

# Economic Development and the Rural-Urban Divide in China

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The paper examines a remarkable phenomenon. There is in China a large divide between rural and urban areas, not only in terms of income but also in terms of various services such as health care and education. How did it come about? How has it been maintained in the face of economic reform and marketisation? What are its implications for equity and for efficiency? Will the rural-urban divide be eroded? In this paper I will discuss the above issues. Meanwhile, the paper goes on to consider the Chinese case in perspective, both theoretical and empirical. China is not alone in having a rural-urban divide - it appears to be a widespread phenomenon in the process of economic development, commented on even by Adam Smith in *The Wealth of Nations*, 1776. However, China is exceptional in the size and the sharpness of its divide.

## I. Introduction

China is an important economy. It accounts for about 20% of world population and for nearly 20% of the world's poor. Moreover, it is becoming more important. During the period of economic reform - roughly the last 25 years - it has achieved a remarkable trend rate of economic growth: over 8% per annum. By comparison with other communist or ex-communist countries, it has so far made a smooth transition from a planned economy towards a market economy. The Chinese economy is arguably the most interesting economy in the world, and it presents fascinating challenges to economists.

The research reported in this paper arose from an international project on income distribution in China. The project

was based on a very detailed and representative national household survey, designed by a team of Chinese economists in the Institute of Economics, Chinese Academy of Social Sciences, and foreign scholars including the author. It was an improvement on official surveys because it permitted empirical analysis at the micro (household and individual) levels, because it was designed with research hypotheses in mind, and because it used a broader definition of income, including the various forms of payment in kind that were important in China. The 1988 survey was followed by a comparable survey in 1995, and by another in 2002. One of the most startling figures to emerge from the initial survey was the ratio of urban to rural household income per capita, which had a value of no less than 2.4 to 1. Recognising that this

rural-urban divide deserved further study, Lina Song and I decided to accept the challenge, and wrote a book entitled *The Rural - Urban Divide: Economic Disparities and Interactions in China* (Knight and Song, 1999).

The paper has the following structure. In section 2 we describe the rural-urban divide in China, and in section 3 we attempt to explain it: why and how it came about and has been maintained to this day. In section 4 we pose the question: will the rural-urban divide be eroded? To examine this issue we provide a framework of endogenous government responding to various pressures and interests. In particular, we examine three forces now driving economic policies: rural-urban migration, rising income inequality, and state-owned enterprise reform. The rural-urban divide is a common phenomenon, although China represents an extreme case: section 5 places China in perspective. Section 6 concludes.

## II. Describing the rural-urban divide

In 1949 90% of the Chinese population was classified as rural whereas in 2005 the rural population accounted for only 57% of the total. Despite the urbanisation that goes along with economic development, the rural population has grown in absolute terms and the great majority of Chinese people continue to

live in rural areas. Almost all of China's arable land was already in use in 1952, and yet over the next half-century the rural population was to grow by over 350 million. This growing pressure on the land posed a threat to both rural and urban living standards.

Figure 1 shows rural and urban income, and also consumption, per capita, expressed in constant prices, from 1952 to 2000, taken from official sources. Both rural and urban income rose very slowly until the process of economic reform began in 1978. Figure 2 shows the ratio of urban to rural income, and consumption, per capita over the same period. Throughout the planning era, the ratio exceeded 2 to 1, and they were particularly high (over 3) in the mid-1950s. The ratio narrowed over the years 1978-1985, when rural economic reforms - the disbanding of the communes and the restoration of household production - took place. As urban reforms began and accelerated after 1985, urban incomes grew rapidly. The rural-urban divide actually increased, and in the year 2000 the ratios (2.8 for income and 3.0 for consumption) were higher than they had ever been throughout the economic reform era.

The rural-urban divide is not confined to conventionally measured income. It is apparent also in education, health care and housing (Knight and Song, 1999,

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Figure 1 Urban and Rural Real Income and Consumption Per annum at 1985 Prices

