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Fang Cai,

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The Great Exodus
How agricultural surplus laborers have been transferred and reallocated in China’s reform period?

Fang Cai
Chinese Academy of Social Sciences, Beijing, China

Abstract

Purpose – The purpose of this paper is to review the process of rural labor reallocation and unfolds its growth effect through sufficiently supplying human resources, preventing diminishing return to capital, and increasing labor productivity.

Design/methodology/approach – The author surveys literature and statistics related to the subject to comprehensively picture the 40-year course of the shift and reallocation of agricultural surplus labor.

Findings – In the past 40 years, reforms in relevant areas have eliminated institutional barriers deterring labor mobility and allowed agricultural laborers to exit from low-productivity farming employment, migrate beyond rural-urban boundary and across regions, sectors, and ownerships, and enter higher productivity employment in non-agricultural sectors. As a result, resources allocative efficiency has been substantially improved, contributing a significant part to labor productivity growth and thus economic growth of the Chinese economy as a whole.

Social implications – To sustain this source of economic growth as far as China completes its transition from upper-middle income status to high-income status, deepening reforms is urgently needed. The author provides policy suggestions for further reform.

Originality/value – This paper enhances people’s understanding of the Chinese economic reform and its nature of efficiency and inclusion.

Keywords Chinese economy, Hukou system reform, Labour transfer, Resources reallocation

Paper type Research paper

Introduction

Unprecedented economic reform in China began with two symbolic events. The first event was the 3rd Plenum in 1978, held by the 11th Central Committee of the Communist Party of China (CPC). This meeting re-established the CPC’s ideological line of emancipating the mind and seeking truth from facts and decided to shift the party’s focus from political movement to economic development, which laid a theoretical foundation for reform and opening up. The second event occurred in the same year when 18 households in Xiaogang village of Anhui province were determined to abandon the production brigade and work privately for collectively owned land. Such a practice, subsequently known as the household responsibility system (HRS), spread nationwide in the early 1980s and caused the abolition of the people’s commune system that had existed for a quarter century. This reform should be considered the first breakthrough in the planned economy.

The master said, “At forty, I perceived truth and doubts ceased [1].” To actually cease doubts requires systematically studying the various aspects of the reform experience, understanding where the reform is now, and determining the direction of further reform. This paper is intended to provide a retrospective on how the reform and opening up have spurred agricultural labor transfer and reallocation, which has contributed to the economic growth and structural changes of the past 40 years. This paper also attempts to reveal the unfinished tasks of modernizing the country and suggests key areas of further reform.

When the People’s Republic of China was established, it inherited an industrial structure characterized by a typical agrarian economy. In 1952, 83.5 percent of laborers were engaged in agriculture, whereas secondary and tertiary sectors employed 7.4 and 9.1 percent of the
total laborers, respectively. Motivated by promptly altering such a lagging industrial structure and boosting the national economy, the Chinese leadership was resolved to implement a big push type of economic development strategy, that is, a heavy industry-oriented development strategy. Because this adopted strategy repelled the resources endowed at the time – for example, Lin and Wang (2010) phrased it as a comparative advantage-defying strategy – to practically implement it, a logically compatible economic system needed to be formed that would be characterized by a distortion of production factor prices, centrally planned allocation of resources, impediment in the free flow of factors of production – especially labor – and lack of operational autonomy and work incentives (see Lin et al., 2003).

Such a system turned out to be the root cause of the unsatisfactory economic performance in the first three decades of the People’s Republic of China. A handful of studies envisaged a counterfactual scenario of economic development if an alternative system existed. By specifically examining the loss caused by the Great Leap Forward and the Cultural Revolution, Kwan and Chow (1996) found that China’s labor productivity would have been 2.7 times that in the actual situation in 1993 if those two movements had not existed. In their estimation, Cheremukhin et al. (2015) also pointed out the negative impacts of the Great Leap Forward on total factor productivity (TFP), gross domestic product (GDP), per capita GDP, and thus the overall catching-up of the Chinese economy.

However, under the planning system and ultra-left political environment, these two disastrous events occurred could be considered inevitable. Although far from representing the total loss caused by repressing work incentives and distorting resource allocations, they could well epitomize what the Chinese economy actually lost during its planning period.

