

## Fighting for Harmony: the Threat of Social Instability During the Global Financial Crisis

### Introduction: Guaranteeing 8

Social stability is widely seen as the *x* factor in most, if not all, of the Chinese Communist Party's recent moves to blunt the domestic effects of the global financial crisis. GDP predictions for 2009 released in state media run from an optimistic 9.3%<sup>1</sup> to a dire 5% estimate by the World Bank<sup>2</sup>. While the percentages themselves are no more than uncertain projections at this point, the regime sees each as a measure by which it can calculate a corresponding volume of social instability.

9.3% GDP growth would be much cause for celebration in 2009, but the CCP right now is focused on "lucky number" 8. This is the rate of annual GDP growth economists consider necessary to accommodate the 20-25 million Chinese entering the domestic workforce next year. To this end, it is hardly surprising that China is willing to invest nearly all USD 586 billion of its stimulus package into large-scale infrastructure projects to 'guarantee 8' (保八) in 2009. These projects are labor intensive and promise employment to those the regime is most wary of: poor, local, and increasingly assertive factory and migrant workers. If recent protests are any indication, this group will be unafraid to aggressively promote its economic interests during the downturn.

Western media has spent a great deal of coverage speculating over what degree the crisis will affect social stability and what it will mean for CCP legitimacy. Party leadership has also admitted that managing the crisis will test its ability to govern.<sup>3</sup> Yet there has been surprisingly little discussion about a comparative period during China's economic reform: the state-owned enterprise reform of the 1990s. In order to examine what type of political and social ramifications a global financial crisis could potentially have in China, the 1990s provides a useful point of comparison. During the 1990s, the CCP faced similar external and internal economic conditions as well as domestic pressure borne of widespread unemployment. How it managed during this period may provide clues to its future actions.

The mechanisms at the CCP's disposal during the crisis are also important and tied to the 1990s reform period. Regulations such as the Labor Contract Law, which was formulated to provide a measure of worker protection after mass SOE layoffs, is one aspect of the debate among academics. More broadly, the debate includes the conflict between the LCL and economic necessity, disagreements over the proper execution and implementation of the stimulus, and the future direction of China's economic reforms.

### State-owned Enterprise (SOE) Reform 1994-1999

State-owned enterprise (SOE) restructuring and reform began in earnest around 1995. It was considered a risky and dramatic economic initiative. The state firms were emblematic of China's "Iron Rice Bowl," a system of guaranteed, lifetime employment. They were managed by political appointees, and faced little financial discipline or profit expectations. SOEs were required to fulfill certain social obligations, i.e. the hire and retention of superfluous labor, and provision of healthcare and schools. Figures vary, but by official count, China had 300,000 SOEs employing around 75 million people in 1995.<sup>4</sup> Half of them were

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1 Predicted by the Institute of Quantitative Economics under the Chinese Academy of Social Sciences.

2 "IMF sees world slowdown next year," *BBC*, December 15, 2008.

3 Reynolds, James "Economy Warning from China Leader," *BBC*, 30 November 2008.

4 Cao, Yuanzheng, Yingyi Qian, and Barry R. Weingast, "From Federalism, Chinese Style to Privatization, Chinese Style." *Economics of Transition*, 1999.

unprofitable.

Yet many assert that profits were secondary to the main rationale of supporting a loss-making SOE: the promotion of social stability. No system of social services had, or has since, been significantly developed independent from SOEs. The regime was understandably reluctant to simultaneously throw millions of Chinese workers out of their jobs *and* sever their access to critical social services. To do so would mean seriously jeopardizing social stability.

But by the mid-1990s it was clear the economy could no longer accommodate such unwieldy, capital-eating companies if it wanted to continue its reform and opening up. SOEs had become too much of a financial liability. Operations were entirely dependent upon loans from the major state commercial banks. There was often political pressure involved in securing loans and little expectation the SOE would pay it off. The average NPL in the major banks was 25% (officially) in 1999, the first year figures were released. Most NPLs stemmed from loans extended to SOEs. In 1994 the Big Four banks were commercialized and bank oversight centralized. This, as well as the introduction of hard budgets into the state sector, reduced the ability of local governments to secure questionable loans from local bank branches. SOEs were allowed to fail.

