

Rural Urban Income Gap and Critical Point of
Institutional Change

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Abstract

By employing an analytical framework based on institutional economics, this paper intends to investigate the rural urban income gap and its critical points for change. The level of rural urban income gap in 1978 broke the institutional equilibrium on which the traditional rural urban relationship relied, leading to overall reform in rural China. In the post-reform period, utilizing their superior influence on policy-making, urban residents have so far succeeded in maintaining urban biased government policies, deterring rural labor from migrating to cities permanently. The urban residents' major lobbying mechanism is through their "vote" and "voice", something in which their rural counterparts are lacking. However, farmers have a way to "get around" the urban biased policies which are unfavorable to them. This "voting with their feet" eventually will drive the policy change. When the rural urban income gap increases to the level of 1978, a critical point for institutional change will have been reached. The timing and conditions will be ripe for reform of the whole policy package on which the present rural urban divide has been built.

Key words: rural urban income gap; urban bias; institutional equilibrium; *hukou*; system reform.

I. Introduction

It is common in developing countries that the relationship between the state and the peasants is coercive, and that the relationship between rural and urban sectors is urban-biased. This is opposite to the situation in developed countries, where agriculture and farmers are protected by government policies (Anderson et al., 1986; Schultz, 1978). The rural urban divide brought about by such policy intention is, therefore, a phenomenon prevailing in developing countries and a focus of much discussion within development economist circles. A host of literature in development economics has attempted to answer challenging questions such as (1) how are urban biased policies formed and why do they continue to remain in developing countries? (Krueger, 1991 and 1992; Lipton, 1977; Bates, 1981; Olson, 1965 and 1985), (2) in order to implement those policies, what measures are adopted and what are their functioning mechanism and welfare effects? (Knight et al., 1999; Fields, 1979 and 1974; Harris et al., 1970), and (3) what are the appropriate timing and prerequisites for policy reform? (Anderson, 1995). Explaining the formation of, and change to, urban biased policy requires observation of long-term economic development and various kinds of institutional change in developing countries. While researchers do this, their theories are more often than not competing with each other. This is because very few developing countries have gone through the whole process of policy formation, partial reform, the ups and downs of reform, and foreseeable, thorough change of the urban biased policy intention. China, however, is a unique country that has experienced various periods of central planning, transition to a market economy, together with the different stages of rural urban relationship (Yang et al., 2000). Both similarity and uniqueness between China and other developing countries, in rural urban divide and its institutional roots, make China an outstanding case for studying urban biased policies.

The currently existing income gap between rural and urban sectors is a legacy of the planning system. After rural reform was initiated, the income gap between rural and urban people first narrowed, then widened again and has become severe in recent years (Fig. 1). Statistics show that real income of rural and urban residents increased annually 17.7 percent and 7.9 percent respectively, between 1978 and 1984. After that, the relative rates of increase reversed – the rate of increase of rural income dropped to 4.1 percent and that of urban income remained as high as 6.6 percent in the period of 1985 to 2002. There has been a long period in which there has been a large difference in the growth rates between rural and urban income. As a result there has been a re-emergence of an elevated income gap. This has drawn great attention from researchers and policy-makers. The "three-dimensions of agriculture-related issues" – the "issue of farmers' income", the "issue of rural development", and the "issue of agricultural development" (or *sannong wenti*) have been raised by researchers, and a host of measures have been enacted by the government, such as

implementing protective prices first on the grain markets, then providing direct subsidy for grain production, and undertaking “tax for fee” reform. However, all those measures so far have resulted in no significant effect.

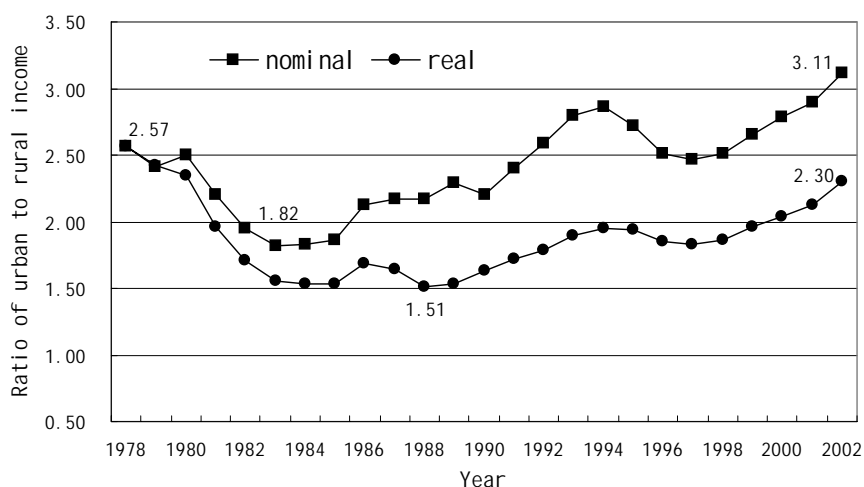


Figure 1 Changes in Rural-urban Income Gap in Nominal and Real Terms
Source: NBS, 2002, 2003.

The ratio of urban to rural income is often used as a measure to indicate farmers' wealth relative to urban residents'. The higher the ratio, the larger is the rural urban income gap. Figure 1 reveals the ratios calculated in nominal and real terms in the period from 1978 to 2002. In nominal terms, the ratio of urban to rural income declined between 1978 and 1983, then went up again after 1984, by 2002 surpassing the level reached in 1978. However, the nominal ratio does not reflect the actual gap in wealth and consumption between rural and urban residents. After deflating the nominal ratio by rural and urban consumer price indices, we get the ratio in real terms. In real terms, the gap of urban to rural income had narrowed down between 1978 and 1988 and then continued to diverge until the present time. The ratio in 2002 has not yet reached again the level of 1978. This comparison is meaningful, because the nominal and real differences in income between rural and urban people would induce different incentives for policy change.

