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China's Welfare State: Mission Accomplished?

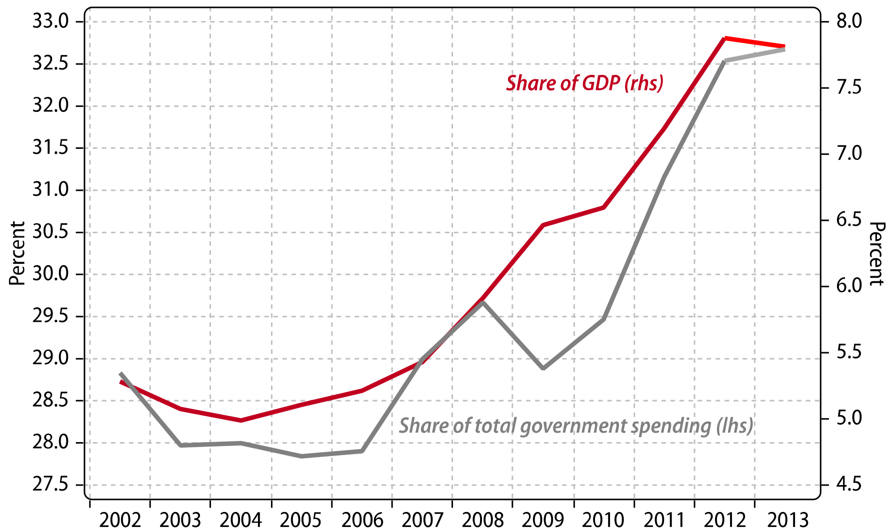
Outsiders have long encouraged China to build a better social welfare system

China has received no shortage of well-meaning advice from economists in recent years, and on one point there has been surprising unanimity. Since at least 2005, the International Monetary Fund and similar bodies have been urging China to create a social safety net that will ease households' worries about providing for the future, and thereby get them to save less. The resulting boost to consumption should in theory help the economy move away from investment-driven growth. In this context the plans announced at China's recent legislative session look worrying: growth in government spending on social services is now budgeted to slow markedly in 2013. Social spending's share of both the economy and total expenditure, which has risen sharply since 2006, will be roughly flat this year. So is China giving up on building a social safety net, and will this be a disaster for the hoped-for rebalancing of the economy?

But the latest government budget shows that spending growth will slow

Is the building of China's social safety net slowing down?

Total government spending on health, education and social security



Ministry of Finance, CEIC, GaveKal Data

China has in fact already built many of the key programs for a social safety net

The answers are no and no. This is simply because China has already done more than many observers realize to create the fundamental institutions of a social safety net. That doesn't mean China has nothing left to do, but it does mean that in the future the government will be focusing more on consolidating and improving the social safety net, and not on creating it from scratch. The genuine accomplishments of recent years, unfortunately, have had no observable impact on China's high household savings rate. And if the significant changes in the social safety of the last few years haven't produced the hoped-for change in household savings behavior, it seems at best unlikely that the more gradual changes of the future will do so. There are plenty of reasons to think China's savings rate will fall in coming decades, but factors outside the government's control—namely changing demographics and the slowing trend rate of economic growth—are likely to be the main drivers.

A stronger safety net has yet to have an effect on China's high household savings rate

The economic argument for expanding China's social safety is the so-called "precautionary savings" hypothesis. This holds that the myriad uncertainties unleashed by China's shift to a market economy, and the collapse of social benefits once provided by state-owned enterprises, put enormous pressure on households to save for future medical and living expenses. As government benefits can reduce the need for such savings, they are an obvious solution. Although China has a long track record of ignoring Western economic advice, this argument has proved surprisingly influential. We do not think it unfair to say that part of the appeal of this theory came from its hard-nosed economic argument for changes in government policy that many Chinese scholars wanted to see for reasons of social justice and fairness.