Under the planning system, the people’s commune system, the household registration (or hukou) system, and the rationing system of major agricultural products strictly restricted labor mobility between sectors and across regions. Such a troika of institutional arrangements not only deprived the rural population of choices related to inhabitance and employment, but also regulated the crops that should be cultivated (taking grains as the key link) and how labor, machinery, and land should be used. Specifically, the time, type, attendance, and compensation of collective work were all determined by a production brigade of the people’s commune.

This traditional system did significant harm to the incentives of production teams and their members (farm workers) at the micro level and resulted in a distortion of resource allocation at the macro level, hindering improvements in agricultural productivity. Despite mass production factor inputs, agricultural performance was very poor. In 1978, the eve of reform initiation, China’s agriculture utilized 70.5 percent of the total labor force and produced only 28.2 percent of the total GDP. By calculation, comparative labor productivity – namely, the ratio of output value share to labor share in a given sector – was 0.40 in agriculture, only 14.4 percent of that in secondary sectors and 20.4 percent of that in tertiary sectors.

Furthermore, with such a large proportion of labor inputs, the national average amount of major agricultural products per head was hardly beyond the subsistence level – for example, 316.6 kilograms for grains, 2.3 kilograms for cotton, 5.4 kilograms for oil, 24.7 kilograms for sugar, and 11.0 kilograms for meat. As a consequence, food and other necessities in urban areas were in significant shortage and were supplied through a rationing system. In 1978, 250 million rural people lived on less than 100 yuan per year. According to the World Bank criterion of 1.90 dollars per day (at 2011 international prices), 878 million Chinese people lived in absolute poverty in 1981.

A sequence of studies explored the positive impacts of the adoption of the HRS on incentives, of increased procurement prices of agricultural products on farmers’ income, and of agricultural output growth on the urban food supply. In the years during which the
HRS was distributed (1978-1984), grain yield per unit area was enhanced by 42.8 percent, total grain output increased by 33.6 percent, and the real agricultural value added grew by 52.6 percent. As Lin (1992) estimated, the introduction of the HRS accounted for 46.9 percent of the increase in agricultural output during the period. As a result, rural households’ per capita income increased by 166 percent in nominal terms, the rural population living in absolute poverty declined from 250 to 128 million, and the poverty line doubled. Such changes tremendously enhanced the supply of agricultural products and, thus, created the necessary conditions for abolishing the rationing system in urban areas a few years later.

A more significant effect of rural reform on the economy as a whole came after the first wave: surplus laborers were released from agriculture and reallocated to non-agricultural activities in rural and urban areas, which contributed to labor productivity growth and, therefore, rapid economic growth in the reform period. In the following sections, reforms in relevant areas that allowed laborers to exit from agriculture, migrate between regions and across sectors, and enter non-agricultural employment are narrated, indicating the effects of such successive processes on the improvements in resource reallocation and economic growth. Then, by illustrating the status quo of the labor allocation and placing it in an international comparison, the tasks facing further reform are revealed and policy suggestions are proposed.

**Shift of surplus laborers in reform period**

The reform and resulting growth have created the necessary conditions that enable surplus laborers in agriculture and youth laborers in rural areas to be reallocated between regions and between sectors. That is, whereas rapid economic growth and dramatic structural change expand opportunities for non-agricultural employment, market-oriented reforms provide signals of relative income and that reallocation has occurred. In what follows, the process of categorizing those reforms are chronicled into three aims related to how the elimination of a series of institutional barriers has given rural laborers the right to exit from low-productivity agriculture, migrate across regions and sectors, and enter high-productivity urban sectors, thus altering the profile of the urban labor market.

**How were surplus laborers released from farming?**

The universal introduction of the HRS is the critical reform that released surplus labor from engaging in agriculture at an extremely low marginal productivity of labor. Even without official permission prior to 1978, the HRS was secretly piloted in numerous villages in the remote countryside. Immediately after the 3rd Plenum of the 11th Central Committee of the CPC held in 1978, the HRS was first acquiesced, then accepted, and eventually legitimized by the government. By the end of 1984, all production brigades and 98 percent of households in rural China adopted that system and, simultaneously, the people’s commune system was abolished.

The initial aim of the reform was to improve production and work incentives in agriculture by granting farmers autonomy of operations and rights of residual claimants under the prerequisite of guaranteeing the state and collective rights. An unexpected result is that rural households have since obtained autonomy of owning and allocating factors of production, as the logic of the reform and actual process subsequently showed. Under the HRS, after paying agricultural taxes, meeting the state procurement task, and turning over the collective retention, households have autonomy to decide on what crops to plant and how to allocate their work time. Given two such autonomies, when the labor surplus became overt, farm households began to reallocate their laborers and other production factors.

