Farewell to Groping Stones?
The Case of the Labor Contract Law in China

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1. Introduction

China's Labor Contract Law (*Laodong Hetong Fa*; henceforth LCL) came into effect in January 2008 as one of the most important reforms of her labor market regulation. While the law is celebrated for its comprehensive protection for the employed, it also gives rise to a variety of controversies over its economic impacts ranging from increasing costs of labor for enterprises to rising unemployment both in business and academic communities. In addition to these controversies over the LCL's potential economic impacts, the passage of the LCL was a puzzle to many students of China's political economy.

In the first place, while China has always claimed herself to be a "*socialist*" market economy since the economic reform began, workers, especially migrant workers from the rural areas, have been experiencing extremely tough working conditions without proper channels for addressing their grievances. Within China's political system, they also fail to have a strong advocate to represent their interests and fight for their rights. The passage of the LCL thus marks as a surprise to everyone not because it is not timely enough but because China's political system did not have any fundamental transformation to have the voice of this previously disenfranchised population suddenly heard in the political arena loud and clear. As a result, how can we account for this sudden move by the Chinese government in favor of the working class?

Secondly, this sudden move seems to run against the long experimentalist tradition in China. China has been widely praised for its gradualist approach to economic reform where almost every significant institutional change is experimented in selected localities

before it is implemented nationwide. Experimentation has enabled the party-state to generate policy innovations to adapt to a rapidly changing economic environment (Heilmann 2008). The 2007 LCL, however, seems to mark a distinct outlier in China's long tradition of experimentalism. During the annual meeting of National People's Congress in March 2008, one representative from the Guangdong province, LI Shuguang, openly suggested to experiment the LCL at local sites before it is implemented nationally[1]. Within academia, this suggestion was echoed by a lampoon made by CHEN Ping of Peking University that the LCL obviously violated the experimentalist tradition that has brought China both prosperity and stability[2]. Does the promulgation of the LCL indeed break the rule of Chinese experimentalism? If yes, why do some labor policy reforms in China follow the principle of experimentation while others don't?

Thirdly, the implementation of the LCL seems to decrease firm's demands for labor and thus might cause unemployment. The labor costs incurred due to the LCL has undermined the comparative advantage enjoyed by the export sector which has contributed remarkably to China's economic miracle since the late 70s and, more importantly, created tons of jobs for surplus labor force originally left idle in the rural areas. The LCL is a surprise because it raises the cost of these labor-intensive export enterprises. Why did the Chinese government announce the new policy that was likely to

[1] "The implementation of the LCL is indeed beneficial to employees. I don't think the law is overly pro-employee though. However, to promote such an important law as the LCL, we should consider to experiment it in some localities first... Is the LCL suitable for China's current situation? The central government should be more cautious," said by the NPC representative LI Shuguang. See China Social Security website: http://www.cnss.cn/xwzx/zl2/ldhtf/rdjj/200803/t20080303_179475.html

[2] "The most successful story of our economic reform is experimentalism. But now, we want to implement the LCL without any experimentation. This violates our most important experience. It is nothing but an imitation of Western failed welfare state, " said by CHEN Ping. See Research Seminar on the 2008 Sessions of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC), held by the China Center for Economic Research (CCER) at Peking University: http://finance.jrj.com.cn/news/2008-03-20/000003432093.html

worsen the unemployment rates?

As the discussions around the LCL are coming to an end in the Chinese society for lack of any signals from the central government to rescind it, this paper seeks to explore systematically the policymaking process of the LCL and to identify the causes for adoption or rejection of the LCL by Chinese policymakers.

The paper proceeds as follows. In section 2, we describe the lawmaking process of the LCL and identify the actors who are involved. Section 3 analyzes the labor contract system in terms of experimentalism. We analyze the political economy of the LCL and provide our explanations on the implementation of the LCL in Section 4. We argue that the LCL was passed not because the pro-labor forces suddenly had their way in the Chinese politics, but because the LCL is going to facilitate the industrial upgrading in China. We conclude the paper in Section 5 by suggesting that rising unemployment caused by the LCL has made the Chinese government consider to slow down the speed of economic upgrading.

2. Making the Labor Contract Law

The labor contract system (*laodong hetongzhi*) was implemented nationwide in 1986 to replace the iron-rice system when the urban unemployment rates skyrocketed due to the return of youth who were sent out to the countryside during the Culture Revolution. Along with the concerns of unemployment, the Chinese policymakers also started to recognize that the iron-rice bowl system would highly contribute to low labor productivity. The ideal of the labor contract system is to reduce state administrative

control on labor allocation, and to give firms the rights to recruit their own workers according to their requirements. Since the new system is implemented, new employees can only been hired by signing contracts with his/her enterprise, and the renewal of the labor contract is supposed to only depend on worker's performance (White 1987, 369-70). The new system marked a breakthrough point of China's labor market reform. The initial steps of the reform were modest, however. Since the "Reform and Open Door" policy was announced in 1978, until 1994 when the first Labor Law (*Laodong Fa*; henceforth LL) was promulgated, there had been more than 160 labor regulations and rules issued by the government (Ngok 2008, 49). But it was only until 1994 that workers on contracts rosed rapidly (Brooks and Tao 2003, 16).