It is meaningful to identify accurately the real income difference between the rural and urban populations. Practically speaking, as a result of reform initiated from the rural sector, a substantial improvement in farmers' standard of living, relative to that of their urban counterparts, is consistent with all the changes which have happened in the rural sector. These changes include the introduction of the household responsibility system (HRS), rapid expansion of township and village enterprises (TVEs), the reform of agricultural prices and the marketing system, and the democratic construction of rural grassroots organization etc. All this must be reflected in the improved standard of living for farmers. In fact, during the entire period of 1978 to 2002, per capita income for farmers, in real terms, increased by 7.2 percent annually, which is higher than that of urban residents (6.7 percent). The achievement of rural poverty reduction is another example. There were 250 to 260 million rural people living in absolute poverty in 1978. Only a few years later, in 1984 the number of the rural poor reduced to 89 million. Currently, in 2002 there were about 20 million.

Whether or not the rural urban income gap has reached the level of 1978, it is also important for observers to gain a unbiased understanding of the actual situation in rural areas, because this has strong implications to theoretical studies and policy options. Early reform in the rural sector focused mainly on the adoption and widespread distribution of the HRS (Household Responsibility System), and liberalization of the prices and distribution system of agricultural products. This can be seen as a major rectification of the relationship between farmers and the state, and a major contribution to the enhancement of most farmers' incomes. (Lin, 1992; Zhou, 1994). Any reform is a kind of institutional change. Whether an institutional change happens or not depends on the demand for it, and the supply of it. It was in 1978 when Chinese farmers desired the new institution – HRS - so desperately that the government, as the supplier, first acquiesced to, then accepted and finally promoted the implementation of the HRS. As a result, the

supply of the institution met the demand for the institution, and new institution equilibrium was reached. Because 1978 was the year when the reform started, the level of rural urban income gap of this year has significance. That is, when we look back into history, we find the critical point where the demand for and supply of new institution met. Thus if we look ahead, it suggests the timing for next round of reform of rural urban relationship. In other words, when the real income gap between rural and urban sectors returns back to the level of 1978, a new breakthrough of reform of rural urban relationship should be made.

This paper intends to examine the critical points of rural urban income gap from the perspective of the political economy of institutional change, suggesting the timing and direction of reform incubated by the three dimensions of agriculture-related issues. The rest of the paper is organized as follows. Section II reviews some of the prevailing theories explaining motivating factors and policy tools of governments in developing countries which lead to an urban biased policy, and provides a framework within which the Chinese case can be analyzed. Section III narrates the process of China's rural reform from the point of view of changes in institutional equilibrium, and incentives for lobbying policy-makers. Section IV discusses the commonly used lobbying mechanisms by urban residents ("vote" and "voice"), versus the way farmers respond to policies which are unfavorable to them ("exit", when a certain incentive is reached), identifying critical points for reform. Section V concludes with an indication of the arena for further reform of the rural urban relationship in China.

II. Demand for and Formation of Institutions: Explaining the Rural Urban Relationship

There are primarily two analytical paradigms for explaining the formation of urban biased policy in the process of economic development. One theoretical stream views the policy intention of urban bias as the logical result of implementing the strategy of industrializing an agriculture-dominated economy. It is central to the thinking of political leaders and economic policy-makers of developing countries to spare no pains to industrialize their backward economies and raise living standards of the people. The consensus on peasantry prevailing among development theorists and development planners at the time was that peasants are backward in technology and irrational when responding to any economic incentives. This consensus was then translated into a set of policy tools used to tax the agricultural sector in order to raise a surplus for industry, since the latter was viewed as the only catalyst sector for rapid growth (Krueger, 1991 and 1992). While this paradigm mainly focuses on an explanation of government motives to adopt urban biased policy, another theoretical stream tries to explain how this urban bias is formed and why it exists from point of view of political economy. This theory argues that agriculture is disfavored in development because peasants are politically powerless in influencing policy-making, compared to their urban counterparts (Lipton, 1977; Bates, 1981). In developing countries, urban residents win almost all the debates on policy issues, even though the rural population is much greater than the urban population. There are two reasons for the so-called "paradox of numbers", (the phenomenon that a much larger proportion of the population plays a much smaller role in influencing government policy). First, peasants live in more scattered areas where transportation and communication is inconvenient. (Transport and communication are necessary for peasants to take any collective action). It is too costly for peasants to be politically active in lobbying for the making of policy. Secondly, because the outputs produced by each individual farmer contribute only a tiny share of total agricultural products, the free-rider problem prevents them from taking collective action to change unfavorable policy (Bates, 1981; Olson, 1965 and 1985).