### **SOE Reform: Political Fall Out**

The most immediate and direct consequence of SOE reform was unemployment. From 1995-2002 7,798 SOEs were allowed to go bankrupt; official statistics put the number of laid off workers at 28 million during the same seven years. Combined with the number let go from the dismantled collectives, the total reached upwards of 30 million. The regime tried to specifically support state workers through compensation, severance, and reemployment programs. None of the three strategies were that effective. In particular, bankruptcy and asset stripping by management meant that workers were often denied severance or compensation.

Corruption was an indirect and pervasive consequence of large-scale restructuring. Outright embezzlement or the undervalued sale of public firms to family incurred billions in economic loss for the state. China's State Administration of Foreign Exchange estimated that capital flight from China amounted to USD 52 billion between 1997 and 1999, much of it by way of SOE executives and officials.<sup>5</sup> In 1999, the national auditor general estimated at USD 14.2 billion in tax revenues had been misappropriated by government officials.<sup>6</sup>

Unemployment combined with such brazen official corruption demoralized the public. According to the Hong Kong-based Information Center for Human Rights and Democracy, 60,000 worker protests took place in 1998 and 100,000 in 1999. This includes a purported three-day miners protest of 20,000 in Liaoning in 1999. Official statistics themselves report 10,000 protests in 1994 but a surge in protests or "mass incidents" by 2004 to 74,000 and around 86,000 protests in 2005.<sup>7</sup> While actual numbers are unclear, it is likely that the number of protests per year from 1994 onwards trended dramatically upwards into the tens of thousands as

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Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank and the Agricultural Bank of China.

A very comprehensive overview: Zhang Juwei "Urban Xiangang, Unemployment, and Social Support Policies". Institute of Population and Labor Economics, CASS.

5 "Capital Flight from China Hits US\$ 53 Billion in 1997/1999," *AsiaPulse News*, 13 August 2001.

6 Zonis, Marvin "Politics and Economics and Development" 2000

7 Pei, Minxin "Will China's Capitalist Revolution Turn Democratic," *Project Syndicate*, 2006.

SOE reforms deepened and unemployment grew.<sup>8</sup>

At the same time, regional economic uncertainty was also placing pressure on China. The Asian Financial Crisis (AFC) caused a precipitous drop in the growth of exports: 20% in 1997 to .5% in 1998. The crisis also scared off foreign investors. Foreign investment dropped to its lowest in two decades. Furthermore, between 1995-1999 China had experienced four consecutive drops in annual GDP growth.<sup>9</sup> This trifecta—domestic economic slowdowns, a hostile external economic environment, and political unrest—forced Beijing to reevaluate its reforms. In 1999 it stepped back from its most aggressive SOE reform policies. Hu Jintao and Wen Jiabao resumed them in 2003.

## **The Debate over Mechanisms of Stability**

### **The Labor Contract Law (LCL)**

The Labor Contract Law came into effect 1 January 2008. It was passed partly to preempt scenarios similar to those of the SOE reform period involving management corruption and mass unemployment that led to unrest. The LCL has been controversial for what many perceive as its pro-labor bias. It defines and strengthens employees' legal rights while broadening employer obligations toward labor contracts and contract termination.

Conservatives believe that adherence to the Labor Contract Law under the present circumstances will bankrupt companies that are looking to streamline as their profits contract. In particular, they argue that the LCL makes it difficult to fire excess or incompetent labor. A company unable to exercise this function will grow inefficient and unprofitable. This may shield workers short-term, but enterprise bankruptcies will mean wider unemployment and lost investment. Leftists take a different approach. They believe the LCL creates impetus for efficiency through production updates and high-tech innovation. Provisions allow for “collective layoffs” (20 employees or more) when, after an enterprise switches to more efficient production, introduces a major technological innovation or revises its business methods, still finds that it needs to reduce its workforce. According to Leftists, the law thus serves two purposes: one is to protect workers in ways that were unavailable to them in the 1990s. The other is to offer companies an opportunity to promote efficiency through the practices encouraged by the law.