Such a reallocation was successively experienced in three steps of the labor movement. In the early period of the reform, surplus laborers were reallocated within agriculture, namely, they were transferred from planting or even sole grain production to diversified...
farming, and from farming to broadly defined agricultural sectors, including farming, forestry, animal husbandry, fishery, and sideline businesses. Surplus laborers and new entrants to the labor market were then allowed to work in rural industry (township and village enterprises, or TVEs), known as leaving the land without leaving home. Eventually, they began to migrate from agriculture and local non-agricultural work to urban employment, when more deregulations occurred.

**Labor mobility across sectors and regions**

Under the planning system, the people's commune system, the *hukou* system, and the rationing system of major agricultural products strictly restricted labor mobility across sectors and across regions. As incentives improved and labor efficiency increased, labor surplus in agriculture became obvious. Taylor (1993) reported that, in the mid-1980s, surplus labor was 100-150 million, accounting for 30-40 percent of the total workforce. As the institutional barriers were gradually eliminated, surplus laborers began to move out of where they were engaged, causing what is called the migration tide.

Several noticeable reform breakthroughs occurred during the rural-to-urban migration. In 1983, given a substantial increase in agricultural output, farmers were permitted to transport and sell their own farm products beyond hometowns, which – for the first time – eliminated the geographic restriction on farmers' economic activities. In 1988, farmers were allowed to work in neighboring towns by bringing their own rations, thus eliminating for the first time the boundary of employment between rural and urban sectors. In the early 1990s, with the abolition of the rationing system, practical obstacles that prevented rural laborers from working and residing in cities no longer existed.

Although the *hukou* system still exists and serves to segment public services provisions in accordance with residence identity – preventing migrant workers and their accompanied family members from gaining equal access to compulsory education, basic social security programs, minimum living guarantee programs, and subsidized housing programs in their cities of work – it no longer serves as an obstacle by deterring labor mobility and population migration.

**Breaking barriers for migrants' entry into urban sectors**

Non-agricultural employment for shifted laborers was marginal under the segregation of the labor market between rural and urban areas. Until the 1980s, TVEs were still the sole job opportunity for shifted laborers. After 1992, rapidly expanded labor-intensive manufacturing and non-public sectors in coastal regions began absorbing mass cross-regional migrant workers, thus creating the first migration tide. In the late 1990s, radical reforms of the employment system in state-owned enterprises (SOEs) were carried out to integrate rural and urban labor markets. As a result, barriers that deterred labor mobility across regions and across sectors were gradually eliminated.

Although reforms initiated as early as the 1980s granted SOEs with the autonomy of hiring and firing on paper, management teams were not practically encouraged to use this autonomy because the undeveloped labor market and imperfect social security system could not handle the layoffs that might occur. In the late 1990s, under the pressure of severe operational difficulties, SOEs began reforming the employment system by breaking the long-lasting "iron-rice-bowl" for their employees – namely, laying off redundant workers.

Since then, the basic elements of a labor market have gradually formed. First, the laid-off and unemployed have been re-employed mainly through the labor market with the assistance of the government's proactive employment policy. This policy includes both the introduction of unemployment insurance and other social security programs and the implementation of assistant programs for training, job intermediary services, and public jobs provisioning. Second, new entrants to the labor market have since had to find a job through
the job market instead of through assignments. Third, migrant workers have gained more equal opportunities to compete for jobs against urban workers in the labor market, enabling them to enter all sectors in urban areas and to be paid market-determined compensation.

Change in urban employment composition
A significant achievement during the 40 years of economic reform is the gradual elimination of the dual structure formed as part of the planning system. Throughout the entire reform period, surplus laborers have exited from agriculture together with rural newly entered laborers, migrated across the boundary between rural and urban areas, and finally settled in urban sectors. Therefore, the statistical composition of urban employment can be informative in understanding the course of labor reallocation and its effects on structural change.

Official statistics on urban employment collected on the basis of ”establishments” as units show that urban employment was 178 million in 2015[2]. By incorporating employment in private enterprises and self-employed individuals, this figure increases to 368 million. In addition, most temporary employees and dispatch laborers, of which migrant workers are a part, are often not reported by enterprises and, thus, are missing from the statistics. Therefore, household-based surveys conducted in accordance with the definition of the International Labor Organization suggest a larger number of urban employed, at 404 million. The difference between these survey data and regularly collected data can be viewed as informal urban employment.