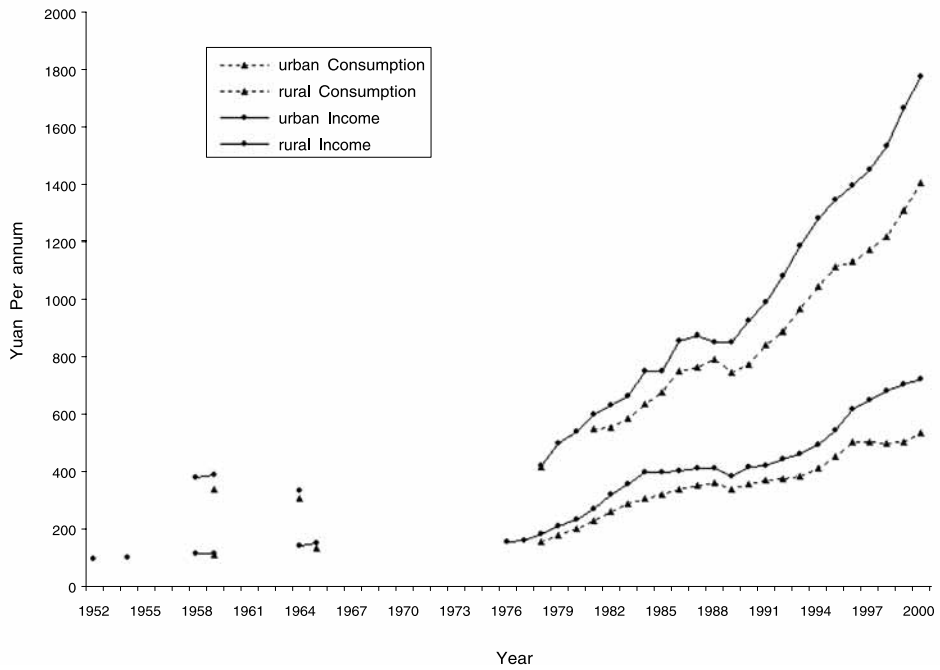
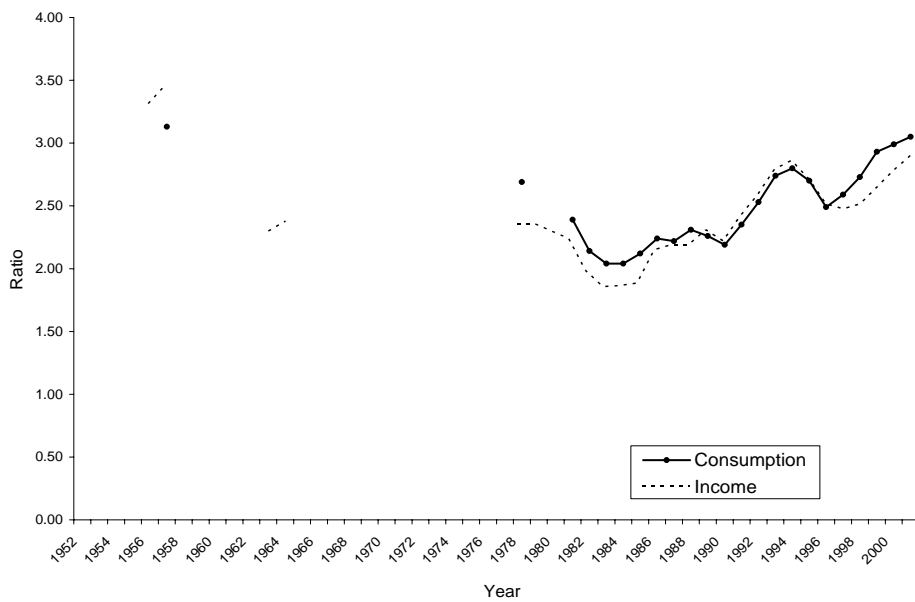


Figure 2 Urban/Rural Income and Consumption Ratios



chs. 4, 5 and 6, respectively). The most important factor influencing a person's educational attainment, or enrolment, after his age, is whether he lives in a rural or urban area. The standardised mean difference in educational attainment is no less than 4.6 years in favour of urban-dwellers. Moreover, school cost per pupil, public subsidy per pupil, and the average quality of teachers, are all far higher in urban than in rural areas.

There is a considerable gap between urban and rural provision of, and access to, health services. The rural population is at a disadvantage in both quality and quantity of health care. Moreover, urban services have been much more heavily subsidised, so that rural people have had to pay no less than urban people for health care. Yet the difference in mean incomes contributes to the contrast in the underlying healthiness of people in urban and rural areas. Using the extreme measure of unhealthiness, mortality, we find premature mortality rates to be considerably higher in the countryside, especially for infants and children.

There are too many dimensions, with their valuation problems, to decide whether urban- or rural-dwellers are better off in terms of housing. Urban people live in cramped conditions but the quality of their housing is generally higher than that of peasants. Peasants have to build and improve their own houses, and must do so without the help

of mortgages, whereas until recently urban-dwellers have paid only minimal rents and have thus enjoyed heavy subsidies of their housing. The recent sale of much urban housing to occupiers at low prices has effectively capitalised the previous rental subsidies.

Even the addition of education, health and housing to income yields too narrow a concept of 'well-being'. There are also the relative degrees of freedom and of security that different people enjoy. Perhaps the greatest difference between rural and urban people is that they have different forms of security. Peasants have secure access to farming and housing land, whereas urban workers have until recently had their 'iron rice bowls' guaranteeing secure jobs and pensions. Peasants had more, and earlier, freedom to pursue their economic self-interests locally, but they were in the past prevented from migrating to the cities, and they are still largely prevented from settling in the cities.

### III. Explaining the rural-urban divide

So far we have described the rural-urban divide: now to explain it. Why, and how, did it come about? The Communist Party, when it came to power, proceeded to build an institutional framework in which the State, dominated by the Party, divided China into rural and urban compartments, separated in

terms of administration, finance and resources. The State either prevented or controlled the flow of funds and resources between the sectors. Rural residents, forming the great majority of the population, were governed by the urban representatives of the State. During the period of economic reform the policies of decentralization and marketization contracted the role of the State and expanded the role of market forces. However, the institutional framework remained in place, and the urban-rural income ratio did not decline. The 'invisible Great Wall' which separates rural and urban China remained standing.