Widely discussed measures to enforce an urban biased policy are put in place through the so-called "price scissor", by which governments, through distorting the prices of commodities and factors of production, create a policy environment disfavoring agriculture, farmers and rural development, for the purpose of extracting rural surplus in order to fuel industrialization (Schultz, 1978; Anderson et al., 1986). The policy measures which are enacted to bring about urban bias may be summarized as follows. First, governments monopolize the distribution system of agricultural products, artificially lower agricultural prices and enhance industrial prices, generating unequal terms of trade between agricultural and industrial products. This directly produces the price scissor. Secondly, governments intervene in the organizing of agricultural production. Since unfavorable terms of trade against agriculture are a precondition, in order to

prevent rural factors of production from flowing out of the rural sector, the imposed organization is often used in direct agricultural production, which greatly depresses work incentives. The collectivized farm system in China and the former Soviet Union in the pre-reform period was a typical case of this kind. Thirdly, various leverages are used to make the sectoral relationship discriminatory against the agricultural sector. They include (1) monopolizing international trade and overvaluing domestic currency, by which exportation of agriculture serves to subsidize the importation of equipment and raw materials that industry needs, (2) investing disproportionately in industry, making conditions tight for agricultural development, and (3) strictly restricting labor mobility from rural to urban sectors¹, delaying the process of urbanization. Finally, they include establishing an unjust welfare system excluding rural people and creating a big gap in living standards between rural and urban residents.

Urban biased policy in China originated from the implementation of heavy industry-oriented strategy, starting in the 1950s (Yang et al., 2000). Almost all policy tools distorting the rural-urban relationship used elsewhere in other developing countries could be found in the Chinese planned economy. A unique institutional arrangement, however, was to strictly control rural urban migration (Knight et al., 1999; Chan, 1994). In economic literature, models and empirical studies explaining labor migration are rather rich (for example, Lewis, 1954; Todaro, 1969; Harris et al., 1970; Fields, 1974). Many of those can be used for reference to start our investigation of the Chinese case in terms of a theoretical framework and methodology. However, more should be done to extend their power to explain the distinct institutional background of China, under which rural urban segmentation set in.

The Lewis model can be depicted in Figure 2-a, showing the process of reallocation of the labor force between rural and urban sectors, as the economy grows. The horizontal axis, O_aO_u , measures the total labor in the economy, assumed to be fixed and to be distributed only between rural and urban sectors. Rural employment is measured rightwards from O_a and urban employment is measured leftwards from O_u . At the beginning, demand curves of labor in rural and urban sectors, D_a and D_u , intersect and divide the total labor force between the two sectors, O_aL_a in the rural sector and L_aO_u in the urban sector. Accordingly, this equilibrium determines an equated wage rate between the two sectors ($W_a=W_u$). In the process of economic development, as the urban sector expands, its demand for labor increases, pushing the labor demand curve in the sector to move upwards, from D_u up to D'_u in Fig. 2. If, at this stage, the labor demand curve of the rural sector does not move accordingly, the new equilibrium wage rate determined by the now higher labor demand curve of urban sector, D'_u , and the unchanged one of rural sector, D_a , would trend up. This is contrary to what Lewis suggested: that urban industry can continue to expand while the wage rate remains unchanged. Lewis's assumption of zero or negative marginal productivity of labor in agriculture, which implies that continued outflow of rural labor would not reduce agricultural production, is a way to resolve the contradiction. But a new inconsistency arises, since the assumption of a neoclassical urban labor market contradicts the existence of an institutional wage in the rural sector that determines the urban wage.

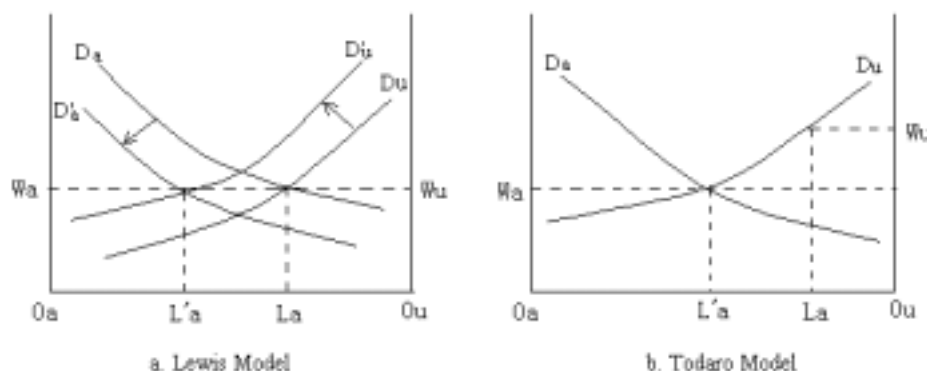


Figure 2 Lewis and Todaro Migration Models

¹For example, Knight et al. (1999) combined the Lewis model with a price-scissor model to explain how the distorted policies of rural-urban relationship result in the rural urban divide, under an economy with unlimited labor supply.

To solve the problem that Lewis left behind, Ranis and Fei (1964) eliminated the Lewisian assumption by the conviction that the marginal productivity of agricultural labor in a dual economy is not necessarily zero or negative, as long as the technology of agriculture advances. That leads to labor productivity in this sector increasing and releasing surplus labor to be absorbed by urban sector. As shown in Fig. 2-a, as the result of enhancement of agricultural labor productivity, the labor demand curve of the rural sector moves downwards, from D_a to D'_a , and intersects the labor demand curve of the urban sector, D'_u , at the point where total labor is divided into $O_aL'_a$ in the rural sector and L'_aO_u in the urban sector, and the rural-urban equated wage rate ($W_a=W_u$) remains unchanged. In this variant of the Lewis model, the increasingly enlarged urban demand for labor constantly absorbs surplus the labor force released by increased agricultural productivity at a fixed wage rate, until the so-called “Lewisian turning point” is reached at which the increase of labor productivity of agriculture lags behind the requirement of industrial expansion, and as a result, both rural and urban wage rates start to mount up and the dual economy tends to disappear.