The process to introduce the labor contract system first and to make the LL later reveals that in China, policy always comes first, and then law follows. Only those policies that have been experimented successfully can be codified into law (Ngok 2008, 48). The LL is the first codified legal framework regulating China's labor market, but the clauses dealing with labor contacting are all simple. Right after the LL was enacted, efforts to make a national law on labor contract started (Cooney et al. 2007, 2). The initial work by the Legislative Affairs Office of the State Council were, however, not continued because the former Premier ZHU Rongji considered the restructuring of state-owned enterprises (SOEs) and layoff policy to be the priorities at that time[3].

In the 90s, the labor policy regime was characterized by the prevalence of varieties of regulations. The LL provides a general legal framework while many administrative regulations were issued to deal with the implementation. These regulations are more

[3] Informant 1, member of the Legislative Affairs Office of the State Council. Interview conducted on March 15, 2008.

flexible than law, leaving much room for local governments and enterprises to maneuver. Many have pointed out the inadequacy of the LL alone in regulating the labor market. First, the LL does not require employers to pay any severance payment (i.e. economic compensation) for employees when they are dismissed due to contract expiration. Second, the LL does not regulate the time limit for an employer to sign a contract with newly recruited workers (Ngok 2008, 55). In practice, employers usually do not sign any contracts with the workers, or only sign very short-term labor contracts, such as three-month contracts with their employees. Moreover, the articles in the LL on labor contracts focus almost entirely on termination, and do not address contract formation in any detail (Cooney et al. 2007, 789). Considering the poor performance of the LL, together with the concerns that most private enterprises have even less satisfied records than SOEs in signing contracts, the Chinese government embarked on drafting the LCL and published the first draft in March 2006. Before discussing the lawmaking process of the LCL, we will first examine the differences between the two labor laws.

2.1 Differences between the 1994 Labor Law and the 2007 Labor Contract Law

While both the 1994 LL and the 2007 LCL regulate employment relations, many regulations in the two are different. In general, the provisions of the LCL is more specific and operation-oriented. The LCL is regarded as a more pro-employee regulation than the LL in the following ways.

1) The LCL penalizes employers if they refuse to sign a written labor contract.

While the LL has a chapter on labor contract, it does not have any regulations on how

an employer will be punished if he fails to sign a written labor contract with an employee. In practice, the rate of use of labor contracts is extremely low especially in township and village enterprises (TVEs), small-and-medium-sized private enterprises, and small-and-medium-sized joint ventures. Without written labor contracts, workers have difficulties in proving their employment relationships.

In the LCL, however, it requires that a written labor contract shall be concluded within one month after the employer starts using the laborer (LCL Article 10). If an employer fails to sign a written labor contract with a laborer after one month but within one year, it shall pay a double salary to its employees affected (LCL Article 82). Moreover, if the employer fails to sign a written labor contract with an employee after the lapse of one full year, it shall be deemed that the employer and the employee have concluded a labor contract without a fixed term (LCL Article 14).

2) The threshold of making a labor contract without a fixed term is lowered in the LCL.

Low rate of signing labor contracts is not the only problem. Even when there is a labor contract, chances are it is a very short-term contract. The government proposes rules on labor contract without a fixed term to remedy this practice. A labor contract without a fixed term (*wuguding qixian hetong*) refers to the contract in which employer and employee stipulate no certain termination date. In other words, the term is indefinite, and the contract can only be terminated for cause. It is one of the three kinds of labor contract, the other two being fixed-term labor contract and labor contract with time limits for the completion of a specific task. Some points out that the LCL innovates a fourth category of labor contract, the non-fulltime engagement of labor (*fei quanri zhi*

yonggong). This employment is remunerated by hour and is terminable at any time without notice or severance pay. The use of one non-fulltime laborer is restricted to an average of no more than four hours per day, and no more than 24 hours per week (Cooney et al. 2007, 797).

Labor contract without a fixed term is one of the most controversial articles in the 2007 LCL. In the 1994 LL, when a laborer requests for a contract without a fixed term after working continuously with the same employer for more than 10 years, a labor contract without a fixed term shall be concluded (LL Article 20). On the other hand, in the LCL, similar to the LL, if the employee proposes to renew a labor contract when the employee has already worked for the employer for ten full years consecutively, a labor contract without a fixed term shall be concluded (LL Article 20). However, unlike the LL, the LCL lowers the threshold of making a labor contract without a fixed term by stating that a labor contract without a fixed term shall be concluded after two fixed-term labor contracts have been concluded consecutively. Moreover, when an employer introduces the labor contract system for the first time, or when a SOE recruits workers as a result of SOE restructuring, s/he should sign labor contracts without fixed terms with those workers who will reach the statutory retirement age in less than ten years and have already been working for him/her for ten consecutive years (LCL Article 14).