Consider the policies of government as they evolved. The first tasks of the Communists, when they came to power, were the elimination of the landlord class, land reform, and the introduction of centralized economic planning. Recall that it was a peasant-backed revolution. Nevertheless, the main economic objective was rapid industrialization, and this meant urbanization. The terms of trade between agriculture and industry were an important policy variable to this end. Following the example of the USSR, the government depressed the terms of trade in order to provide cheap food in relation to manufactures, and thereby to secure high industrial profits for reinvestment. This was the so-called 'price scissors' policy (Knight, 1995, Knight and Song, 1999, ch. 7). The hand that wielded the

price scissors effected a transfer of income and resources from the rural to the urban sector. The relative invisibility of the transfer and the opaqueness of the burden added political attractiveness. The creation of the communes and enforced procurement of food can be seen as the State's need to extract a surplus from agriculture in the absence of price incentives for farmers. In fact, it led to rural stagnation up to 1978. The peasants bore most of the sacrifice in consumption, and effectively paid for industrialization.

The real wages of urban workers were set at a level which enabled households to enjoy a higher standard of living than their rural counterparts. Thus, part of the investable surplus was diverted to the support of urban workers and their 'iron rice bowls'. It was not only future generations that gained from the price scissors: urban workers also benefited. There is a fine line between the so-called 'efficiency wage' and 'political pressure' explanations of the relatively high urban wage. Worker discontent, low morale, and threat to political stability are all aspects of the latent power - latent rather than overt in the Chinese case - which residentially concentrated, interacting workers appear to possess.

The period of decollectivization, 1978-1984, was one of rapid growth in peasant incomes. The changes reflect a shift in the concerns of the Chinese leadership

from the ideological to the economic. The rural reforms were that rare event, a Pareto improvement with hardly any losers. It is interesting that the reforms, which began at the grassroots level, went further and faster than was intended. A process of atomised peasant behaviour and cumulative causation pulled the leadership along behind.

In the mid-1980s government attention turned from rural to urban reform policies. The once-for-all nature of the gains from decollectivization and the policy reluctance to raise food prices produced agricultural stagnation for some years thereafter. However, this was ameliorated by rapid rural industrialization and an increase in temporary migration of rural workers to the cities and towns.

Government policy with regard to procurement, producer prices of grain and other necessities provides a good test of the relative political influence of workers and peasants. Government came to recognise the need to raise producer prices in order to elicit more farm production. However, when producer prices rose, government was also concerned to protect the living standards of urban workers. This necessitated a sharp increase in food subsidies. The budgetary expenditure on urban food subsidies actually came to exceed budgetary expenditure on agriculture in the early 1990s. The tardy and tortuous

dismantling of the 'price scissors' policy suggests that the urban minority were politically more important to government than were the rural majority.

Urban real wages rose rapidly over the period of urban reform. This occurred despite the abundant supply of rural labour that was potentially available. It was made possible by the shielding of urban workers from the competition of rural labour, and the decentralization of power to enterprises. Managers appeared willing - possibly for efficiency reasons - to share profits with their employees.

It is of course misleading to speak of *the* urban-rural income ratio. There is considerable inequality within rural and within urban China. Much of the inequality of rural income per capita is spatial in character, reflecting the vast size and diversity of China. Spatial inequality existed even under the egalitarian policies of the pre-reform period, but both spatial and household inequalities increased during the reform period. We have found reasons to expect that processes of cumulative causation are at work, increasing inequality at the province, county, village and household levels (Knight and Song, 1993, Knight and Li, 1997). In some areas rural industrialization has proceeded rapidly, labour shortages have emerged, and rural incomes have risen towards urban incomes. In other areas rural

development remains limited, surplus labour is chronic, and the potential economic gain from rural-urban migration is very great.

Spatial variation in urban real wages and incomes is not large across urban China, although it has increased (Knight, Li and Zhao, 2001). Urban incomes have been standardised by the institutional element in pay determination whereas rural incomes reflect regional disparities in natural resources and economic opportunities. This means that the urban-rural gap is greater in poor provinces.

The reasons for the superior provision of education in urban areas is to be found mainly in the separate administrative and funding arrangements for rural and urban education. However, it also reflects the opportunity costs and the lower perceived economic returns to education for rural households. The educational attainment of a rural area is strongly related to its income per capita, on account of the decentralised funding of rural public expenditures and of the credit constraints that peasant households normally face. There is no such urban relationship, owing to the more centralised funding arrangements.

China has a good health record, even in rural areas, by comparison with most poor countries. The emphasis on preventive medicine has borne dividends. It is probably the high quality of health care

in urban China that is the real international outlier. The disparity between rural and urban China is the result of the institutional divide in health care arrangements, which in turn stems from the separate administration of rural and urban areas. Urban residents have had widespread access to state-supported health care, although the private cost of health care, as also of education, has been rising with marketisation. The rural co-operative health schemes that operated during the commune period collapsed during the reform period. Especially in the poorer villages, which cannot afford collective insurance schemes, rural households face user charges for curative care and medicines. Other than for preventive care such as the vaccination of children, peasants' access to state-subsidised services is limited.

The general stance of the State with regard to education, health care and housing is that the rural sector should be self-reliant. The peasants have had to take care of themselves and not be a burden on the State. There are large differences in urban and rural tax revenue per capita, reflecting the industry-centred tax base, and these differences are not offset by fiscal transfers.