Time for a bit of socialism

Not all observers appreciate the scale of the social programs that China has rolled out in recent years

The changes that have resulted are dramatic. Public medical insurance programs for rural residents and low-income urbanites, launched in 2003 and 2007 respectively, now cover more than 95% of the population. For the poorest of the poor, the Medical Assistance Program (2003) helps out with health insurance premiums and any out-of-pocket expenses. As a consequence, the share of medical bills paid out of pocket has fallen to less than 40%, from 60% in 2001; also, nearly all rural residents now have some healthcare coverage, while just 13% did in 2000. Pension coverage has also expanded dramatically: in 2002 only 55m rural residents and 147m urban employees had pensions, but today nearly 700m rural and urban residents have some form of coverage, of which more than 240m were enrolled since October 2009 under the new rural pension system. In addition to these two essential planks of the social security system, many other smaller reforms have helped to fill in the gaps. A minimum living stipend (*dibao*) was extended to rural areas in 2007 to top up the income of the poorest households, and free compulsory rural education has been available since 2006. The government's roll-out of subsidized urban housing nationwide over the last couple of years has also added another major benefit to this arsenal of welfare programs.

The next stage is to gradually improve the benefits already on offer, rather than creating new programs

China has certainly not created a European-style welfare system just yet: the level of medical and pension benefits is still very low for many of the participants in these new programs. But this just reinforces the point that the future focus of social welfare reform is likely to be on gradually raising the level of benefits, rather than on big new initiatives to expand coverage. Minister of Health Chen Zhu made just this point in a briefing on the future of healthcare reform last month: with 95% coverage already achieved, he said, the next steps are to gradually raise the level of government subsidies and the share of medical expenses reimbursed. And the big healthcare reform priority for the immediate future is an overhaul of the nation's public hospital system—in other words, improving the functioning of China's welfare institutions, rather than creating new ones.

Yet the progress on the social safety net over the past decade has not in fact brought about the promised reduction in household savings. Indeed, the

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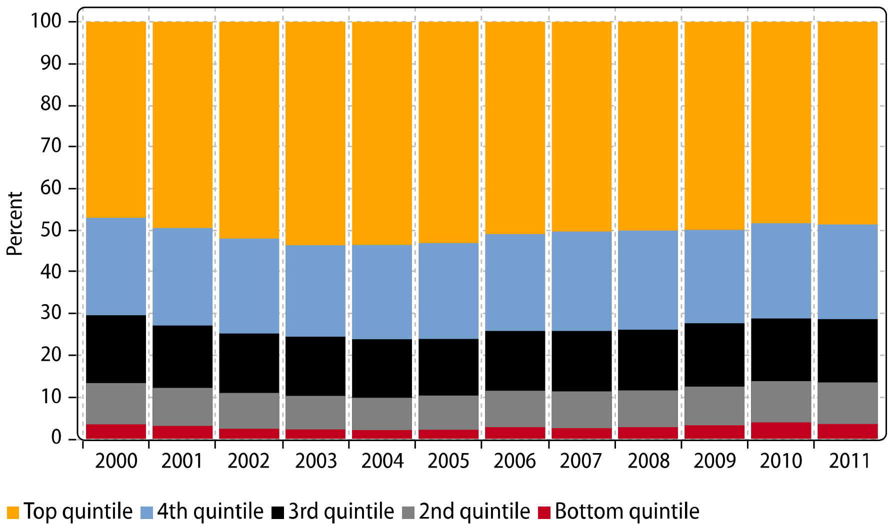
Social programs do help the poor but don't do much to change the incentives of the upper crust

savings rate implied by household survey has risen from 25% in 2003 to 29% in 2012. This is a bit of a problem for the precautionary savings hypothesis, since the degree of future uncertainty for medical expenses, for instance, should now be much lower. This is easier to understand once we realize that for the aggregate savings rate, it matters a lot just whose uncertainty is being assuaged. About 50% of the total savings of urban households comes from the top 20% of the income distribution, while less than 4% of savings come from the bottom 20% of households. While the improved social safety net may indeed have reduced precautionary savings by lower-income households, any impact on the aggregate household savings rate would be very small.