Even this number omits some migrant workers in urban sectors. A rough estimate shows that in 2014, approximately 47.1 million migrant workers were excluded from urban employment statistics (see Cai et al., 2016). That is, if migrant workers are fully included in the urban employment statistics, total employment in urban areas would increase to as high as 440.2 million, of which 168.2 million are migrant workers, or 38.2 percent of the total 2014 employment in urban areas. In Figure 1, urban employment is presented that consists of workers with urban hukou, migrant workers officially included in statistics, and migrant workers excluded from the statistics.

Structural and growth effects of labor reallocation
The essence of dual economy development as defined by Lewis (1954) is that there is surplus labor with very low marginal productivity in agriculture. As capital accumulates, the demand for labor from industry expansion can be met by the transfer of labor from agriculture.
Until surplus labor is exhausted – namely, the arrival of the Lewis turning point – the real wage rate remains unchanged. Kuznets (1957) contended that the structural change characterized by the movement of factors of production, particularly labor, from low-productivity sectors to high-productivity sectors is the key driver of labor productivity growth that keeps pace with economic development. Such a process, which is also implicitly assumed by the Lewis model, can then be phrased as the Kuznets process (see Aoki, 2012).

The economic growth in China’s reform period was accompanied by a demographic transition phase in which the working age population continued to increase and the population dependence ratio declined – a situation well defined as dual economy development. This section is intended to examine the effects of labor reallocation among sectors on economic growth in general and on productivity enhancement in particular.

Structural results of labor mobility across sectors
The massive labor mobility toward non-agricultural sectors in rural and urban areas has significantly mitigated the extent of the labor surplus in agriculture. However, the official statistics do not seem to reveal such significance. According to officially reported data, in 2015, the share of the labor force engaged in primary, secondary, and tertiary sectors was 28.3, 29.3, and 42.4 percent, respectively. Citing these figures, some researchers considered Chinese agriculture as a large pool of surplus labor, denied a labor shortage and wage inflation as a result of demographic transitions and structural change, rejected an increase in the marginal product of labor in agriculture, and disagreed with the assertion of the arrival of the Lewis turning point (see e.g. Meng, 2014; Minami and Ma, 2009). However, the following arguments severely questioned both the official statistics on the sectoral distribution of the labor force and propositions based on them.

First, the assertion that still large numbers of surplus laborers exist in agriculture is inconsistent with the fact that China experienced the largest ever migration in human history during peacetime (Roberts et al., 2004). A nationwide survey conducted annually by National Bureau of Statistics of China (2017) showed that migrant workers totaled 282 million in 2016 in China, of whom 169 million left their hometowns and townships for more than six months (more than 80 percent entered cities), leaving 112 million engaged in non-agricultural employment in their hometowns and townships. Accordingly, after 2004, labor-saving agricultural mechanization developed very rapidly and labor inputs in agriculture were significantly reduced (Cai, Wang and Du, 2013).

Second, official statistics on agricultural labor imply that during China’s high-speed economic growth and dramatic structural change, the annual rate of decline in the agricultural labor share in China from 1978 to 2012 (2.2 percent) was only less than half that observed in Japan and South Korea during a comparable timespan. That is, the share of agricultural labor in Japan declined by 4.5 percent annually between 1953 and 1987, and that in South Korea by 5.1 percent annually between 1963 and 1997. If it can be said that China lagged behind in structural changes during its planning period, there is no evidence that alleges any behindhand regarding its structural change performance during the reform period.

Third, some studies are supportive of such questioning, including the following: in an international comparison, International Monetary Fund (IMF) (2006) found that the share of agricultural labor in China indicated by official data was abnormally higher than what was theoretically expected; in retrospect of prior periods, Rawski and Mead (1998) believed that the official data overstated the share of agricultural labor from a very early period; and in their empirical study, Brandt and Zhu (2010) found that the actual share of agricultural labor in China was significantly lower than that suggested by the official data.

Almost an identical result to that in Brandt and Zhu (2010) was obtained by Cai, Du and Wang (2013). That is, the official source overstated the 2009 share of agricultural labor by 13.4 percentage points. Taking the result as a benchmark, a time series of the data from
1978 to 2015 is obtained by splitting the difference between the re-estimated datum and officially reported datum of the share of agricultural labor in 2009 into all of the years before and after 2009. The changing trend over time is shown in Figure 2 by presenting the officially reported and scholarly estimated shares of agricultural labor (and their differences).