It is arguable that a large urban-rural income gap should not survive the impact of equilibrating market forces. As the Chinese economy became more

marketised, why were the returns to factors not equalised across space? Why did the income gap not get competed away? The answer to the question is: the continued control of rural-urban migration. Without this, the income disparity would have served as a magnet to rural people wanting to better themselves, and it would not have survived. The 'invisible Great Wall' has become more permeable during the period of economic reform. However, central and local governments have attempted to control the flow of temporary rural-urban migrants. Their objective has been to meet the needs of the growing urban economy while giving preference to urban residents. Moreover, it remains very difficult for rural-born people to acquire the right to permanent city residence.

#### IV. Will the rural-urban divide be eroded?

##### 1. Endogenous government

The policy implications of this analysis can be approached in two ways. One is to assume that government formulates its objectives exogenously, i.e. independently of the pressures arising from the economic interests of various groups in society. We might, for instance, assume that government possesses a given social welfare function which makes no distinction between rural and urban

people *per se*, and that the poorer the person, the higher the value placed on additional income. By this criterion, various Chinese government policies are difficult to understand, and must be regarded as errors, attributable to imperfect knowledge or imperfect control. A government with the social welfare function posited above would share our vision for the future elimination of the rural-urban divide. The more complete marketisation of the economy would help to achieve this vision, as would the elimination of the administrative and institutional boundaries between rural and urban China.

The second approach is to recognise the endogeneity of government, i.e. that government is itself an economic agent, whose objectives are determined by the political economy. The government's social welfare function is in principle predictable from the relevant model, and government - more realistically, different segments and tiers of government - responds in predictable ways to dangers, threats and pressures. Government may be self-interested, in that it is ultimately concerned with staying in power. On this view, the apparent policy errors are in fact chosen correctly in the pursuit of government objectives. For instance, there may be good political reasons to favour urban people over rural. The remedy therefore lies in changing those objectives. The issue becomes one of



influencing the balance of pressures that mould government policy.

It is necessary to form a view of the factors that shape economic policy in China. In the early years the Communist Party was securely in power, having won over almost all the population. Ideological objectives were therefore a luxury that could be pursued with little hindrance. Later on, particularly after the Cultural Revolution, the State became more sensitive to threats to political stability. The retention of power became an important influence on economic policy.

It is possible to analyse certain policy outcomes by reference to the interests of various institutions and groups in society, and the pressures that they could exert on a government whose primary objective was to stay in power. However, these pressures were normally implicit rather than explicit, passive rather than active. Underlying the urban bias often observable in State policies and institutions was State bias, to be explained in terms of the concerns and objectives of the Chinese leadership.

In the early years pressures on government were weak. The process of economic reform gave rise to clearer economic groups and perceptions of group interests. The rural-urban divide has become more apparent because the two sectors now communicate and interact directly, whereas they previously

interacted only through the intermediation of the State. Conflicts of interest have come more into the open. A good example is the huge discrepancies that for some years existed between the producer prices, the market prices, and the rationed consumer prices of staple goods.

What are the prospects for the erosion of the rural-urban divide, bearing in mind current changes and trends in the economy and society? It has been argued that, as South Korea and Taiwan developed, their governments switched from urban bias to rural bias policies (Moore, 1993). The explanation is in terms of the changing structure of the economy, which reduced the need to extract a surplus from the agricultural sector and increased the political threat that can come from rural-urban migration. Similarly, some of the changes taking place in the Chinese economy may assist the peasants. For instance, the price scissors policy is no longer at all important for the accumulation of capital. Also, the diminishing share of food in urban household budgets makes urban real incomes less sensitive to the price of food. The voice of rural people may be enhanced by the greater awareness of their relative position that better education, greater mobility and improved communications can foster. The increased marketisation of the economy may itself reduce the degree of urban bias in

government policies insofar as it accords greater weight to market-based allocation of resources and income and less weight to location-based allocation.

The future of the rural-urban divide depends to a great extent on the forces driving economic policies in urban China, in particular those relating to rural discontent, rural-urban migration, rising income inequality, and state-owned enterprise reform. Moreover, the evolution of Chinese political economy is well illustrated by these four important phenomena. We consider each in turn.

## 2. Rural discontent

To begin with the rural sector, what is the prospect for the peasant voice to be strengthened, so that peasant interests can acquire a greater weight in government policy objectives? In the 1980s the State's power to govern the countryside was eroded. To cope with the crisis of legitimacy, government decided to rejuvenate grassroots institutions and to encourage peasant participation. It gave legal recognition to village communities and encouraged elections to them, and it encouraged village representative assemblies. This has improved village governance and political consciousness. However, it has not given peasants political influence at higher levels of governance, not has it impacted significantly on the underlying conflict between the peasant and the State on

account of its urban bias policies.

The process of economic reform has assisted the development of 'civil society' in rural China, as various social organisations have emerged. These can be seen as intermediaries between government and people and, in principle, can articulate peasant interests. In practice, however, the influences of rural social organisations are weak, nor are they concerned with the central issue, i.e. peasant feelings of relative deprivation and of unfair treatment.

