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The Hukou and Land Tenure Systems as Two Middle Income Traps—the Case of Modern China

Running head: Institutional Middle Income Traps

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Abstract

China's prevailing Hukou system and land tenure system seem to be very different in their applications. In reality, they share one hidden commonality—the denial of exit right to rural residents from a rural community. Under these two systems, rural residents are not allowed to exit freely from collectives if they do not want to lose their entitlements such as their rights to using collectively owned land and their land-based properties such as their houses. Farmers are neither allowed to sell their houses to outsiders, nor allowed to sell to outsiders their rights to contracting a piece of land from the collective where they register their households. In addition, they cannot automatically get an urban Hukou and all the entitlements associated with it at a locality where they are currently working and living. The combined effect of the Hukou system and land tenure system leads to serious distortions in labor market and land market respectively, resulting in discriminations against migrant workers, sprawling and exclusive urbanization, housing bubbles, and depressed domestic demand among other distortions. These distortions further consolidate the existing much widened urban/rural divide. Unless these two systems are

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thoroughly reformed, the rural residents in mainland China will be trapped in their relatively much lower income as a result of being unable to share the agglomeration effect of urban areas.

Key words: Hukou, Land Tenure System, Middle Income Trap, Monopsony, Monopoly

JEL code: O5, P3, Q15, J7, D3

I. Introduction

1.1 The East Asian Experiences

As an East Asian economy, China can most benefit from the experiences of its neighbors such as South Korea and Taiwan (China). In terms of culture, political tradition, ethnic background, and geographic proximity, the experiences from these economies are more relevant to China than that from other continents. These neighbors rose from traditional agrarian society to take-off in 1960s. In the ensuing roughly 30 years they overcame the middle income trap to join successfully the rank of developed economies. One often uses GNI per capita, or the dollar value of an economy's Gross National Income (final income) in a year, divided by its population, to measure its average income. In 2012, Taiwan's per capita GNI reached \$20,400 (CEPD, 2013). Japan's per capita GNI reached \$ 47,870, and South Korea's per capita GNI reached \$22,670.² Measured by the definition of high income given by the World Bank as an income level of US\$12,615 or above in 2012 (United Nations, 2005), these economies have long entered the rank of high income economies.

1.2. The East Asian Model

As the East Asian Model shows (World Bank, 1993), starting with an equal distribution of land per capita through land reform in rural areas in the early 1950s, followed by allowing farmers to own and trade their land freely, and to migrate to urban areas without institutional barriers, an economy can reduce the rural-urban divide and avoid the worsening of rural-urban income disparity under an open and market-oriented economic system even under an authoritarian regime. For example, in 2011 the agricultural population in Taiwan was estimated to be 12.7 % (CEPD, 2013). Between 1945 and 1985, the urban population of South Korea grew from

² The World Bank. "GNI per capita, Atlas method (current US\$)", <http://data.worldbank.org/indicator/NY.GNP.PCAP.CD>. 2014-05-12

14.5% to 65.4% of the total population. In 1988 the Economic Planning Board of S. Korea estimated that the urban portion of the population would reach 82.9% by 2010 (United Nations, 2011).

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1.3. Real Economic Miracle

South Korea and Taiwan have achieved shared growth by not only maintaining high growth rates for a long period of time during their take-off period, but also a very moderate Gini Coefficient values at the same time. They were both Japan's colonies, designated to be agricultural economies as their main role under the colonialist regimes. Both of them are now high income economies as a result of rapid and sustained growth for a long time. In addition to very high growth, admirably they have also been maintaining fairly equal income distribution. For example, in Table 1, we can see that Taiwan's Gini coefficient value in 2011 was 0.34, and the ratio of its richest 10% to the poorest 10% (R/P ratio at 10%) was 6.1; For South Korea, in 2007 its Gini coefficient value was 0.31, its R/P ratio at 10% was 7.8, and its R/P ratio at 20% was 4.7. For this very rare combination of high growth with equity, it is not surprising that they were praised by the World Bank as achieved real economic miracles. (World Bank 1993) This is in sharp contrast with China. As Table 1 shows, its Gini coefficient value was .47 by official source, much higher than that of Taiwan or South Korea, and 0.61 by Gan (2013). If Gan's estimate is true, China could hardly be classified as a typical East Asian nation. Instead, it should be grouped with Latin American nations in terms of its income distribution.