It seems as if the CCP is looking to have it both ways. Officials and media continue to insist that reforms will continue unabated. Factories have been closing, particularly in export regions, without intercession from the central or local government. 10 million workers have reportedly been laid off since November. The planned minimum wage hike for January has been delayed.

Yet in other respects, the regime seems to have moved away from the efficiency promoting aspects of the LCL and straight to labor protection. The State Council has urged companies to refrain from firing workers, and some provinces have taken the initiative by requiring firms to apply for approval from local human resources and social security authorities if they want to lay off 40 or more workers. Central and local governments have moved in recent weeks to resurrect lay off methods of the 1990s: some workers are being sent home to “celebrate Spring Festival early” and will be called back in when business picks up.<sup>10</sup> Others

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8 Despite the violence of some of these “mass incidents” the government felt most threatened by the religious sect, Falun Gong. Its ranks swelled with the unemployed during the mid to late 1990s. Although peaceable and originally tolerated by the regime, the CCP began to see its organizational capacity as a potential danger, particularly after it organized a peaceful protest outside government headquarters in 1999 without the knowledge of authorities. Afterwards, Falun Gong was swiftly and decisively repressed.

9 China Statistical Yearbook 2004: 1995 10.5%; 1996 9.6%; 1997 8.8%; 1998 7.8%; 1999 7.1%.

10 Xu, Weiyi "China to Ensure Stable Employment Amid Global Financial Crisis," *Bridging the Straits*, 19 November 2008.

have been told that they will be asked to return when the market improves but compensated in the interim.<sup>11</sup> Beijing also took a step back from SOE reform by announcing lower evaluative standards for 2009 after SOEs under SASAC reported a 26% drop in year-on-year profit in the first 11 months this year.<sup>12</sup> By relaxing its criteria, the regime will avoid a wave of laid off SOE workers that would undoubtedly stretch its resources beyond its capabilities.

The regime is moving decisively to guarantee employment and unemployment benefits, despite the drag it may have on the economy. The cash flow is seen as vital in avoiding unrest. However, it is unclear whether the regime expects enterprises to shoulder the burden of compensating “sent home” and laid off workers. Many question the CCP's own capacity to do so, particularly when only 1% of the stimulus budget is planned for increased social services.

### **The Stimulus: 3 Criticisms of Execution**

Criticism of the stimulus has divided mainly into three parts. The first is whether the money is being used efficiently. Supporters believe that the investment not only supports the sagging construction industry but is also a tried and true method of economic growth, as proven by the CCP's infrastructure investments during AFC. The stimulus is expected to offset the drop in global demand while domestic initiatives will spur consumer spending at home. Critics depict the stimulus as economic retrenchment. An economic slowdown was predicted *before* the financial crisis. This period was originally intended to be used to shift economic direction and investment away from low-end mass production to areas such as quality production and inspection, services, R&D, etc. Though an infrastructure stimulus may have worked during the AFC, critics say it is providing temporary jobs and supporting an export industry that is not likely going to see global demand pick up soon. Further, critics claim that domestic demand will not rise enough to justify planned areas of spending.

A number of scholars point to social services as a much needed area of investment. In a way, social services represent a link between the debates over the LCL and the stimulus: where the LCL cannot—or is prevented from—providing severance, compensation, or any other form of contractual fee to a laid off employee, the central government's plan for increased social services should, ostensibly, ease the burden from individual households. However, 5.86 billion (1% of 568 billion) hardly seems sufficient considering the current state of the social service system in China, the size of the population, and the potential demand for such services in the coming months. While the regime is open about the need for social services reform, officials see systems like the healthcare system in such dire need of reform that any significant amount of money would be an irresponsible and ineffective allocation of resources. To them, the regime is staying on the right course by ensuring employment and thereby ensuring that people can afford the services themselves.

