more effectively boost domestic demand. This has also been the common experience for developed countries.

In countries with large income gaps, there is often a large amount of room for the development of commercial insurance. In China, expenditure on commercial health insurance accounts for only approximately 3.6% of total health expenditure, so there is plenty of room for development; expenditure on commercial endowment insurance, including occupational annuities, accounted for less than 1% of annual GDP, so in this area, too, there is plenty of room for development.

For the medium and long term, it will still be necessary to improve the quality and efficiency of China's supply of public services through innovation of systems and mechanisms, to fulfill the requirement, as proposed in the CPC report to the 20th National Congress, to "ensure much more equitable access to basic public services [and] develop a better multi-tiered social security system," and to alleviate the people's tax burden anxiety. The general experience in every country is that unless people can see simultaneous increases in the strength of social security and the quality of public services, they will not be willing to pay for the costs of adjusting the tax structure. In the past ten years, China's fiscal spending on people's livelihoods has grown rapidly, and the public's sense of benefit has improved significantly, but there is still a lot of room for improvement. Take, for example, basic medical insurance for urban and rural residents. In recent years, this social security system, which has a high proportion of financial subsidy and is considered to be "heavily tinged with welfare," has been coldly received in rural areas. Farmers' willingness to pay its fees has continued to decline, and the difficulty of collection has increased every year. Therefore, it is necessary to improve the effectiveness of fiscal investment, continue to promote supply-side reform, optimize capital allocation methods, and meet the diverse needs of the people in a better and more timely manner.

Translated by Thomas E. Smith