The reality in developing countries, however, is that from very beginning of their development process, as is observed by Todaro (1969), there exists an institutional wage in the urban sector, which appears much higher than that formed in a situation of equilibrium, and even the rural-to-urban migration is unable to even up the wage gap between the two sectors. This is manifested as $W_u > W_a$ in Fig. 2-b. Meanwhile, the actual urban employment is less than what an equilibrium situation requires – that is, $L_aO_u < L'_aO_u$ – and then a gap between actual and equilibrium amounts of employment exists ($L_aL'_a$). This gap can be embodied as urban unemployment, underemployment in the urban informal sector, or rural labor surplus because of immobility of labor market. The coexistence of rural-urban income gap, which is believed to be a major pooling force attracting migrants, and insufficiency of urban jobs, which is a pushing force repelling migrants, has engendered a paradox in explaining consistently the labor migration and urban unemployment in developing countries (Todaro, 1969; Fields, 1974). Therefore, explaining why the urban institutional wage exists is crucial to an understanding of income gap and migration between rural and urban areas.

The causes of that institutional wage which exists in the urban formal sector can be found in the same way in which we examined the formation of urban biased policy in developing countries. According to the paradigm of development strategy in explaining urban bias, institutional wage is caused by capital-intensive preference in investment, which is unfavorable to employment in the urban sector. In the general process of development, as the economy grows and capital accumulates, the demand for labor in the urban sector can either increase or remain unchanged, depending on the strategy it implemented. There are typically two scenarios in terms of employment absorption in economic growth. As is shown in Fig. 3-a, the ratio of capital to labor remains constant, as more capital is available for investment. As a consequence, the faster the urban economy grows, the larger the demand for labor becomes and the greater the number of rural laborers who can migrate to the urban sector. Fig. 3-b shows the opposite scenario, where, as capital accumulates, before the rural surplus labor force is exhausted, the urban industry shifts to a capital-intensive one, and economic growth no longer absorbs rural-to-urban migrant workers. As a result, the urban wage comes up to the institutionally determined level that is higher than otherwise would be in equilibrium. On the other hand, the paradigm of political structure in explaining urban bias would suggest that the stronger bargaining power enjoyed by urban classes persuade the government or other social bodies into protecting their wage and welfare. The relevant institutional arrangement that early theory on migration observed is the law of minimum wage in the urban formal sector (Harris et al, 1970).

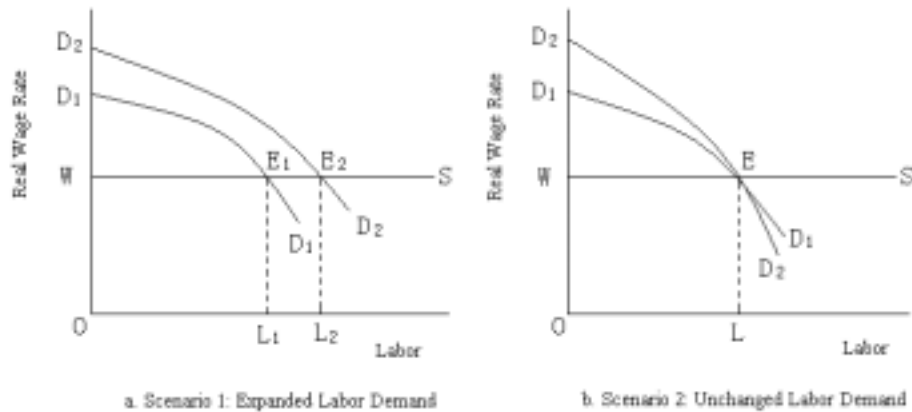


Figure 3 Two Scenarios of Labor Demand as Urban Sector Expands

In the pre-reform period, the planning system served as a tool for implementing heavy industry-oriented strategy. The pursuit of capital-intensive industrialization in a capital-scarce economy had limited employment absorption capacity in the urban sector, impeding rural labor migration to the cities. Feng et al. (1982) estimates that in the pre-reform period, the employment absorption ability of heavy industry was only one third that of light industry. During the period of 1952 to 1980, the accumulated amounts of capital investment in heavy and light industries were 374.2 billion yuan and 39.4 billion yuan, respectively, which resulted in a severe imbalance in capital allocation. Compared with a scenario where these two industries were supposedly invested equally, the heavy industry-biased investment caused a 40% loss of employment (Cai et al., 2003). This labor-repellent industrialization strategy would not have come about through the normal market mechanism, because it contradicted China's labor-abundant nature, or comparative advantage, at that time. Therefore, once the strategy goal was adopted, it became necessary for the government to step in, setting up various institutions preventing capital and labor from transferring among sectors, regions and ownerships. Any mobility of factors of production was deemed a planning disobedience. Those institutions, included the household registration (or *hukou*) system (that divided the rural and urban population into separate groups), urban employment policy and welfare policy (that excluded rural residents from its entitlement), the urban rationing system for food and necessities, and the urban biased social security system.

Of all those institutional arrangements separating population and labor between rural and urban areas, the household registration (or *hukou*) system was the most important one. In the early years of People's Republic of China, migration was not restricted. In the period 1949 to 1957, 70-80 percent of the increment of population in Chinese cities and towns can be attributed to rural-to-urban migration, as typically happened in other developing countries (IPS 1988). Later, in order to guarantee the adequacy of laborers producing agricultural products in rural areas, and to limit the number of people enjoying low priced food in urban areas, a set of institutions were needed to restrict population mobility between rural and urban sectors. Issuing of *Regulations on Household Registration of People's Republic of China* in 1958 marked the beginning of the complete establishment of *hukou* system, restricting migrations between rural and urban areas, and across regions.