3) The LCL requires severance pay when a fixed term labor contract expires.

The 1994 LL does not require severance pay when a fixed term labor contract ends. In the Ministry of Labor's 1995 “Opinion on Certain Questions concerning the Implementation of the Labor Law” (*Laodong Bu guanyu Guanche Zhixing Zhonghua*

Renmin Gongheguo Laodongfa Ruogan Wenti de Yijian), it clearly states that when the term of a fixed term labor contract expires, the contract terminates (LL Article 23) and no economic compensation is required (1995 Opinion Article 38).

The 2007 LCL, however, requires that when the term of a fixed term labor contract expires, except in the case where the laborer does not agree to renew the contract, the employer should pay economic compensation (LCL Article 46). This rule has been thought as the most significant change to the LL since it may prevent employers from using fixed-term contracts to avoid the severance pay (Lin, Sandy 2007).

4) The LCL clarifies the penalty for employee's breach of contract.

While there is no regulation on penalty for employee's breach of contract in the LL, the LL does not prohibit employers from fining the penalty on employees. Without the prohibition, there emerged various kinds of provincial regulations on how to fine an employee if s/he breaches the contract.

Some of these provincial regulations are proven to be illegal as the LCL regulates that the amount of penalty for employee's breach of contract shall not exceed the training fees provided by the employer (LCL Article 22).

5) A discussion with the assembly of employee's representatives or all the employees is needed before an employer can adjust a employee's salary.

The LL does not have any requirements on employers to discuss the adjustment of salary with employees before the action is taken. However, the LCL asks an employer to discuss the formulations or revisions on rules and regulations concerning labor

remuneration, working hours, and insurance and welfare with the assembly of employee's representatives or all the employees (LCL Article 4).

6) Only one probationary period is permitted by the LCL.

The 1994 LL requires that probationary periods shall not exceed six months generally (LL Article 21), but in practice, as an employer may terminate, without cause, the employment relationship with a worker who is serving the probationary period (LL Article 32), many employers have extended the probationary period and forced employees to serve more than one probationary period. To address this problem, the 2007 LCL clearly states that only one probationary period is permitted. The maximum length of probationary period varies and depends merely on employment duration: if the term of a labor contract is not less than 3 months but less than 1 year, the probationary period shall not exceed one month. If the term of a labor contract is not less than one year but less than 3 years, the probationary period shall not exceed 2 months. For a labor contract with a fixed term of 3 years or more or without a fixed term, the probationary term shall not exceed 6 months. For a labor contract that sets the completion of a specific task as the term to end the contract or with a fixed term of less than 3 months, no probationary period may be stipulated (LCL Article 19).

Moreover, the LL does not provide any regulations on the salary payable to employees during the probationary period. In practice, many workers are abusively underpaid during their probationary periods. To correct the problem. the LCL proposes three standards of salary for probation. The salary for a worker in his/her probationary period should not be lower than the minimum salary for the similar positions in the employer, or 80% of the

salary as agreed in the worker's labor contract. Moreover, the salary should not be lower than the local minimum wage where the worker is located (LCL Article 20).

7) Regulations on labor dispatch are provided.

Labor dispatch (*laowu paiqian*) occurs when an employee works for an enterprise but do not have direct employment relationships with the enterprise. In other words, it cuts the direct employment relationship between the employee and the employer. The employee is not hired by the employer; s/he only works for the employer. The employee is obtained from another firm, the labor dispatching agencies, which dispatch the worker to the employer (Cooney et al. 2007, 800). Labor dispatch is welcomed by most employers because it makes them escape paying statutory employment benefits or even remunerations to the dispatched employee. It is the dispatching agencies who bear these costs. Although labor dispatch was already widely used in the 90s, the 1994 LL does not set out any principles on it.

While there were no national rules on labor dispatch in the 90s, there were several city-level regulations. For instance, the Beijing city pioneered labor dispatch regulation in 1999 by issuing the "Beijing Tentative Administrative Measure on Labor Dispatching Organization and Management". The 2007 LCL is the first national legal framework on labor dispatch. The LCL requires a labor dispatching agency to sign a fixed-term contract with a term of more than two years with its dispatched employees. Dispatching agencies should pay remuneration on a monthly basis. When there is no work, the remuneration should not be lower than the local minimum wage where the dispatching agency is located (LCL Article 58). Article 66 of the LCL states that labor dispatch shall generally

be practiced for temporary, auxiliary or substitute job positions. Article 67 forbids firms to establish their own labor dispatching agencies to dispatch employees to work for themselves.

2.2 The lawmaking process of the 2007 Labor Contract Law

As indicated, provisions in the 1994 LL on labor contract do not provide adequate regulations on the labor market. On August 4, 1995, the Ministry of Labor issued the "Opinion on Certain Questions concerning the Implementation of the Labor Law". The Opinion provides several supplementary regulations. For example, it prohibits upfront payment of money as a guarantee of an employee's performance. The Opinion, however, does not enjoy the status of law (Cooney et al. 2007, 790). Since then, many local governments issued their own local rules. For example, on November 15, 2001, Shanghai's Municipal People's Congress passed the Shanghai Municipality Labor Contract Regulations (*Shanghai Shi Laodong Hetong Tiaoli*); In Beijing, the Beijing Municipality Labor Contract Regulations (*Beijing Shi Laodong Hetong Guiding*) was issued by the Beijing Labor Bureau and was effective on February 1, 2002.