Table 1 Income Distribution

Economy		R/p (10%) ^①	R/p (20%) ^②	Gini (%) ^③	Urban/Rural income ratio
Mainland China (2007)	China	21.6	12.2	47 (61) ^④	3.2
S. Korea (2007)	Korea	7.8	4.7	31.3	
Taiwan		6.1 (2002) ^⑤		34.2 (2011) ^⑥	

Source: ① Data show the ratio of the income or expenditure share of the richest group to that of the poorest. United Nations (2009)

② Data show the ratio of the income or expenditure share of the richest group to that of the poorest. United Nations (2008)

③ United Nations (2012)

④ The much higher Gini coefficient value was found by Gan etc. (2013) .

⑤ Central Intelligence Agency(2007)

⑥ Central Intelligence Agency(2010)

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1.4. The benefit of free migration and free trade of land

Without free migration, wage difference across regions will not reduce, resulting in lasting, if not further worsening, regional income disparity. By allowing population to migrate freely across regions, regional labor surplus and shortage will eliminate over time, resulting in equalization of wage rates of same kinds across regions. We can apply the same analysis to land. Without free trade of land across regions and the uninterrupted transfer of land prices from areas where land price is rising to areas where land price is low, land shortage in densely populated areas and land surplus in sparsely populated areas will not mitigated. By allowing land to be traded freely by people across regions, an economy can help reduce regional rental income disparity, at the same time raise the efficiency of land use.

1.5 The similarity and difference of China's recent experience and the early East Asian Model

If one compares the economic regime of Taiwan and South Korea during the period 1950-1980 with that of mainland China during the period 1980-2010, we find many similarities. Both were open, export-driven, and market-oriented. Although from 1950 to the end of 1970s China followed a Central Planning path that set mainland China as a very different type of economy from that of Taiwan and Korea, by 1980s mainland China gradually opened up and adopted more and more market-oriented institutions by abandoning the Central Planning system while still keeping tight government control politically. Thus the political and economic institutions in mainland China exhibited high similarities to that of Taiwan and Korea in their early period from 1950-1980 when both were under authoritarian regimes. Only in 1990s both of them started democratization.

Therefore, we can conclude that China's current political and economic institutions are very similar to that of the early East Asian model that was characterized by its openness and export-driven under an authoritarian regime. The puzzle is, given that the East Asian model has successfully demonstrated that high growth can be achieved with equitable income distribution, why mainland China so far has failed to achieve this desirable trait despite all the similarities?

In what follows we will show the main differences in economic institutions between the early East Asian model and that of mainland China in terms of two traps. Section II discusses Hukou as the first trap that China has to overcome before it can reach high income rank. Section III discusses the land tenure system as the second trap that mainland China has to overcome in order to reach high income rank. Section IV concludes the paper.

II. The First trap that China has to overcome before reaching the high income rank

2.1 The Hukou system

Started in 1958, the Chinese government officially introduced this system to control the movement of people between urban and rural areas. Individuals were broadly categorized as either a "rural" or "urban" resident based on whether his or her mother's household registration was in rural areas or urban areas. A person seeking to move from the countryside to urban areas would have to apply through the relevant bureaucracies. The number of rural residents allowed to make such moves was tightly controlled by the government. People who did not have local Hukou would not be qualified for grain rations, employer-provided housing, and health care. There were also controls over access by migrant workers to local education, employment, or forming families through marriage with local people and so on.