Unlike population registration in most other countries, China's *hukou* system is unique, because it aims to make rigid the separation of population between rural and urban areas. According to its regulations, any person at birth should be registered in locality where his or her mother is registered, and will have little chance to change this registration locality in his or her entire life. In practice, residential movement across locales was controlled by departments of public security. It was impossible for rural residents to move to cities without official approval; labor mobility across sectors was planned by departments of labor and personnel, and no labor market was allowed. During the period from the 1950s to the beginning of the reform, the *hukou* system had been strictly implemented and it effectively prevented laborers from migrating from rural to urban areas. A survey conducted by the Institute of Population Studies, Chinese Academy of Social Sciences (1988, p. 6) suggests that only 45.2 percent of the total number of migrants in the period from 1949 to 1986 were of rural-to-urban type.

Once the *hukou* system was put in practice and began effectively to impede the rural population from entering cities, the urban welfare system was in turn established, which exclusively provides various social services that included housing, medical care, education and pensions for virtually all urban residents. Exclusive guarantee of full employment for urban laborers is the core of this welfare system and characterizes the overall procedure of labor allocation under the plan. In short, the *hukou* system not only underlies the welfare configuration under the urban biased regime, but also makes this overall setup consistent with the implementation of heavy industry-oriented strategy.

III . Incentive Strength, Institutional Equilibrium, and Rural-urban Relationship Reforms

Previous studies suggest that it is only when the numbers of farmers dramatically decline and, consequently, the urban dwellers dominate the population that the critical point for policy changes from urban bias to balanced rural-urban development is reached (Anderson et al., 1986). This is because the reversal in numbers of population between rural and urban areas would change the relative power influencing policy-making – that is, the “paradox of numbers” plays a role in an opposite direction now. Once there are less people engaged in agriculture, transaction costs relating to farmers’ collective action of influencing policy-decisions, such as that of free-riding, communicating and receiving information, would decrease, then as their bargaining power is enhanced, farmers gain much greater advantage in influencing the policy-making. On the other hand, the reversed change in relative share of population in turn causes the change in lobbying incentives of farmers, relative to urban residents; therefore, it’s less costly for the government to carry out a policy reform in an opposite direction¹.

Reforms of public policy, like any institutional changes, occur when the net gains from changing to the new arrangement outweigh the costs of the change. Usually changes in institutional arrangement are the result of long bargaining between people or groups from demand and supply sides of institutions. In a political market, producers, consumers and traders are the demanders of the policy, while the government agencies are the suppliers. In the process of policy formation, the government acts as an agent with economic rationality, maximizing political revenues and minimizing political costs (Downs, 1957). That is, the government decides whether or not and to what extent to provide (supply) a new policy, while ceasing an old policy, by weighing its political costs and benefits. Here, costs are referred to potential opposition caused by the new policy, and benefits to potential support gained from the new policy. Lobbying activities seeking or opposing the policy then positively or negatively influence the decision-making, respectively. In trying to understand “three dimensions of agricultural issues” in developing countries, most theories with this simple political economy perspective are more or less confined to existent Western-type means of lobbying, believing that only through the mechanisms of “vote” and “voice”, or increase in incentives, the policy change is finally reached. If that is the case, unless the relative numbers of rural and urban interest groups change, the relative lobbying incentives will not change, the urban biased policies and their resulting interest pattern will not be broken, and farmers hungering for the policy change can expect nothing but to wait, with no hope

¹By using a computable general equilibrium model, Anderson (1995) found that even without the difference in transaction costs between farmers and urban classes while lobbying for policy favors, different relative incentives of farmers versus urban people can sufficiently explain the policy intentions at various stages of development. On one hand, in poor countries, where agriculture is taxed, potential benefit from farmers’ and their agents’ activities seeking agricultural protection policies and opposing industrial protection policies is only one ninth to one sixth the benefits gained by their corresponding groups in industrialized countries where agriculture is protected. In contrary to this, industrialists and their agents in poor countries have over 10 times the incentives to seek a policy package that subsidizes industry and taxes agriculture relative to their counterparts in rich countries. On the other hand, the benefits brought to industrialists from taxing agriculture and subsidizing manufacturing are 10 times and 5 times the loss that the policies imposed on farmers in poor countries and richer countries, respectively.

of success.

In the reality of developing countries, “exit” is a more commonly observed reaction that peasants take to oppose urban biased policies when the policies become unbearable¹. This kind of activity aiming to improve welfare level is an individual one, and therefore there is not a free-rider problem, and the “paradox of numbers” in collective action has no role to play. The commonly observed rural-to-urban migration, which is conceptualized by Todaro (1969) and seems sometimes irrational because it causes the so-called “disease of city” in developing countries, is in fact the peasants’ “exit”, their response to government urban biased policies. It seems that the institutional arrangement in rural China in the pre-reform period put an end to any possible “exit” mechanism. In fact, although the rural-urban divide was extremely wide, peasants were at a loss as to what to do, because the compulsory commune system deprived them of their right to withdraw from the incentive-lacking farming organization (Lin, 1990) and the *hukou* system barred them from freely migrating to cities (Chan, 1994). However, universally existent shirking in farm labor was also an “exit”, though in disguised form and as a result, brought about low agricultural efficiency. In the end, when the incentive problem and the resultant food shortage become so severe that both farmers’ subsistence and cities’ supply were threatened, around the time of late 1970s, this means by which farmers responded to the discriminatory policies could bring a result in influencing policy change similar to the prevailing mechanism of lobbying in the western countries.