Questions over domestic demand are part of the second criticism. Critics of the initiative wonder how the stimulus will boost consumer spending when the country's very economic infrastructure encourages saving. China is a nation of savers. Consumer spending is only about 33% of the country's GDP. Many point to the high savings rate as a result of individual household's responsibility for social services and the rising costs of those services. The stimulus will not alter spending and saving behavior when consumers are not confident about their economic futures. Though Beijing has ensured employment by putting a freeze on wages, this only ensures that people will spend *something* rather than nothing, and it hardly guarantees that they'll spend *extra*. In fact, by reserving so little for social services in the stimulus while existing services have yet to improve, the average Chinese consumer is more likely than ever to save as much as possible.

The third critique focuses on the distribution and oversight of the investment. In the 1990s, the ends—SOE

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11 "China Strives to Avoid Large Layoffs in Financial Crisis," *China View*, 16 December 2008.

12 Zhou, Hao "China Grants Leniency to SOEs," *China Daily*, 17 December 2008.

reform and restructuring—often overshadowed the activities, i.e., asset stripping and embezzlement, of those managing the policy. Similarly, the scope of investment and the urgency by which the regime is acting leaves room for provincial pork barrel requests and financial misdirection. Politically, financial mishandling in the 1990s was a huge source of anger with the public. Today, that public is infinitely better connected via Internet (a community of 290 million) and mobile phone (over 600 million mobile phone owners) than they were a decade ago. They are more willing to scrutinize government officials and direct public attention towards those they suspect of misappropriating funds. Public opinion has become more important to the regime in recent years. It seems to not only share this concern over corruption, but also how it could play with the public. It has formed 24 inspection teams to travel across 31 provinces to monitor the implementation of the investment. Critics, however, remain skeptical over the institutional capacity and preparedness of the CCP to exert proper oversight.

## Conclusions

The 1990s SOE reform period provides a useful point of comparison for China watchers today for several reasons. First, because SOE reform is ongoing. When Hu and Wen assumed power 159,000 SOEs remained. They employed approximately 50 million people. By 2009, it was estimated that 2,000-3,000 of them would go bankrupt; others would downsize through privatization or mergers. Between 2003-2007 the government expected 9 million layoffs and millions to follow. Yet for all its rhetoric about continuing its strategy of reforms, China has adopted a worker protection approach by lowering SOE standards and promoting lay off disincentives.

Second, because the 1990s reform period spurred a greater push towards corporate law and governance. How the CCP negotiates institutionalized mechanisms for enterprise reform (and indirectly social stability) like the Labor Contract Law and largely ad-hoc initiatives like the stimulus will provide an indication of the priority of law vis-à-vis immediate economic need.

Thirdly, during the 1990s the regime faced falling domestic indicators, a regional crisis, and domestic unrest. As a result, it slammed the brakes on reform. Now it is facing similar circumstances with an economy much more integrated than it was ten years ago. Although the full measure of its response has yet to come, all indications point to another halt in painful SOE reforms and a return to mass labor industries such as construction. The regime seems willing to sacrifice short-term reform if it also means achieving short-term social stability.

Whether or not this is possible remains to be seen. *People's Daily* acknowledges maintaining social stability during the crisis as an “arduous task”<sup>13</sup>. High-ranking officials are featured on television and in newspapers exhorting their local counterparts to act preemptively and respect workers' rights to reduce conflict. Though intolerance for those that seek to disturb social harmony is expressed, the regime's approach has been conciliatory thus far—witness, for instance, the regime's concessions during the taxi strikes this December. As long as protestors remain unorganized, the regime is likely to remain so.

Indeed, the lessons the regime has learned since the 1990s are evident in its willingness to turn its “soft charm” inward, as opposed to using heavy-handed police tactics against protestors. Its political savvy may provide the regime with cover despite a drop in GDP. Media consistently portrays the CCP as China's best hope for economic recovery and continued growth. Rather than challenge the regime's legitimacy, the financial crisis offers it the opportunity to entrench itself further as China's only political option. Compromises with protestors plus new domestic media freedoms to cover protests indicate an increasing confidence by the CCP. The belief that it or the authoritarian system will be seriously challenged in the upcoming months underestimates the regime.

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13 Hornby, Lucy "Unemployed Masses Worry Stability-Obsessed China" *Reuters*, 17 December 2008.