Many years had been wasted in China since 1954 in experimenting with radical collectivization movement under the Central Planning System, resulting first in dramatic drop in total factor productivity (TFP) in agricultural production during the Great Leap Forward period, and then in long stagnation of productivity under the commune system until 1978 (Lin 1990; Wen 1993). After 1978, China adopted a policy of reforming and opening up. Since then China has achieved remarkable growth for the last three decades in every sector. However, its income distribution, especially its rural-urban income disparity, has deteriorated to an extent that it is approaching 0.61 (Gan et al., 2013) among the worst in the world.

The urban-rural income ratio is another important index to measure the urban/rural divide. This index once fell from 3.4 to 1.93 in 1985 (Cai & Yang, 2000) when the people's commune was being replaced by the household responsibility system. However, since then it was rising steadily. By the early 2000s it climbed to more than 3 (Li & Luo, 2010) and has been staying at that level since then despite the heavy subsidies given out by the government in recent years.

2.2. Hukou system as a Trap

Before 1980s, China tightly controlled the rural residents to prevent them to go to urban areas. After 1980s, the rapid growth in urban areas created huge demand for cheap labor. Meanwhile the sharply rise in rural labor productivity after dismantling the commune system led to a sudden increase in rural surplus labor.

To respond to this new reality, the Chinese government gradually loosened its control over the movement of rural population and allowed them to go to urban areas to work. However, under the current Hukou system, the rural population is only allowed to work for a period of time. They still cannot settle down permanently in urban areas without the permission of the local government.

Restrained by this system, migrant workers often have to leave their spouses and children in their native villages even after having worked in an urban area for a long period of time. This system not only has caused many broken families, but also forced a large number of migrant workers to leave their children behind in their native villages, in the amount of 60 million, or 22% of China's total children (Women's federation, 2013). These kids grow up in rural areas, often under their grandparents' care. They receive low quality education, pick up rural accents and behavior before following their parents' footsteps to come to urban areas as cheap laborers.

Here, we can clearly see that the Hukou system has de facto blocked the social mobility of rural population by denying them the opportunities to raise their social status from poor and isolated peasants to better informed and educated urban citizens. In this sense, the Hukou system is clearly a trap that prevents rural population to move up along the social ladder in terms of their income, social capital, and human capital.

There is some good news on the horizon. Having realized the limiting effect of Hukou system on rural population's upward mobility, the Chinese government has decided to partially relax the Hukou restrictions by urging rural population to settle down in towns and small cities, although the medium- to large-sized cities basically remain close to migrant workers.³

³ See "The National New-type Urbanization Plan (2014-2020)", http://news.xinhuanet.com/house/wuxi/2014-03-17/c_119795674.htm, 2014.03.17

2.3 Hukou system has made China fragmented as a nation

While the new policy to open towns and small cities represents some progress, its impact is limited, because non-agricultural employment is the basis of urbanization, the capability of offering jobs to rural population for inland towns and small cities is very limited, meanwhile the towns and small cities in East Coast are reluctant to accept them. This is especially true in China's eastern region, where the difference in living standards and social development between rural villages and towns and small cities is not that big. Many of the local farmers have already moved into the local towns and small cities. The remaining farmers, having high income from farming sector, actually want to stay in their native villages.

But it is exactly these areas that have attracted a lot of investment, including FDIs, because of their proximity to coastal ports and metropolitan cities. Therefore, they are booming and there is a strong demand for labor but facing the exhaustion of local supply. Over years these towns and small cities have attracted a large number of migrant workers from poorer areas in inland China. However, most of them are not allowed to settle down locally despite the policy change announced a few years ago⁴ to call for the open-up of towns and small cities. They only open to the local rural residents, not to outsiders.

The local government and population have strong resistance to the idea of accepting migrants from poor areas for fear that such a policy will reduce their welfare level per capita. This attitude, if not being changed, will greatly reduce the significance of the recent changes in Hukou system.