The 2007 LCL is the outcome of several rounds of discussion in the Standing Committee of China's National People's Congress (SCNPC). The initial drafters involved the Ministry of Labor and Social Security (MOLSS) and the All China federation of Trade Unions (ACFTU). In 2004, the two proposed the first draft of the LCL. As the deputy director of ACFTU's legal department, GUO Jun, said in a press conference on May 10, 2006, the LCL is aimed at ensuring worker's rights and enhancing labor quality when China is advocating a new development strategy focusing on

technology and creativity (China Labor Bulletin 2006).

After the initial draft of the LCL was proposed, the SCNPC started to comprehensively investigate the implementation of the 1994 LL. The results were extremely unsatisfying. As ZHANG Shichen, the vice director of the Legislative Affairs Commission of the Working and Administrative Bodies of the SCNPC, said, "SCNPC's investigation directly led to the promulgation of the LCL[4]". The principle of the draft was passed by the Standing Conference of the State Council led by Premier WEN Jia-bao in October 2005, and then put on the agenda of SCNPC on December 24 in 2005.

The first publicized draft of the LCL was released in March 2006 for public consultation. It is recognized as the fifth law in the Chinese history that openly seeks for public opinions. Totally, it received 190 thousand public feedbacks. Several articles in the first draft were under intensive debates. For example, for the use of labor dispatch, article 12 of the first draft asks labor dispatching agencies to deposit a sum of at least RMB 5,000 in bank account designated by local labor administrative department for every employee dispatched. Moreover, it also requires that when a labor contract with a dispatched employee ends, the employer must hire the employee directly. If not, the employer cannot use a labor dispatching agency to hire a different person for the same position. Many enterprises were strongly against this article due to the reduction of manager's discretion on flexible employment. For example, the US-China Business Council openly issued its comments against this article (see US-China Business Council 2006). These regulations were significantly modified in the second draft, which was publicized in the late 2006.

The lawmaking process of the LCL witnessed a compromise between competing

[4] Sina Finance News, http://finance.sina.com.cn/g/20071227/22104344693.shtml

demands of many interest groups. According to our interview with a representative of the SCNPC[5], the LCL was one of the most eye-catching laws in SCNPC's discussion sessions. He pointed out that in other cases, only those who are specializing in the law would be interested in the discussion. But in the case of the LCL, most representatives rushed to lay out their own opinions. Some have indicated that the debates involving not only a range of Chinese actors, but also international business lobbyists, such as the American Chamber of Commerce in Shanghai, and international labor organizations, such as the International Labor Organization in Beijing (Cooney et al. 2007, 788). The polarized drafting process represented the conflicting viewpoints of these "pro-worker" and "pro-business" lobby groups.

The third draft was on SCNPC's agenda in May 2007. The version added new clauses such as requiring an employer to construct a worker recruitment list when the labor relation is established (LCL Article 7). This new regulation is usually thought as an reaction to the serious coal mine accident in Shanxi province in May 2007 where the employers concealed the deal toll (Jiang, Jing 2007). This third version, however, was not passed by the SCNPC due to the unsolved debates on the length of probationary period, non-compete clauses, and the regulations on employee's breach of the labor contract if the employee receives professional vocational training from the employer. After several rounds of discussions, the final version, namely the forth draft, was unanimously passed by the SCNPC in June 2007.

[5] Informant 2, representative of the SCNPC. Interview conducted on 04/10/2008.

3. Experimenting the Labor Contract System

China has been widely praised for its gradualist approach to economic reform where almost every significant institutional change is experimented in selected localities before it is implemented nationwide. Experimentation is adopted not only when policymakers intend to provide incentives for increasing productivity before central planning is dismantled, but also when they are not sure about the national impacts of re-regulating the economy. Students have pointed out that experimentation has shaped China's policymaking in varieties of issues ranging from rural collectivization to SOE bankruptcy. Is experimentalist convention also guiding China's labor market reform? To investigate China's labor market regulation, we use several databases to conduct a comprehensive survey on various governmental regulations, policies, and laws of China. These databases include the Wang Fang Data of Policies and Laws of China (PLOC)[6], the MOHRSS database on labor policy and regulation[7], and provincial databases of local labor bureaus on provincial labor market regulations. We also collect provincial Documentary Compilations (*Wenjian Huibian*) issued by local labor bureaus' work conference offices.