The way Chinese farmers, by exiting from making an effort in collective labor, changed marginal political costs in policy implementation and thus the equilibrium of the old institutional arrangement can be depicted graphically. In Figure 3, the horizontal axis represents the strength of implementing the urban biased policies; it reaches S determined by equilibrium at E , where political costs of implementing a certain policy, MC , intersects political revenue, MR , being equal to P . If the strength further strengthens, which induces farmers “exit” in the form of shirking in farm production, the costs of continuing to implement the present policies would shift upwards to MC' . The new intersection between MC' and MR accordingly forms an equilibrium E' on the left, which pools the policy implementation strength towards a weaker S' . The inefficiency in agriculture which resulted from lack of incentive mechanism reached its worst level, which trapped 260 million peasants in absolute poverty and raised up the strong need for changing the institutional arrangement. The failings of price distortion, incentive deficiency and poor efficiency caused by the urban biased policy package became increasingly obvious over time, and the political costs of discarding the policies became zero in the year of 1978, when the new generation of leadership authority felt a great opportunity to gain political support from the masses by implementing the reform. Consequently, a great reform came about.

¹ Hirschman (1970) first used the terminology “exit” to express the reaction when people dislike the incentive mechanism they face.

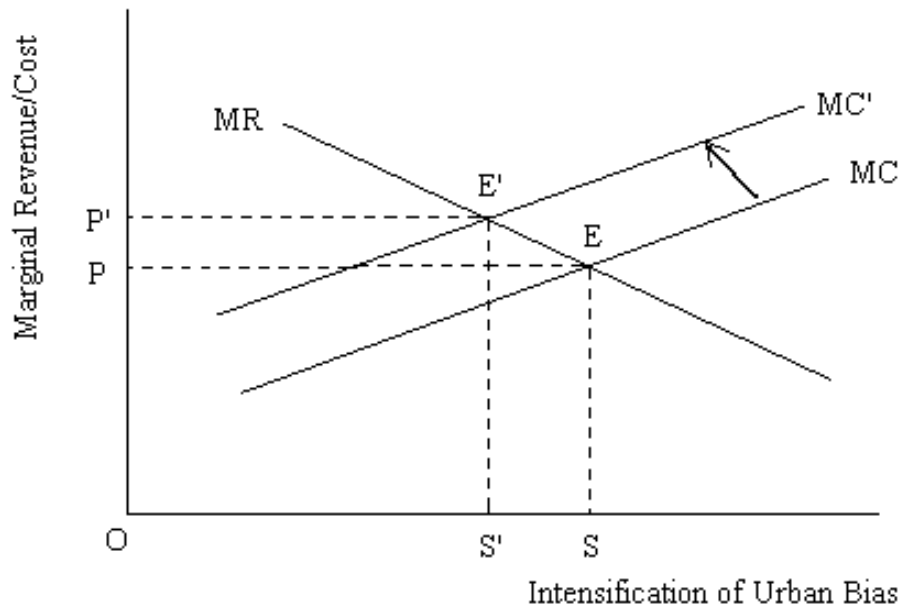


Figure 4 Institutional Equilibrium and Its Changes

The HRS initiated in the late 1970s made farm households the residual claimants of their marginal effort, thus solving the long-standing incentive problems associated with the egalitarian compensation rules created in the commune system (see Meng, 2000, pp. 26-28). At the same time, the price system of agricultural products was altered, which stimulated an increase in farm productivity, thus releasing surplus laborers from agriculture. The higher returns to labor in non-agricultural sectors motivated farmers to migrate out of agriculture (Cook, 1999). As the result of labor mobility from agricultural to non-agricultural sectors and from rural to urban areas, labor markets began to develop. This package of market-oriented reforms created remarkable growth in farm household earnings. The rural real per capita income nearly tripled, rising from 133.6 yuan to 357.9 yuan in the period of 1978 to 1985, due primarily to the adoption of HRS and increases in agricultural prices (see McMillan et al., 1989; Lin, 1992). Although farmers' income has continued to increase since then, the income effects were the most dramatic in these initial years of reform.

IV. Vote, Voice and Exit: Influencing Institutional Changes

From the foregoing discussions, one can see that the income gap between rural and urban sectors in 1978 became the critical point for breaking the institutional arrangement underlying the rural-urban relationship in the planning period. It is apparent that the degree to which rural-urban gap reached in 1978 was the symbolic turning point critical to initiate the reforms abolishing People's Commune System. That is to say, when farmers' living standards fell to a certain level comparing to urban residents', the institutions consequently became of disequilibrium, farmers were then pressured to "exit" from the People's Commune regime, spontaneously and thoroughly. Moreover, to the government, this turning point implied minimum political costs and maximum benefits for a major policy change. The rural reform which began in late 1970s first solved the long existing incentive problem in farm organization, then liberalized commodity trading and prices that were previously monopolized by the state. By gradually eliminating the price scissor, the accumulation pattern of industrialization began to change, further impelling the reform of overall development policies. The effect of the reforms during this period, to a great extent, has exhausted the traditional motivations of urban bias that Krueger (1991 and 1992) identified. But this does not necessarily imply the end of the policy package itself, because the traditionally formed vested interests still exist and, in nature, are not easy to break. Under the more decentralized decision-making regime, there is, howbeit, an opportunity for urban residents to take advantage of "vote" and "voice" to represent their group willingness and to influence, especially,

local governments' policy decisions. Both the policy transformation and policy continuation make the two competing hypotheses represented, respectively, by Krueger and Lipton now complementary (Yang et al., 2000).