According to the estimation, the actual share of the labor force that was engaged in agriculture might be 18.3 percent in 2015, ten percentage points lower than the officially reported figure. Despite some relatively strong assumptions on which the estimation is based, as long as the focus is on grasping the overall trend instead of rigidly adhering to concrete figures, the estimated result is a reference value. As is shown in Figure 2, in the final analysis, it is more reasonable to accept that agricultural labor has experienced a dramatic and continuous decline rather than an insignificant and interrupted one amid unprecedented system reform and its resulting economic growth and structural change.

Statistical breakdown of economic growth
Generally, a favorable population structure is admitted to have substantially contributed to the rapid growth during China’s reform period. Using the population dependence ratio – the ratio of the working age population to the dependent age population – as a proxy variable of the demographic dividend and expecting its decline as a factor of economic growth, Wang and Mason (2008) estimated that it contributed 15 percent to GDP growth during 1982-2000. Cai and Zhao (2012) arrived at almost an identical result but used a different data set and model specification.

However, it should be said that the broadly defined demographic dividend as a contributive factor to economic growth requires looking at almost all variables in the right-hand side of a growth accounting equation, whereas the contribution of the dependence ratio as a variable for economic growth is at most a residual of the demographic dividend. In what follows, the relevance of the growth factors to demographics is explained, and the existing research findings are reviewed and summarized for their contribution to economic growth during China’s transition period.

First, a declining dependence ratio is conducive to a high savings rate, and unlimited labor supply helps delay the occurrence of diminishing returns to capital. Both these
phenomena make capital accumulation the main engine of economic growth for countries experiencing Lewisian economic development. Studies showed that China in its dual economy development conformed to such a theoretical expectation until it passed the Lewis turning point around 2004, as are shown in research findings. Returns to capital investment were exceptionally high most of the time (Bai et al., 2006), but rapidly diminished once the labor shortage occurred (Bai and Zhang, 2014). The contribution of capital accumulation to GDP growth was as high as 61 percent during 1979-2010 (Cai and Zhao, 2012). Although labor productivity growth played an important role in economic growth, its major and increasing attribute was capital deepening, or an increase in the capital-labor ratio (IMF, 2006; Kuijs, 2009).

Second, an advantageous population structure guarantees the quantity and quality of the labor force with respect to making a significant contribution to economic growth. A sufficient supply of labor has been widely recognized as a favorable factor for catching-up growth. Often neglected are new entrants with more years of schooling steadily flowing to the labor market, which plays an overwhelming role in improving human capital (see Cai et al., 2016). Cai and Zhao (2012) estimated labor’s contribution to the GDP growth rate at 8 percent and human capital at 4 percent. By adding together the effect of workers’ years of schooling on growth and the effect of education on productivity, Whalley and Zhao (2010) estimated the total contribution of human capital to be as high as 38 percent, and even higher if certain data assumptions hold.

Third, labor mobility between rural and urban areas, among sectors, and across regions that follows the order from low to high productivity brings about an increase in resources’ reallocative efficiency, contributing significantly to TFP growth. By breaking down TFP growth sources in China into resources’ reallocative efficiency and residuals, the World Bank (1998) found that the former – productivity growth resulting from labor mobility from low-productivity sectors (labor surplus agriculture and labor redundant SOEs) to high-productivity sectors (non-agricultural sectors and newly established enterprises) – contributed 16 percent to GDP growth during 1978-1995.

**Contributive factors of labor productivity growth**

Given the labor force estimation by sector, the determinants of the overall increase in labor productivity can be analyzed. From 1978 to 2015, of the real increase in labor productivity (GDP per worker) of 16.7 times in China as a whole, the increase was 8.9 times in the primary sector, 12.1 times in the secondary sector, and 4.6 times in the tertiary sector. In a previous study, Cai (2017) employed different methods to decompose labor productivity growth, concluding its functional contribution and structural contribution. The result can be summarized as follows.