## 3. The evolving policy on migration

Before the start of rural economic reform in 1978, rural-urban migration of any sort was tightly restricted and indeed, with only minor exceptions, prohibited. The introduction of the household responsibility system in farming meant that surplus labour, previously disguised by commune work rules, became available for new farm and non-farm activities. In the 1980s peasants began to sell their products in the reopened urban food markets and new grass roots rural industries responded to the demand for consumer goods. The growth of rural industry was the outstanding phenomenon of the 1980s. TVE employment grew by 13 per cent per annum in the 1980s in response to a market disequilibrium, but by less than 3 per cent per annum in the 1990s as equilibrium was established and competition from the reforming urban

economy intensified. Instead, rural-urban migration was the outstanding phenomenon of the 1990s. This redirection of rural labour absorption was assisted by the abolition of urban food rationing, the acceleration of the urban reforms that had commenced in 1985, and - as the one-child family policy took lagged effect - a deceleration of urban labour force growth. The rapid growth of the urban economy compared with the slow growth of the urban-born labour force meant that there was an increasing need for rural workers in the urban economy. Temporary migration expanded to meet that need.

Rural-urban migration should be viewed from three perspectives - those of the migrants themselves, their prospective employers, and government - each of which might wish to promote or resist migration (Knight, Song and Jia, 1999). Consider each in turn. Many rural people have a strong economic incentive to migrate, having few productive opportunities in the village. Some are put off by the transaction costs involved, including lack of information and contacts as well as the costs of movement. Hence the importance of the village and of migrant networks in facilitating migration.

Many urban employers have a profit incentive to employ more migrants - essentially because migrants are willing to work for lower pay than are residents,

and to accept jobs that urban residents reject. Different parts of government have different objectives. Central government is most concerned to ensure that flows of migrants are orderly and do not threaten social stability. Governments of sending areas - at the province or county level - encourage out-migration and operate recruitment agencies to assist it. As rural-urban migration began to burgeon in the 1990s, city governments, concerned to protect their citizens against the influx of migrants, introduced systems of control over in-migration. Their objectives were to allow temporary migrants into jobs unfilled by urban residents but to protect their residents against undercutting competition.

The late 1990s saw an increase in the number of migrant settlers in the big cities. They were commonly found in distinct migrant communities from a particular sending area, often semi-autonomous and well-structured. These migrants continued to be at a blatant disadvantage with respect not only to jobs but also to housing and schools, whereas access to medical care was now a matter of ability to pay. However, they - and in particular their children - were becoming urbanised: their reference groups were switching from rural to urban. The late 1990s also witnessed increasing conflict for urban jobs between rural migrants and workers. Urban governments responded to the widespread

redundancies by restricting the recruitment and re-employment of rural migrants, and urban job centres gave priority to unemployed and laid-off (*xia gang*) urban hukou residents. Out-migration from rural China, which had grown rapidly in the early 1990s, was constant in the late 1990s (Du, 2001).

#### 4. Rising income inequality and social instability

Except in respect of the rural-urban divide, China was an egalitarian society before economic reform. The Gini coefficient was estimated to be below 0.20 in urban areas and about 0.25 in rural areas in the late 1970s (Adelman and Sunding, 1987). The CASS national household survey for 1988 revealed that, a decade after rural reform had commenced, the Gini coefficient for disposable household income per capita (based on micro data) had risen to 0.24 and 0.33 in urban and rural China respectively; the rural-urban divide meant that the national Gini coefficient was higher than either, at 0.40. In 1995, a decade after the start of urban reform, the comparable urban and rural Gini coefficients were 0.34 and 0.36 respectively, and the national figure 0.47. By 2002, the equivalent values were 0.32, 0.37 and 0.47 respectively. In each year the high ratio of urban to rural income per capita raised national inequality substantially above inequality in each component

sector (Gustafsson, Li and Sicular, 2007, table 1.2).

How important is the income gap between urban and rural areas in the context of overall income inequality in China? A decomposition of the Theil index shows it to have been a major contributor (Gustafsson and Li, 2001, p. 66). In the 1988 household survey, the urban-rural income gap accounted for 43 per cent of overall inequality. This proportion declined to 35 per cent in the corresponding 1995 survey owing to the increase in within-area inequality, but the absolute contribution of the urban-rural income gap to the Theil index actually increased, by over 20 per cent. Thus, overall income inequality in China would be reduced considerably if the urban-rural income gap could be eliminated.

How is the sharply rising inequality of incomes to be explained? Here we must look to government objectives in the post-Mao period. Because the Communist Party's grip on power has been firm by international standards, its concern to remain in power can be viewed more as an underlying influence on policy-making than as an over-riding objective. In the reform period the objectives of government have been primarily economic. These can be interpreted as the rapid growth of the economy and of government revenue, the former objective being stressed by central government and the latter by local governments.

The pursuit of growth objectives has generated rising income inequality - among the important mechanisms being the creation of markets, including markets offering initial high profits; the provision of incentives for enterprise and accumulation; and the application of efficiency rather than equity criteria in public decision-taking, including the demise of egalitarian regional policy. The combination of semi-marketised economy, weak legal system and ill-defined or insecure property rights brought greater scope for corruption, cronyism, rent seeking, and appropriation of state assets. That is a further source of income polarisation.

Rising inequality may threaten government if it leads to social instability. Moreover, social instability may in turn put at risk the continuation of rapid economic growth. Are there signs of growing social instability? If so, does the rural-urban divide play a role in this growth? There is evidence that slow growth of rural incomes - partly due to increases in the taxes and fees charged by local governments - has induced a rise in conflicts between peasants and local officials in recent years (Liu, 2001) and in peasant refusals to pay local taxes and fees (He, 2001). The effect of increased rural-urban migration has been to destabilise the cities. Observing their economic disadvantage, migrants may regard themselves as second class citizens. The weakness of mechanisms of social

control among migrants and the relative deprivation that they feel is said to contribute to rising crime in the cities (Liu and Fan, 2001). The number of criminal cases registered in public security organs rose by 127 per cent between 1996 and 2000, with robberies and larceny rising even more rapidly.