3.1 The First Stage: Experimentation without law

Implementing the labor contract system in SOEs became a national policy in 1986 when the State Council issued the "Provisional Regulations on the Implementation of the Labor Contract System in State-Owned Enterprises" on July 12, 1986. Before the

[6] On-line Available at http://www.wanfangdata.com/ploc/intr.asp
[7] On-line Available at http://www.mohrss.gov.cn/mohrss/Desktop.aspx?PATH=/sy/ztzl/zcfg

document was announced, the initial introduction of the system, however, had already been intensively experimented in a small scale in selected cities in the early 80s. The experimentation can be described as a top-down process. The central government was the initiator of the experimentation and local sites were used to test the effects of its proposed new plan.

Before the market-oriented reform was initiated, all new entrants to China's urban labor market got their jobs directly through labor bureau's "unified allocation" (*tongyi fenpei*). The philosophy behind this practice is egalitarianism. Moreover, "the people" is the ownership of labor, and labor produces social rather than private value. Workers' wage is determined by "potential labor" rather than the results of labor. Education and tenure, not labor productivity, guide the reward system (Becker and Gao 413-4). There were very low levels of inter-enterprise, inter-sectoral or inter-regional mobility. Seniority was the important criterion for promotion within an enterprise. Alongside the system of administrative allocation evolved a *de facto* system of lifetime tenure (White 1987). Workforces on SOEs were very stable and the employees were usually described as permanent workers.

With the high level of job security, the iron-rice bowl system led to overmanning and "unemployment on the job" (Kornai 1980, 254). But unemployment was never not a problem in China. Right after 1978, when those who had been "sent down to the countryside" during Cultural Revolution came back to the cities, the urban unemployment skyrocketed, and this forced the government to consider new policies and to reform the current regulations. In order to expand employment, at the National Conference on Labor and Employment in 1980, the government introduced a labor policy

framework named “three-in-one” (*sanjehe*) to allow job placement through three venues: the labor bureaus, worker's voluntary organizations and self-employment. At the same time, the government also expanded the third sector, encouraged collective and private enterprises, and established labor service companies to match the unemployed with a job (White 1987, 369-70).

Low labor productivity was another problem of the iron-rice bowl system. In the early 80s, many reformers argued for reducing state administrative control on labor allocation, and enabling firms to recruit their own workers according to their needs. This was the original goal to implement the labor contract system. Labor contract was designed to be signed between the worker and the enterprise, and the renewal of the labor contract should depend on worker's performance. For reformers, the central goal of the labor contract system was to end lifetime job security, increase labor productivity and stimulate economic production. The rationale was that signing labor contract would make clear the definition of the rights and responsibilities of the worker and the manager. It would also concentrate worker's mind on performance given that it was the only criterion to determine whether the contract would be renewed (White 1987, 367).

These problems of the iron-rice bowl system, raging from rising unemployment rates to low labor productivity, were the background of central government's reform of its labor policy. In the first stage of reform, however, there were intensive debates over priorities in labor policy, namely the relative importance of creating jobs and enhancing productivity (White 1987, 370-1). Facing increasing public clamor for jobs, the central government's emphasis was to pursue near-full employment (Lam, 1992: 2.17; Westwood and Leung, 1996: 378). Implementing the labor contract system and raising

labor productivity was thus not the priority. At the same time, local labor officials also reacted unenthusiastically to implementing any labor contract reforms because local labor officials did not see these reforms directly serve to improve the employment situation (White 1987, 373).

The introduction of the labor contract system was mainly driven by SOE reform. Staring from the early 1980s, many SOEs found themselves losing money when facing the increasing competition from TVEs and Chinese-foreign joint ventures. In order to make SOEs more competitive, increasing reforms towards SOE restructuring and autonomization were introduced. SOEs were allowed to buy some of their inputs from the market, produce more products beyond the quota, and sell them autonomously at higher prices than those under the planned economy (Chang, Genying 2008, 86). Moreover, reform of the wage system was also started. Bonuses were introduced to workers who made good performance. These reforms made the implementation of the labor contract system necessary. SOEs regarded the iron-rice bowl system as one of the contradictions to any SOE reform. SOEs who wanted to have more autonomy in their economic decision would find low labor productivity as the major obstacle to profit generation. The reform of SOEs thus fostered the introduction of the labor contract system (Ngok 2008, 47).

The first local test site that was chosen by the central government to experiment the new system was Shanghai (Chen, Shaohui 2003, 152). In September 1980, Shanghai started to hire contract workers, and the total amount of contract workers rearched 3,000 (National Bureau of Statistics of China 1999). These experiments were concluded in 1982 when the Shanghai government issued the “Notice of Experimenting the System

Contract Workers in Some SOEs" in 1982 to guild further reforms (Editorial Committee of the Shanghai Labor Gazette 1998).

In addition to Shanghai, more provinces were gradually included in the experiment. At the end of 1982, there were totally nine provinces experimenting the new system. They were coastal provinces such as Shanghai, Beijing, Guangdong and Shangdong, and inland provinces Guangxi, Henan, Hubei, Anhui and Gansu. These provinces were selected to be the text sites of the new policy because compared to others, these localities succeeded in reducing urban unemployment (White 1987: 375). Implementing the labor contract system in these localities helped to change the focus of public discourse from unemployment to productivity (White 1987: 375). At the end of 1982, the number of contract workers researched 160,000 (National Bureau of Statistics of China 1999).