The behavior of high-income households drives the aggregate savings rate

Most of China's household savings come from the well-off

Share of total urban household saving, by income quintile



CEIC, GaveKal Data

If the social safety net is not going to be the decisive factor for China's savings rate, what might be? The leading contender is demographic change. People in their working years tend to be net savers, while the young and the old tend to be net spenders. If the proportion of net savers in the population is rising, then the overall household savings rate should also rise. This is in fact exactly what has been happening in China since the late 1990s: the share of the working-age population has been rising, and the dependency ratio has been falling. But demographic trends are now shifting to a rising dependency ratio and a declining share of the working age population in coming years. And this is a plausible reason to expect the savings rate to fall. The effect could be amplified if the generation now entering their prime working years has a different set of values that lead to a lower savings rate (see From Skinflints To Splurgers). Slower economic growth in the future could also lower savings, as it means fewer households will be experiencing the kind of dramatic, short-term jumps in income that tend to be mostly saved rather than spent.

Future demographic change could well have a more obvious effect on savings rates

Working against the force of demographics, however, is the income effect. Although China will be getting older in coming years, it will also be getting richer. As people's incomes rise, they tend to save more; so as the incomes of all Chinese households rise, they will all have a tendency to save more of

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Higher national income works in the opposite direction from demographic change, and tends to push savings rates up

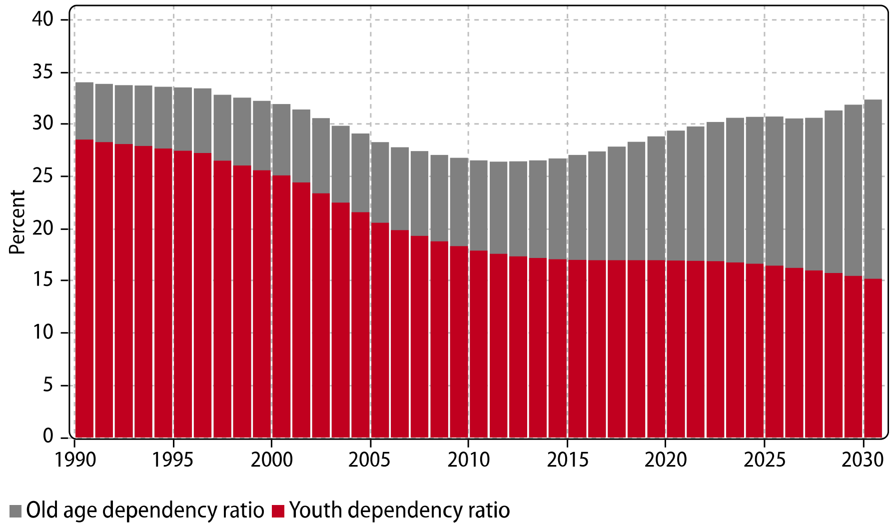
A higher dependency ratio, other things being equal, implies a lower household savings rate

China should focus on raising household incomes rather than trying to force households to save less

their newfound income. This effect is especially clear at lower income levels, where more and more households are moving out of subsistence mode: the bottom 20% of urban households already now save 13% of their income, twice as much as the 6% they were able to save in 2005. These countervailing forces make it very difficult to predict the path of China's savings rate. The experience of Taiwan, South Korea and Japan does however suggest that, on balance, Chinese households will indeed start to save less and spend more as the country gets older and more developed. (For a fuller discussion, see the savings debate in the December 2009 issue of the China Economic Quarterly, with contributions from Calla Wiemer, Louis Kuijs, Jonathan Anderson and Albert Keidel.)

China's dependency ratio is now starting to rise

Share of population aged 0-14 and 65+



US Census Bureau, GaveKal Data

But it is nonetheless true that it has proved extremely difficult for China's government to engineer a lower household savings rate, despite significant changes in policy over the past decade. There is a compelling argument, advanced by Nicholas Lardy among others (see All About Interest Rates) that the government should instead be focusing on raising the real interest rates that banks pay on household savings. This would increase household income, and also mean that households would have to save less of their income in order to meet their savings goals. This argument only reinforces our conviction that the priority for a successful rebalancing of China's economy should be on sustaining household income growth, probably in part by redistributing income from the corporate and government sectors, and not on trying to force households to be less prudent.