It was concern about increasing economic inequality and consequent social conflict that recently led the Chinese Government to announce its new policy of promoting "the harmonious society". Among its early actions in pursuit of the new policy was the abolition of the agricultural tax on farmers and the abolition of school fees during the nine years of compulsory education in rural China.

##### **5. The evolving policy on state enterprise reform**

A further source of greater social instability was the policy of reforming the state-owned enterprises, which began in earnest in the mid-1990s. The policy is worth examining in some detail because it appears to be the most serious discrepancy in our explanation of the rural-urban divide.

The remarkable development of rural industry over the economic reform period was a response to extreme market disequilibrium. Supernormal profits were there to be earned by competing against the inefficient, high-price, state-owned

enterprises. Township and village cooperatives and private entrepreneurs responded to these opportunities, and the number of workers engaged in rural non-agricultural activities rose remarkably, by 100 million over 20 years. State-owned firms were affected also by private sector development under the urban reforms, and by the tendency for local governments to over-invest. This increased competition for the state-owned sector depressed its profitability severely, and consequently government revenue also suffered. By the mid-1990s the reform of the state-owned enterprises had become a crucial issue which the government could no longer ignore.

One of the problems of the state sector has been overmanning: estimates suggest that about 20% of urban employment has been superfluous (Knight and Song, 1999b). Until recently, government had a political preference for disguised unemployment within enterprises rather than open unemployment on the streets. The reforms involved the withdrawal of subsidies, and state directives to lay off surplus labour. Few young people were recruited, many middle-aged workers were retired early, and many previously protected employees became *xia gang* workers, i.e. they continued to be nominally employed by the relinquishing enterprise while receiving a low wage, but they did not have to attend the workplace. According to the *China*

*Statistical Yearbooks* over 33 million redundancies were created in the period 1995-99. For many who continued in their jobs, employment was no longer guaranteed, their 'iron rice bowls' were now made of cardboard, and feelings of insecurity were rife.

Even the creation of *xia gang* status for laid-off workers did not protect them from hardship. A survey conducted early in 2000 showed that over half of the workers made redundant since 1992 were still unemployed, that the expected average duration of unemployment was about four years, and that they suffered a considerable loss of income during their period of unemployment (Appleton et al, 2002). There were journalists' reports of social unrest among the unemployed, especially in cities where unemployment was high (e.g. *Newsweek*, 4 March 2002). When, in a survey conducted in 2000, urban people were asked to rank the most important social problems, unemployment was ranked first, corruption second, and increasing income inequality third (Project Team of the Academy of Macroeconomics, 2001).

Does the new determination to reform the state-owned enterprises signify the end of the policy of urban bias? Perhaps the most plausible interpretation runs as follows. The reform was forced on government by the declining profitability and the rising incidence of loss-making in the state-owned sector, with adverse

implications for both government revenue and prospects for continued rapid growth. Faced with a threat to the achievement of its main objectives, government was willing to risk a degree of political threat inherent in the erosion of urban-dwellers' privileges.

The risk was worth taking given that there were three safety valves. First, to some extent unemployment could be exported to rural China, through tighter restrictions on the recruitment and renewed employment of migrants in cities. Second, as a result of the reform, the state-owned sector should become more efficient; and more difficult, therefore, for rural industry to compete against. In these ways the burden of the reform could be transferred from urban to rural people. Third, the majority of urban workers continued to be employed, and their real wages continued to rise despite the increase in urban unemployment. Standardised real wage growth averaged 5 per cent per annum over the period 1995-99 (Appleton et al, 2004). The fact that wages were sensitive to profits, and became more so between 1995 and 1999, suggests that managers were willing to share rents with their remaining workers (Knight and Li, 2004). Rent-sharing and efficiency wage explanations are difficult to distinguish, both conceptually and empirically: the wage increases might be viewed as payments for maintaining the morale, goodwill and effort of urban

workers. According to the official household surveys, the real income per capita of urban *hukou* residents rose by almost 6 per cent per annum between 1995 and 2000; the ratio of urban to rural income per capita thus actually rose, from 2.71 to 2.79. The new urban hardship was borne unevenly, and by a relatively small minority.

#### 6. Market forces and the Lewis turning point

The Lewis model (Lewis, 1954) provides a helpful theoretical framework for examining the effect of market forces on labour incomes in the process of economic development. Lewis distinguished two stages in the development process: the labour-surplus stage, in which rural labour is abundant and available to the urban sector with an elastic supply curve, and the labour-scarcity stage, in which the rural supply curve is upward-sloping. When the turning point is reached, both the market-determined urban wage and the rural incomes, reflecting the rural supply price, begin to rise, and relatively unskilled labour incomes grow generally in the economy. If it is the case that prior to the Lewis turning point the labour market is segmented, with urban wages above the level that would be determined by market forces, when rural labour decreases relative to the other rural factors of production, labour incomes

will be pulled up and the urban-rural income gap will begin to close.