Though in the pre-reform era, urban wages were hardly raised for a long period of time, and shortages of consumer goods were common, urban residents were guaranteed the basic necessities and social welfare (food, housing, education, and medical care) under the rationing system and "iron-bowl" employment policy. None of the peasants could enjoy the same benefits and guarantees. In many ways, urban residents were a privileged class. This is shown in the continuing large gaps in rural-urban incomes (Yang et al., 2000). The opening of city gates to rural migrants, especially in the labor market, means that the urban privileges were beginning to be shared, even partially. This was bound to invite complaints from urban residents.

Two channels, also used elsewhere in other countries, are used in China to express urban people's concerns relating to policy making. The first is through "vote". In the current Chinese people's congress system, direct election of representatives is adopted at the city district level. These representatives then elect those of the higher (city) level. Major municipal government positions in each city have to be endorsed by the municipal people's congress. In the post-Mao/Deng political economy, many preferences and wishes of urban residents were conveyed to various government policy levels through this way. Local governments are becoming more responsive to local preferences. In recent years, we can find in the media that migrants are a major concern of many congress representatives. Very often they take a negative position towards the incoming labor from the countryside.

The second means of expression is through "voice". This is mainly the media and views expressed at public meetings. On the issue of floating population, local media often have negative portrayals of migrants, giving the public the impression that unemployment, crime and a chaotic city environment are attributed to peasant migrants from other places (see Davin, 2000). Research institutes affiliated with local governments also produce plentiful "evidence" in support of these claims (e.g. Wang, 1995, Chapter 14). Since the economic reform initiated in the late 1970s and early 1980s, the interests of people have been diversified as the result of diversification of the economic structure and ownership. Media caters to broader interests of different groups of citizens other than just reflecting government slogans. More precisely, the double challenge faced by media – political correctness and economic profitability – require it to be responsive to both government concerns and readers' concerns. The Chinese media has long faced the dilemma of "prettifying the brightness – exposing the seamy side". That is, the government requires it to be the positively propagandist, whereas the mass of readers require it to be representative of their interests. In the case of the migration issue, the media can combine these two requirements perfectly by reflecting complaints of job competition from urban residents, and concerns of urban social stability by governments. Davin (2000) points out the joint willingness of government, journalists and the urban population to lay blame on migration, but not to relate the issue to its institutional background, thus failing to reveal the actual incentives that urban people have to be negative toward migrants.

Before the reform, when China was ruled by a more authoritarian government, policies were mainly decided by the political elite and were relatively immune to pressures generated by the public. The accountability and competence of each level of government were evaluated in accordance with its performance in terms of implementing policies assigned by higher levels of the governmental hierarchy. Or put it another way, because of the simplification of the task of each level government – function as a part of the bureaucratic machine in implementing the central planning (people's welfare was supposed to be included in it), it was sufficient for the higher levels of government to effectively supervise their subordinates through a hierarchical channel and to judge their performance accordingly. Under such a decision-making system, the governments at all levels were responsible only to those supervising them, and central government and the central leadership of the party made the final judgment of bureaucratic performance. Ordinary citizens were only supposed to express their willingness to follow the policies made by each level of government, while the media was mainly the party's propaganda tool. Under the current political system, however, urban social groups are more effective in expressing their preferences and voice, and in influencing policies as the system of evaluating government performance changes, and the media begins to partly reflect the concerns of ordinary people, under the condition that the voice of the masses does not conflict with the political regime.

In the framework of political economy, policy is made in accordance with consideration of

the political costs and benefits, and political costs and benefits respectively refer here to decline and increase in political support gained by issuing a specific policy (Downs 1957). Under the assumption that the local government in China is also a maximizer of the political net benefits, i.e. it weighs the costs and benefits of different policy options and chooses one that gives the largest net political benefits, it is natural that local government will represent local urban residents' interests and institute policies that are protective of locals' jobs and welfare. In other words, local urban governments tend to favor the segmentation of urban and rural labor markets. In particular, the system of evaluation of government performance applied currently in the Chinese bureaucratic system motivates local urban governments to care about the votes and voices of local residents. Currently, governmental performance at each level is evaluated annually according to a series of criteria. Of those criteria, some crucial indicators are considered to be "one vote veto" (*yipiao foujue*), which means that if a government leadership fails to fulfill any one of these crucial criteria, it fails to pass the evaluation. The selected criteria for "one vote veto" differ from place to place, but two of them are universally employed, given their importance as posed by central leadership of the party: family planning and the incidence of a political crisis. If the birth rate exceeds the controlled quota, or any severe political chaos caused by turbulent events¹ happens in a certain region, then the local government is considered not qualified to perform for the year, and the leadership is potentially discharged. In this regard, the People's Congress votes are indicative of local residents' judgment of the leadership, and the voice of the press is a barometer reflecting potentially political pressure from masses.