A breakdown using the method by Timmer and Szirmai (2000) suggests that from 1978 to 2015, of the overall labor productivity growth of China as a whole, the sectors contributed – the aggregated increase in labor productivity of the primary, secondary, and tertiary sectors – 56.0 percent and the structural changes contributed 44.0 percent. The structural change effect on the overall growth in labor productivity can be further decomposed into two parts. The first part was the dominant contribution made by the dynamic effect generated from a shift in labor toward sectors with higher labor productivity growth rates, which accounted for 38.6 percent of total labor productivity growth. The second part was the contribution of the static shift effect generated from a shift in labor toward sectors with higher labor productivity at the beginning of the period examined, which was as insignificant as 5.5 percent.

A breakdown using the method by Bosworth and Collins (2007) suggests that the contribution of the primary sector to overall labor productivity growth was 21.9 percent, which declined over time, that of the secondary sector was 42.5 percent and it increased over
time, and that of the tertiary sector was 14.5 percent and it was relatively stable. From this decomposition, the reallocation effect – labor mobility among the three sectors – contributed 21.1 percent to overall labor productivity growth.

Can China stay to declare a modernized economy?

After three decades of rapid economic growth fueled by the demographic dividend, the demographic transition of China entered a new phase in the first decade of the twenty-first century. The data show that the working age population between 15 and 59 years peaked in 2010 and the economically active population of the same ages peaked in 2017. Correspondingly, the dependence ratio reversed from downward to upward in 2010. More specifically, the population between 16 and 19 years (mainly graduates from middle and high school) in rural areas, as an overwhelming component of incremental migrant workers from rural-to-urban sectors, reached its peak in 2014 and has declined significantly since then.

As a result, following the first appearance of a shortage of migrant laborers in 2004, new entrants to the urban labor market began to decline in absolute numbers, and the net increase in migrant workers almost stalled, which tends to significantly slow down urbanization and narrow the room for labor reallocation (Cai et al., 2016). According to economic development theories and experiences, the present pattern of labor distribution and urbanization is not sufficient to sustain China’s economic growth until it becomes a high-income, modernized country.

After China passed through the Lewis turning point, its population structure becomes less supportive of economic growth, which is manifested in an insufficient supply of human resources, diminishing returns to capital, and a slowdown of labor mobility. However, because institutional obstacles exist that deter the labor supply and its reallocation, reforms that aim to eliminate those obstacles could result in new momentum for economic growth. In a scenario simulation, Cai and Lu (2016) found that the hukou system reform could significantly postpone the disappearance of the demographic dividend and, thus, reap reform dividends by promoting labor migration, expanding non-agricultural employment, improving resources reallocation, and – as a result – increasing the potential growth rate.

International experiences and development economics suggest that the “iron law” – that the agricultural share of both production and the labor force shrinks as the economy grows – does not stop working until an economy enters a high-income phase in which neoclassical growth becomes a normal pattern. In Figure 3, the share of agricultural labor and the urbanization rate in China are compared with the world averages, with the upper-middle income countries to which China now belongs, and with a group of reference economies whose 2016 per capita GDP ranged from China (8,123 US dollars) at the lower end to Hungary (12,665 US dollars, approximately, the starting level of high-income countries as defined by the World Bank) at the higher end.

In developed countries, the labor structure is highly non-agricultural and the population pattern is highly urbanized. In 2016, in the high-income countries as a group as defined by the World Bank and that had an average per capita GDP of 40,678 US dollars, the share of agricultural labor was only 3.1 percent and the urbanization rate was as high as 81.4 percent, a level that far exceeds that of China. That is, not only does China still have a long way to go, but also its task is urgent in the near future if it is to declare a modernized economic structure. As is predicted, China’s per capita GDP at a constant price and exchange rate of 2010 will reach 12,600 US dollars around 2022, when it crosses the threshold between upper-middle income countries to high-income countries. Therefore, it is more relevant to compare China with the reference economies previously mentioned.

As is shown in Figure 3, regardless of which figures are used – officially published, ILO estimated, or scholarly estimated – they all indicate enormous room for further reductions in...
the share of agricultural labor during China’s transition to high-income status. In addition to the significant gap in urbanization between China and high-income countries and reference economies, a gap also exists between de facto urbanization (migrants being included in the statistics) and de jure urbanization (migrants being excluded from the statistics and the equal access to urban public services) within China. In that regard, the hukou system reform that aimed to transform migrant workers and their families into urban residents is a key initiative in sustaining labor migration and population urbanization in general and in eliminating institutional barriers that concretely deter the processes.