Consider the application of the model to China. While China remains in the labour-surplus stage, we know that there is a considerable income gap between rural and urban people, and even between rural farm-workers and rural-urban migrants. However, migration has increased rapidly since 2000. The number of people in rural China began to fall in the mid-1990s. (Cai et al, 2007), using the Ministry of Agriculture's household panel survey, estimated the number of rural workers in the urban labour market to be 78 million in 2000, when they accounted for 37% of the urban labour force, but no less than 132 million in 2006, accounting for 47% of the urban labour force. These authors conclude from this trend and evidence of rising wages in the coastal areas which employ many migrants that China is now close to the turning point. However, Meng and Bai (2007) provide evidence inconsistent with this conclusion. Because of the vast underemployment of labour in China's interior provinces, rising migrant wages may well be temporary on account of labour immobility rather than general and permanent (Knight, 2007). Nevertheless, the continued rapid development of the urban economy will at some time in the future unleash powerful market forces that raise rural incomes generally and thus erode the rural-urban divide.

## V. The Chinese case in perspective

The Chinese case can be viewed from two perspectives, the empirical and the theoretical. First, we make comparisons with other countries, so as to establish whether the rural-urban divide in China is ordinary or extraordinary.

### 1. Empirical perspective

We present results for twelve countries on which we could obtain data. Only Zimbabwe and South Africa exceed China in their ratios of urban to rural income per capita. These two southern African countries have in the past been subject to powerful class and race bias in government policies, for which rural-urban distinction serves as a proxy. Their rural households, reliant on farming and labour migration, possess very little land and resources, and have been powerless and neglected. China's successful neighbours, Taiwan and South Korea, report extremely low urban-rural ratios; indeed, in South Korea there appears to be no difference between urban and rural living standards. The ratios in Sri Lanka, Egypt, Iran and Turkey are all well under 2 to 1. In terms of size, resources, structure and level of development, the economy of India is most similar to that of China. However, the Indian ratio of consumption per capita is only half the Chinese. This may be because in India markets operate more freely, factors of



production can move unhindered, there is a wealthy landlord class, and there is a more democratic form of government. All but one of our countries has a sizable urban-rural income gap. China is not unique but it is unusual, at least by Asian standards. State institutions and government policies are responsible for China's artificially great rural-urban divide.

Rural-urban inequalities are not only to be found in poor countries of the late twentieth century: they are a more general phenomenon. For instance, in *The Wealth of Nations* (1776, ch.10), Adam Smith argued that '...the inhabitants of a town, being collected into one place, can easily combine together...' to prevent free competition, whereas '...the inhabitants of the country, dispersed in different places, cannot...'. Throughout Europe, townspeople 'incorporated' themselves, that is they regulated to restrict entry to industries, trades and occupations so as to increase their profits and wages, whereas rural people did not. The effect was to '...break down that natural equality which would otherwise take place in the commerce which is carried on between (town and country)'. 'Stock and labour naturally seek the most advantageous employment. They naturally, therefore, resort as much as they can to the town, and desert the country'. The forms, mechanisms and degree of rural-urban division may vary

from one nation or one era to another, but there are underlying reasons why it is often to be found.

## 2. Theoretical perspective

Consider the relevance to the Chinese case of four possible models of the relationship between the rural and urban sectors of a developing economy. These are the Lewis model, the price scissors model, the urban bias model, and the state bias model. Any interpretation of government policy, or of changes in policy, invites the criticism that the beneficiaries of the policy are too readily assumed to have been responsible for it. It is difficult to adduce direct evidence of the influences that govern policy, but all too easy to infer them. We recognise this methodological problem. Nevertheless, the four models provide a framework for a plausible and consistent account of policymaking.

We begin with the well-known Lewis model. Recall that this envisages economic development proceeding as a transfer of labour from the rural (identical to agricultural) sector to the urban (identical to industrial) sector. The industrial sector accumulates capital through the reinvestment of profits. In conditions of surplus labour the industrial real wage - being determined by the rural supply price - remains low and constant until rural labour becomes scarce. At first sight, the Lewis model

applies well to China, with its abundant labour and its urban industrialization policy, especially during the period of central planning. However, it requires qualification.

Economic reform did not simply accelerate the transfer of labour from the rural to the urban sector, in line with the Lewis model. Rather, it led to the growth of the third sector - non-urban, non-state, non-agricultural - the rural industrial sector. The relationship of the new sector to the existing two sectors is mainly complementary in one case and competitive in the other. It was promoted by agricultural development and it in turn promoted agricultural development. Although it diverts resources from agriculture, the opportunity cost of rural labour is low. Rural industry competed with urban industry, particularly for raw materials in the early stages of the reform process, and for markets in the later stages. It contributed to the falling profitability of state enterprises, which occurred as a result of the price reform and the opening up of competition.

The new sector developed in the rural rather than the urban areas largely because of the institutional divide between rural and urban China that the State had created. Only in the rural areas could economic agents respond to the supernormal profits available in light industry. Moreover, the policy of rural

fiscal self-reliance created a strong incentive for rural authorities to promote the industrialization of their localities. In this sense the institutional divide generated a degree of 'rural bias', in contradistinction to the more familiar urban bias in state policies. The fact that the most dynamic industrial growth in recent years took place in the rural sector should in itself have reduced the urban-rural income ratio. However, as this development was more than offset by other changes, the ratio actually rose after the mid-1980s.