Towns and small cities in poor areas have very limited capability to absorb rural migrants locally. By allowing rural population from China's poor inland to move and settle down in towns and small cities in China's eastern region, the population in Western region and their future generations can significantly improve their welfare, social status, and social and human capital through sharing the much higher wage rate, much better infrastructures and education system of the eastern area. They even will benefit from a much better ecological environment since the coastal areas have better supply of fresh water. However, it is difficult to convince the towns and small cities in east region to open up to free migration when the big cities are not setting good

⁴See "Opinion on promoting Urban and Rural Development Jointly, and Further Consolidating the Basis for Agricultural Development", <http://politics.people.com.cn/GB/1026/10893985.html>, 2010-1-31

examples. As long as China fails to dismantle the current Hukou system, this outdated system remains to be one of the middle income traps for the rural population to move up in their income and social status.

III. The Second trap that China has to overcome before reaching the high income rank

3.1. Government as monopsony in land demand and monopoly in land supply

Another middle income trap is the current land tenure system. According to the stipulation of China's Constitution, all the farmland is owned by rural collectives, and all the urban and non-farmland is owned by the state. The rural collectives are not allowed to sell their land or change the use of their land. However, the state can take farmland from rural collectives in the name of public interest at certain compensation.

The above constitutional stipulations on land have inherent conflict in a dynamic situation of urbanization as China is now experiencing. Cities and towns in China are expanding rapidly into suburban areas for all the reasons, either pursuing public interests, or more often, commercial interests. Based on the international experiences, the impulse of an urban area to expand is mostly out of commercial considerations. That is, the agglomeration effect of an urban area will induce a piece of farmland next to it to appreciate to an extent that it does not make sense that the said piece of land should be kept for its farming use. Its owner will be tempted to sell it to a developer so that the latter can convert its use for urban development in a market economy. However, according to the stipulation of China's Constitution, even if the value of a piece of farmland has been significantly appreciated, the owner of the plot, i.e. a rural community, has no right to sell their land or change its use. At the same time, if the local governments really adhere to the stipulation of China's Constitution, they should not get any land from the rural communities unless they could prove that the land taking was really for public interest. Therefore, strictly based on China's Constitution, no towns and cities in China should expand except in the name of public interest. Even if a commercial project can thrive in a particular town or city, it will not be able to gain land legally for its operation and China's urbanization would have come to a dead end had the government adhered literally to the stipulation of China's current Constitution.

In reality, the local governments have been ignoring the stipulation of China's Constitution that all the land takings should be only for public purposes. Instead, they have been emphasizing that all the urban land should be owned by State, as stipulated by China's Constitution. Under such a constitutional argument, they take whatever they need from rural communities. Since the current land tenure system prohibits peasants from owning land individually, and from trading their land ownership collectively with anyone else, the rural communities have no alternative but giving up their land to the local governments. This is why the governments at all the localities are the de facto monopsony at the primary land markets that deal with the supply of farmland and convert it for urban use.

The government is also the de facto monopoly at the secondary land markets that auction leaseholds, (i.e., to auction use rights to state-owned urban land to urban developers). This is because the government is the only legal supplier of urban land on the ground that all the urban land must be owned by the state before the land can be used legally for urban development. The potential suppliers of land for urban expansion, i.e., the rural collectives, are prohibited to do so under this land tenure system. There is a lucrative underground land market, but it is facing crack-downs frequently. Hence, by design of the Constitution, the current land tenure system totally insulates the supply of urban land from its demand, leaving the government as the only intermediary between the supply and demand. The spontaneous interaction between supply and demand through price signals is impossible under this land tenure system. Therefore, it is impossible to nurture a true land market.