In their economic growth, all societies inevitably experience the process of labor outflows from agricultural to non-agricultural sectors caused by the declining share of agriculture in the economy as a whole. Only when the surplus rural labor force incorporates other resources in a much wider area of the economy, which is equivalent to progress in urbanization and industrialization, can the rural and urban standards of living tend to be equalized and the two sectors be integrated. The asymmetry of lobbying mechanisms and bargaining powers between rural and urban sectors is the major reason why the long-lasting rural-urban divide has not been completely broken so far. The uneven political influences between rural and urban residents keep alive the *hukou* system and segmentation of the labor market, and thus the appearance of this divide in China today is the inequality of resources possessions, which leads to the disparity in income and welfare between the two sectors. The *hukou* system is the origin and legitimacy of discriminatory policies and regulations against migrants. First, the existence of the *hukou* system predetermines that migrants, with few exceptions, will not legally obtain an urban residence, expecting only to be part of a transient or circular migration. Second, all discriminatory treatment in terms of employment availability, job security and social services are implemented by identifying whether workers have local *hukou* status or not. Finally, although various aspects of urban biased institutions have been reformed in the past years, as long as the *hukou* system exists, there is a possibility of institutional regression strengthening governmental intervention and control of an unfavorable urban labor market against migrants. From 1995, the urban employment situation in almost all cities in the country started to deteriorate, and urban workers attributed the high rates of unemployment and lay-offs to competition from migrant workers. The municipal governments started a re-employment program, one of the measures being to implement strict control of migrant workers through quota and occupation-specific restrictions. As a result, the once loosened urban employment policy and *hukou* system has returned back on its urban biased track.

If only the lobbying mechanisms of "vote" and "voice", which exclusively benefit urban classes, can be used in the political market, then it will be a long wait for the elimination of the present rural-urban divide, or for the expectation of a restructuring of the political structure. The success of the HRS, however, suggests that farmers can use lobbying mechanism such as "exit" or "vote with their feet" to influence government policies. When incentives cause which farmers to react against urban biased policies become strong enough, their special way of lobbying the

¹ So-called turbulent events referred to those situations in which individuals or groups collectively act in an abnormal way when they cannot reach their goals by acting in a normal way. Those abnormal actions include, for example, public demonstration, destruction of machinery, collective appeal to the higher authorities for help, and strike (see LSI of MOLSS, 2000).

policy-making process can then bring about the timing of institutional change (Anderson, 1995). At the present stage of China's development, the inevitability of decrease in agricultural share makes it impossible for farmers to enhance their income through any measures of increasing production, and there is no room for agricultural prices to rise, given that comparative advantage in agriculture has been diminishing and that supply has exceeded demand in the agricultural products market. Moreover, the HRS, as the basic farming system, provides well an incentive mechanism, and is efficient in allocating resources, so there is no big chance to increase farmers' incomes through improving the land-related system. The only way to further enrich Chinese farmers, therefore, is to reduce their numbers, i.e. to gain reallocation efficiency by changing the pattern of rural-urban resource distribution. The rural-to-urban migration is an adjustment of resource allocation as well as an effective way for farmers to express their need for changes in the rural-urban relationship¹. In reality, the late 1980s, when rural-urban income gap started its upward reversal, was the very time that the first migration tide (*mingong chao*) appeared – that is, farmers “exited” from the agricultural and rural sector, which was no longer a source of income increase. However, with a host of institutional obstacles, a complete urbanization has not evolved from the impermanent and circular labor float between the rural and urban sectors, and since then the income gap has widened. On the other hand, the widening income gap between rural and urban areas, and the resulting withdrawal of farmers from rural engagement, have increasingly caused disequilibrium in the present institutional settings, pressuring the government to implement a substantial policy reform. Judging by the current trend of rural-urban divide, the conditions for a thorough reform are maturing, with a focus on the *hukou* system and attendant institutions. And the timing of the reform will be around the critical point at which the rural-urban income gap reaches the level of 1978.

V. Concluding Remarks

Any institutional arrangement that causes and keeps alive a certain distribution of welfare, exists not necessarily because it is efficient but because it is in a relative equilibrium state given the different forces influencing policy-decisions. The emergence of institutional disequilibrium and its resulting change from an existing institutional arrangement to an alternative is originated mainly from (1) changes in the institutional choice set, (2) changes in technology, (3) long-run changes in relative prices of production factors and commodities, (4) changes in other institutional arrangements (Lin, 1989), and (5) changes in relative lobbying incentives affecting institutional equilibrium (Anderson, 1995). The big flock of rural-to-urban migrant workers which emerged in the late 1980s now accounts for one third of labor force engaged in urban employment, inducing adaptive reforms in many aspects of the traditional institutional arrangement such as reforms of the *hukou* system in small towns and some medium-sized cities, urban employment policies, and the social security system, which have changed the basic environment of institutions and enlarged the institutional choice set. As the share of agriculture declines and accession to the WTO brings pressure for a structural change of the economy, the demand increases for changes to the rural-urban relationship. As a result of continuous widening of the income gap, incentives intensify for reform of the *hukou* system and its attendant institutions, and the need for reform becomes extremely urgent. The success of the first rural revolution in the late 1970s can be attributed partly to the Chinese leadership, which was contemporary with the needs of the masses of farmers to break the People's Commune System and to adopt the HRS, which was a prologue to the overall reform in China. The presently incubating reforms contemporizing with the desire of farmers for legitimate migration will mean decisive institutional change, completely ending the rural-urban divide, therefore sustaining the sources of long-term economic growth and political stability in China.

¹ Tiebout (1956) first used the expression “vote with their feet” to refer to the migration caused by dissatisfaction of residents with public services in a community, while Chan (see Far Eastern Economic Review, 2003) applies this concept to explain the incentives motivating Chinese farmers to migrate to cities.

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