The rural-urban divide has become more porous and less tidy in recent years. The rural-urban distinction is being blurred, and it is no longer equivalent to the agriculture-industry distinction. The main reason for this is rural industrialization - itself a product of the institutional divide - and the socioeconomic changes that it brought about. Although it was trivial at the start of the economic reforms, the overlap between the rural and urban frequency distributions of household income per capita has gradually increased. Some rural people in some parts of China are now better off than most urban people.

The Lewis model of the transfer from agriculture to industry is indeed relevant, but within rural China. The model depicts well the process that operated within the rural sector after

1978. The basic elements of the model are present in rural China: an elastic supply of labour from agriculture to industry, and the rural industrialization which was achieved through the reinvestment of profits within that sector. The Lewis model is a rather less appropriate description of the relationship between the rural and the urban sector. Government set the urban industrial wage at a level which greatly exceeded the supply price of rural labour, and it was necessary for government therefore to restrict and control rural-urban migration. Moreover, the funds for industrial investment, although nominally derived from industrial profits, were extracted from agriculture by means of government pricing policy. The relationship between the rural and the urban sector therefore requires a model that incorporates both the price scissors and the urban bias policies.

The theory of price scissors can be readily applied to China during the period of central planning and the period of early economic reform. Moreover, some government policies such as the formation of the communes, compulsory procurement of food, and urban rationing of food can be seen to flow from the price scissors policy. Government intervention on prices effected a transfer of resources from the rural to the urban sector. These were used for capital accumulation in urban industry, in

accordance with the price scissors model of industrialization. However, they were also used to raise the consumption of urban workers. Thus the Chinese experience does not correspond precisely to the price scissors model: it also requires a role for the urban bias model.

It is likely that urban bias does exist in China, in two senses. First, government allocates fewer resources to the rural sector than it would if it were concerned only with improving economic efficiency, as determined by shadow prices. Second, rural-dwellers receive less priority than they would if the government social welfare function made no distinction between rural and urban residence *per se*, and placed a greater value on additional income, the poorer the person. The urban bias model has perhaps been most forcefully propounded by Lipton (1999). As Lipton put it: 'the rural sector contains most of the poverty, and most of the low-cost sources of potential advance; but the urban sector contains most of the articulateness, organization and power'. Bates (1993) summarized the urban bias displayed by the state in socialist countries in the following terms. Socialist governments create large bureaucracies, forge strong ideological ties with urban labour, and are committed to industrialization and to public ownership; hence their concern to ensure low food prices and high industrial profits. Socialist governments

accordingly adopt policies against the interests of their poorest citizens - the peasants. The Chinese case corresponds well to this general account.

Although the policies of the Chinese government can be accurately described as involving urban bias, the underlying reason for the policies is better described as state bias. A primary motivation was the preservation of government by the Chinese Communist Party. The failure to close, or even to diminish, the rural-urban gap in income and welfare stems from the need to stave off potential political threats to the regime. Even during the early years of economic reform, when the rural sector received priority, the motive was to restore political legitimacy with the peasants and to relax the most serious constraint on the growth of the economy. We do not claim that the State entirely understood or controlled economic events. Take, for instance, the issue of promissory notes instead of money to peasants for their produce in the late 1980s and the early 1990s. This was clearly not a policy objective for central government - indeed, it tried in vain to outlaw the practice. However, it was the outcome of its other policies, such as that requiring rural local governments largely to raise their own revenue and the set of policies making investment in industry more profitable for local government than investment in agriculture.

The Chinese political process should not yet be viewed as the outcome of conflicting articulated pressures from various organized interest groups. The Communist Party remains too dominant for that. Rather, the urban bias policies reflect the latent political power of urban-dwellers. The government purchases an 'insurance policy' to ensure that urban workers will refrain from political protests which could challenge it, and that they will not threaten production and therefore state revenue. The erosion of the economic security of urban households in the late 1990s - associated with reform of the state-owned enterprises - can be viewed as a risky but necessary response to the financial deterioration of that sector, which posed a threat to the public finances and to continued rapid economic growth.

It is apparent that no single model of rural-urban economic relationships is sufficient to describe the Chinese experience. In fact, all four models that we considered are relevant in at least some respect. They were therefore combined to produce an encompassing model 'with Chinese characteristics'.

## VI. Conclusion

It appears from the evidence that the Chinese Government is more concerned to promote economic growth, and to alleviate poverty through growth, than it is to

prevent the sharply rising inequality that is taking place in China. Moreover, the Government's social welfare function seems to accept two classes of citizenship — one class for urban-dwellers and another, inferior, class for rural-dwellers.

There are two main ways in which the rural-urban divide might be eroded in future, but neither is inevitable. First, rapid economic growth will result in the transfer of rural labour out of farming. This should eventually see rural incomes rise - more generally than at present - as China enters the labour-scarce stage of the Lewis model. Second, in an increasingly well-informed society, widening, or even continued, economic disparities - among households, across regions, between city and countryside, and between urban residents and rural migrants - are likely to generate feelings of relative deprivation, expressions of discontent, and outbreaks of social instability. The likely response of Party and Government to these developments could help to bring inequality issues onto the policy agenda, and also to erode the rural-urban divide.

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