The Ministry of Labor extended the experiment to include more provinces in Feb, 1983 by issuing the "Notice of Actively Experimenting the Labor Contract System". The Notice asks those provinces which had not implemented the system to select several sites within their own jurisdiction for experimentation. By the end of 1983, all of the provinces in China had implemented the labor contract system. The number of contract workers reached 650,000 (National Bureau of Statistics of China 1999). The circle of experimentation was closed in 1986 when the State Council issued the "Provisional Regulations on the Implementation of the Labor Contract System in SOEs", which asks for nationwide implementation of signing labor contracts with any new recruits in all SOEs in order to suspend heredity employment. According to the rule, workers who were employed under the planned system before 1986 were not included in the new system. Besides the aforementioned Provisional Regulations, there were other three regulations

announced to guide the new system: the Provisional Regulations on the Hiring of Workers in SOEs, the Provisional Regulations on the Dismissal of Workers and Staff for Work Violations in SOEs; and Provisional Regulations on Unemployment Insurance for Workers and Staff in SOEs. After these National Provisional Regulations were promulgated as a guideline, almost all provinces issued their own detailed rules for local implementation[8].

The introduction of the labor contract system witnessed China's gradualist style of policy implementation. Four years after implementing the system in new recruits of SOEs, the government started to test the effects of expanding the system to include all workers. It asked all employers to prepare contract with all workers including those who had got theirs jobs through administrative allocation by issuing the 1990 "Opinion of the Ministry of Labor on Continuing the Experiment on Optimizing the Composition of Labor". It also asked other kinds of enterprises with different ownership structures to experiment the system. To promote the new policy, the central government did not select several provinces for test sites. Instead, it delegated the power to all provincial governments to choose their own place of experimentation. All provinces were encouraged to experiment the policy in selected cities within their jurisdiction.

The early 1990s saw the increasing diversification of labor relations. Employment in SOEs gradually declined while the share of employment in private enterprises and foreign-invested enterprises doubled. As labor relations increasingly diversified, different kinds of labor contract were widely used in the labor market. However, at that time, there was no governmental document recognizing the various kinds of labor contract. In

[8] For example, Beijing passed the "Detailed Rules for the Implementation of the Provisional Regulations" on September 15, 1986.

February 1992, the Ministry of Labor announced the "Notice on Expanding the Experiment of Labor Contract System in All Workers", and it was the first national document differentiating labor contracts into three categories: labor contract without a fixed term, fixed-term labor contract, and labor contract with time limits for the completion of a specific task.

3.2 The Second Stage: Making the Labor Law

While the 1992 Notice introduces the three kinds of labor contracts, it does not specify under what condition which kind of contract should be signed. The 1994 LL is the first regulation indicating the conditions when a certain kind of labor contract should be concluded. It asks an employer to sing a contract without a fixed term with the employee working continuously for more then ten years (LL Article 20). In the "Notice of the Ministry of Labor on Implementing the Labor Contract System Nationwide (promulgated on August 24 in1994 right after the LL), it adds new rules that when an employee is going to retire within ten years, a labor contract without a fixed should be concluded.

The Notice clearly indicates that, before the LL was issued, the system had already been implemented in many localities including Henan, Hebei, Hainan provinces, and Beijing, Tianjin, Shanghai municipalities. For those provinces which did not widely implement the system, several cities and counties or some enterprises were chosen for experimentation. Moreover, many ministries of the State Council such as the Ministry of Electronic Industries, the Ministry of Metallurgical Industry, the Ministry of Railways, and the China National Petroleum Corporation also started to diversify the labor usage in their enterprises. The 1994 LL can be regarded as the conclusion of these experiments.

The mid-90s did not only witness the promulgation of the LL, but also the restructuring of SOEs into modern market-oriented enterprises. The work-unit-based welfare system under the planned economy placed an enormous financial burden on SOEs and reduced the competitiveness of them. Many SOEs facing financial difficulties were unable to perform their welfare function and meet their social insurance commitments. Under these circumstances, the Chinese government urged the SOEs to change from their multifunctional roles as producers, regulators, and redistributors to be clearly focused on their economic roles. The implementation of the labor contract system to all workers in SOEs helped to proceed this process. Since 1994, workers on contracts started to rose rapidly (Brooks and Tao 2003, 16).

3.3 The Third Stage: Non-experimentation of the Labor Contract Law

Before the LCL was passed and came into effect, the major legal framework for dealing with China's employment issues was the LL enacted in 1994. However, the LL suffered from several flaws that had made China’s regulatory framework for labor issues confusing when disputes between employers and employees arouse. The LL has very little to say about how a labor contract forms. As a result, the applicability of the LL is greatly limited, since, for many cases, it is not entirely clear if the employment relationship is valid in legal terms. For the very lack of details about contract formation and amendment, the law can only apply to those cases where the employment relationship is undisputed, which constitute a small proportion among workers in an under-regulated environment like China’s.