**Conclusion and policy suggestions**

The economic development in China’s reform period is not, as some scholars insist, for example Young (2003), merely from extensive growth-driven by the input of production factors. In fact, both the extraordinary economic growth and the impressive increase in people’s incomes have been supported by increasing labor productivity. Moreover, the relocation of surplus labor has been the major driver that has lifted both rural households’ income and overall labor productivity. Therefore, the reform dividend can be gained by focusing on sustaining the momentum of labor mobility and reallocation.

It is widely admitted that the hukou system functions not alone, but in close coordination with other institutional arrangements. That is, they together serve to block population migration and labor reallocation. In this sense, although the hukou system still exists, its conventional role has been significantly dented. For example, because the people’s commune system and the rationing system of major agricultural products have long been abolished, the hukou system can no longer impede the population registered as rural residents from residing and working in urban areas. Moreover, as public services provisions become increasingly equalized among population groups, the hukou system cannot completely exclude migrant workers from enjoying some of those provisions.
However, the narrowly defined hukou system now serves the last bastion of institutional barriers that prevent new entrants to the labor market who grown up in rural areas from adequately migrating and migrant workers in urban areas from fully enjoying equal provisions of public services. If the hukou system reform has, to date, been primarily carried out from the periphery – addressing the matching policies instead of itself – it is becoming increasingly urgent to push the reform into its core area – that is, settling migrant workers as legitimate urban residents and, thus, increasing the de jure urbanization rate.

Given the existence of incentives incompatibility in providing public services between the central and local governments, progress in matching policy reform but not in the core area of the hukou system reform cannot ultimately guarantee the equal treatment of migrant workers. In China, providing basic urban public services, such as minimum living standard programs, basic social insurance programs, a compulsory education, and subsidized housing, are primarily the responsibility of local governments. Given the non-identity between revenue capability and expenditure responsibility at the local level, as long as the urban population is distinguished by hukou status, migrant workers tend to be treated differently, if not discriminately.

Some Chinese cities have adopted a measure consisting of a residence permit system and a points-based system to gradually absorb migrants who become legitimate residents. That is, migrant workers are first required to obtain a resident permit in the receiving city, and then they must accumulate their points in accordance with the length of time they work and contribute to social security programs and taxation in the city, and so on, until they meet the criteria for obtaining legitimate residence registration. However, because criteria are determined by the municipal government, as long as there is non-identity between revenue capability and expenditure responsibility and, therefore, lack of motivation for local governments to attract newcomers, local governments tend to set too high criteria for new residents to meet.

An incentives incompatibility also exists between the central and local governments in practically giving impetus to the hukou system reform that aims to legitimize migrants’ urban residence. Although the hukou system reform is supposed to generate non-excludable benefits to the Chinese economy as a whole – improvements in the labor supply and resource reallocation boosted by more unhindered labor mobility will spur economic growth – individual local governments have to bear the costs of the reform on their own. Therefore, if the previous reform measures were carried out from the bottom up, the new round of hukou system reforms will have to be initiated and implemented from the top down. Because comprehensive reform initiatives are public goods whose results impact long-term nationwide development, a thorough top design should include at least two aspects.

First, the costs of the reform, such as the incremental spending on public services caused by an expansion of residents with local hukou, ought to be split between the central and local governments in accordance with expected but not accurately estimated and equally shared reform dividends. Taking on a large portion of the direct costs related to more migrant workers and their family members becoming new residents is thus the responsibility of the central government. One such example is that if the central government takes responsibility for paying for compulsory education, the costs shouldered by local governments in the hukou system reform will be significantly mitigated.

Second, the central decision maker should announce a blueprint of the hukou system reform that not only sets mandatory reform targets but also lays out exercisable, controllable, and measurable definite steps for driving the reform. The difference in this centrally designed reform from previous locally spontaneous ones is its rigorous correspondence between costs and benefits. In other words, all compensation transferred from the central to the local governments must be repaid by actual increases in the number of migrants-turned-residents with legitimate status.
Notes
1. This is an oft-recounted quotation in *Confucian Analects*, English translation is quoted from Jin ed. (2005, p. 4).
2. Unless specifically noticed, the data presented here come from NBS (1979-2016).

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About the author
Dr Fang Cai is the Vice President of The Chinese Academy of Social Sciences (CASS) and a Member of the Standing Committee and of the Agricultural and Rural Work Committee. Dr Cai’s main research fields include development theory and policy, agricultural policy, economic reform in China, labor and demographic economics. Dr Fang Cai can be contacted at: caifang@cass.org.cn