Based on these deficiencies of the LL, the 2007 LCL was thought as a necessary

follow-up, but many of the new rules in the LCL are controversial. The policymaking process of the LCL deviates from China's ordinary decision making path where drafters tend to exclude the controversial policies in a law. In most cases in China's history, a law is used to confirm the results of experiments and to codify the existing policies (Ngok 2008, 49). However, several regulations in the LCL were promulgated suddenly in a way against the experimentalist tradition.

The most important deviation in the LCL is the clauses that lower the threshold of making a labor contract without a fixed term. This new change is criticized by business community because it lowers employer's capacity to dismiss employees and thus reduces the numerical flexibility of China's labor market. In the LCL, a labor contract without a fixed term should be concluded in situations not only when an employee works consecutively for an employer for ten years, but also when an employee continues to work for the same employer after finishing two fixed-term labor contracts. This regulation was not experimented in any local test sites before. Moreover, the promulgation of the LCL seems to be a sudden move because besides non-local experimentation, the central government did not announce any national provisional or experimented regulations before the LCL. The policy regarding the labor contract without a fixed term is thus not implemented in a gradualist way.

This non-experimentalist policymaking of the rules about labor contract without a fixed term is an anomaly when we compare it with China's simultaneously-enacted 2007 Employment Promotion Law. Before promulgating the Employment Promotion Law, the central policymakers had adopted a top-down strategy to test the effects of employment promotion and vocational training for many years. For example, to help the unemployed

youth (*daiye qingnian*), the central government chose several experimental counties in provinces such as Liaoning, Shandong and Hunan to test the effects of establishing labor service companies in the mid-1980s. To ask enterprise to put aside monies for employee education programs, several related Decisions and Circulars were announced ahead before the Employment Promotion Law. In 2003, the State Council announced the "Decision on Giving Strong Impetus to the Reform and Development of Vocational Education", and this Decision has several regulations on the issue of enterprise's setting aside monies for vocational training funds. Accordingly, either through selecting local test sites or announcing central provisional regulations step by step, policies regarding employment promotion were well-experimented before the Employment Promotion Law was promulgated.

4. The Political Economy of the LCL: Missing Agents

How do we explain the sudden move of implementing the LCL? In this section, we analyze the winners and losers of the LCL, and provide a political economic explanation on the promulgation.

4.1 A Perspective from Political Economy

Students of China's labor policymaking usually describe China's decision on labor market reform as the outcome of negotiations between reformists and conservatives (see Johnston 2002 for example). The existing literature, whether the focus is political elites or bureaucratic agencies, suffers from two major flaws. To begin with, the policy

preference is assumed exogenously. That is to say, in their explanatory framework, why a political agent supports a particular policy, be it conservative or liberal, has nothing to do with the effects of the policy. This implies that if a political leader chooses a policy position in favor of a more flexible labor market *ex ante* for some reason, s/he will stick to this policy position even if the policy is gong to hurt his/her economic interest *ex post*. While this explanatory framework is very popular among China scholars, it risks exaggerating the role ideology plays in politics and underestimating how strategic most politicians are. Our approach in this paper, however, differs greatly from the existing literature in the sense that we try to endogenize policymakers' choices by looking at who the winners and the losers are, and how they respond to their incentive structure under the political constraints facing them.

What are the winners and losers of the implementation of the LCL? At first glance, the obvious losers of the LCL are enterprises whose labor costs increase substantially due to the Law in addition to other rising costs of primary materials and losing price advantage owing to the appreciation of Yuan against Dollar. On the other hand, the winners are supposedly employees who can enjoy higher job security with the newly-gained legal means to defend their rights. Nonetheless, the actual picture is far more complicated. As far as workers having lower bargaining power against their employers are concerned, paradoxically, they are likely to be harmed by the Law for being laid off when their employers are unable to afford higher labor costs. In more extreme cases, there are enterprises failing to weather the storm and are driven out of business. Their employees, of course, will lose their jobs and turn victims of the Law that is supposed to bring them higher job security.

From a perspective of political economy, these distribution effects are normally directly translated into political dynamics between winners and loser in a democratic context. In the Chinese context, however, the lack of agency for workers has created an asymmetry between politics and economics of labor, and made the distinction between winners and losers irrelevant to explaining how labor policy is made in China. The picture only becomes clearer as we enlarge the scope to include other policy areas and China's quest for industrial upgrading after serving as a factory of low-end products for the entire world.

4.2 Industrial Policy and the LCL

We argue that the LCL was passed not because the pro-labor forces suddenly had their way in the Chinese politics, but because the LCL could facilitate the industrial upgrading by driving small- and middle-size enterprises (SMEs) out of business owing to rising labor costs, and let the survivors to have bigger market shares. In other words, while the distinction between winners and losers in the area of labor policy fails to capture the real political dynamic that determines the process of making the LCL, the industrial restructuring actually provides a better angle from which the micro-foundation for labor policymaking can be more readily observed.

Why did the Chinese government announce the unfavorable LCL to restructure SMEs in the export sector? We argue that these small export enterprises have brought at least two serious problems to the central government: trade friction and regional disparity.

1) Trade friction

China's emergence as a major trading nation in the world economy has not only brought her enormous foreign reserves and capital, but also trade friction with her trade partners as her export sector grows exponentially. At least since 1995, China has become the foremost target of anti-dumping investigation. Moreover, since 2000, the number of anti-dumping charges China received has become twice or even three times as much as that received by the countries ranked 2nd place. This trend reflects, on the one hand, the relocation of production lines from previously popular targets such as South Korea and Taiwan to China, and, of course, the substantial growth of China's private export sector in the processing trade along the Southeast coast on the other. More importantly, as both the foreign investors and domestic private enterprises in processing trade took full use of China's cheap production factors of labor and land, the competition among them over export markets has driven down the prices so much that the Chinese exports have swept across the global market, and at the same time, made China the major target of anti-dumping charges. While the competition among these SMEs brings higher economic welfare for consumers both in China and other countries, it also makes it extremely difficult for the Chinese government to coordinate among SMEs to prevent serious trade friction between China and her trade partners. The rising number of anti-dumping charges has the following negative impacts:

First of all, the trade friction between China and her trade partners might lead to protectionism in foreign markets and further squeeze profit margins for the Chinese enterprises. While protectionism can be deleterious to most exporting countries alike, it is especially threatening to China's SMEs conducting processing trade. As far as most firms

conducting processing trade in China are concerned, they normally occupy the low-end of the entire production chains where the upper stream with higher profit margins are occupied by enterprises in the developed countries. If the exports are charged with anti-dumping duties, their profit margins will surely be squeezed accordingly. The same logic also applies to those SMEs in the manufacturing sector. If the government does not raise the duty drawback rates for intermediate goods imported abroad, these firms have no other way but to absorb the additional costs.

Secondly, trade friction also has its political ramification. For instance, trade deficit has been a top issue on the agenda of US-Sino Strategic Economic Dialogue (SED) for several rounds. It has created great pressure on China's exchange rate policy and intellectual property protection, and squeezed the bargaining space in China's strategic relationships with other countries.

Therefore, even if SMEs in the export sectors have created so many job opportunities, the negative economic and political impacts they bring also motivated the Chinese government to initiate the industrial upgrading project, of which the LCL is a part.

2) Regional disparity

The second critical mechanism that drives the government's promulgation of the LCL is its regional development strategy. The rising labor costs after the LCL took effect have provided more incentives for coastal export SMEs to move from their original locations to inland provinces where factors of production are substantially lower than those in the coastal ones. Although the LCL is implemented nationally and therefore the newly added labor costs incurred by the LCL are not going to be avoided by such a move, the wages

and land prices in the inland provinces are much lower than in the coastal ones. Moreover, both the central and local governments of those inland provinces such as Hubei and Hunan have also began to launch new development projects to lower the transportation costs and provide more policy favors for those SMEs mostly from Pearl river delta of Guangdong besieged with economic difficulties.

To sum up, both policy goals of reducing trade friction and regional disparity are the underlying mechanisms through which industrial upgrading becomes critical to China. To achieve this goal, the promulgation of the LCL and the effect of rising labor costs thereof serve as an efficient means.

5. Conclusion: Bend it without Breaking it

The LCL is aimed at improving Chinese worker's employment situation. But there are several reasons why most workers cannot be easily viewed as real winners of the LCL. While many articles in the LCL do provide comprehensive protection for workers, in practice, there are other conditions to be met for the protection to be realized. To begin with, even though workers now have more legal weapons to defend their own rights, without a well-functioning court system, the more resourceful employers can still gain the upper hand in actual cases when they can hire better lawyers or even bribe judges. Secondly, without robust trade unions, there is no way to help workers to organize themselves and gain more bargaining power against the employer. The LCL is an alternative to granting more collective bargaining rights to labor. For the Chinese governor, protecting laborers through the Law is a more appealing choice than enabling

them to strike. For fear of stronger trade unions undermining the government's monopoly over political power, the LCL only provides an individualist approach to labor protection.

Chinese central government's goal to use the LCL to achieve its economic upgrading were revised when the close of SMEs and the leave of foreign invested enterprises such as those from South Korean and Taiwan started to seriously worsen the unemployment situation. A year after the promulgation of the LCL, the central government began to slow down the speed of economic upgrading, and many policy supports were announced for thsoe survived SMEs. There are two components of the new policy supports for SMEs in the export sector. First, in early August, the government loosened the policy on bank loans to SMEs and planned to set up banks for SME financing. The People’s Bank of China increased loan quotas for commercial banks by 5%, which was expected to 200 billion Yuan for SMEs. Second, in addition to policy support for corporate finance, also starting from August this year, the duty drawback rate was also raised by two percents from 11% to 13%. These policy supports for SMEs essentially run counter to those geared towards industrial upgrading beforehand. This indicates that although the LCL helped to achieve the goal of upgrading the economic ladder, the rising unemployment has made the Chinese government step back to keep these SMEs alive.

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