3.2 The failures of the current Land Tenure System in land allocation

The Constitutional stipulations on land were made in 1982 when China had not started with urbanization on a large scale, and when the commune system was not dismantled and replaced by the Household Responsibility System nationwide. The current land tenure system was formed in this framework that did not take into its consideration the following needs that soon arose when China moved to reform and open up its economy in the direction of marketization, industrialization, urbanization, and globalization. They are

- 1) The need to transfer all the farmland, rural residential sites, rural housings, and the collective construction sites (initially designated for the exclusive use by township and village enterprises)

to fewer and fewer remaining farmers, rural residents, and rural enterprises as urbanization and industrialization proceed;

2) The need to convert suburban farmland into urban land as the existing urban areas expand;

3) The possible need to convert into urban land the farmland that is located in the middle of nowhere to allow a new town or city to emerge.

These transfers involve at least 1.8 billion mu (120 million hectares) of farmland⁵, plus rural land that is not part of farmland such as woods, grassland, ponds, wasteland, wetland, riverside and lake shores, etc., plus hundreds of millions of rural residential sites and the houses above, and the so-called collective construction sites. Most rural population will be urbanized, and will leave their land and houses to the fewer and fewer remaining rural residents.

If there are land markets across the nation, the land markets will take care of the transfers of rural land and other resources through voluntary exchanges among peasants and between rural and urban residents. This will be a spontaneous, mutually beneficial, and therefore, peaceful process at mutually acceptable prices emerged at the land markets. Usually the most efficient or most devoted peasants will choose to stay and to obtain the land and other resources from those who are less efficient or less devoted to farming, and therefore, choose to leave the farming sector. Both sides will benefit from the transactions. Those who choose to stay will benefit from higher income as their operation scale increases; those who choose to leave for cities benefit from higher income generated by the agglomeration effect that will be available to them after migrating to urban areas.

But under the current land tenure system, no such spontaneous transactions can happen beyond the boundaries of a village. All the transfers of rural land and houses are illegal if one party of the transaction is from outside of a village. Even within a village, the residents can only transfer their contracting rights, not the ownership of the land that is under their use. Under such a rigid institutional arrangement, a real land market can hardly emerge.

⁵The eleventh five-year plan of P.R.C. proposed first, and repeated by the CPC later, to hold fast the red line of 1.8 billion mu farmland. See http://news.ifeng.com/mainland/detail_2013_12/24/32433850_0.shtml

What is more hopeless for the emergence of a true land market under the current land tenure system is, China's urbanization is equivalent to nationalizing all the farmland that has been converted into urban land. Hence, urbanization is equivalent to eliminating collective land ownership within the boundaries of urban areas. In this sense, the current land tenure system in its very nature and by its very design is anti-market.

To address this impasse, the recently adopted decision at the third plenary session of the 18th CPC Central Committee convened in last November opens a small window and thus represents a meaningful change. It calls for the formation of "a construction-land market that unifies urban and rural areas. Allow the sale, leasing and demutualization of rural, collectively owned buildable land under the premise that it conforms to [urban] planning. Enlarge the area in which State-owned land can be leased. Reduce land allocation that does not promote public welfare."⁶ If China is serious with this proposal, a small part of the collectively owned land that has been designated by urban planning and zoning as rural construction land for production or commercial purpose will be allowed to enter the urban land market directly instead of being nationalized first, as the current practice requires. It is yet to see how soon China will put this proposal in effect.

3.3 Problems arisen in the absence of a real land market

Under this land tenure system, land allocation mechanism so far is almost the same as what we saw during the Central Planning era--it relies mainly on administrative method. Despite the fact that the governments at all localities do not have correct information about the opportunity cost of each plot, they enjoy controlling more and more urban land by assigning themselves the most profitable role as a monopsony and monopoly at the same time. The farmers' land ownership, collective or not, can be eliminated overnight as soon as their land is designated as urban land by urban planning and zoning authorities. As urbanization accelerates and urban areas expand rapidly, collectively owned farmland has been turned into state-owned land everywhere at low cost.

In the absence of a land market, the government can only pretend that it has enough information in an attempt to replace the land market to allocate land and belief that it can do so efficiently. In

⁶ See "The Decision on Major Issues Concerning Comprehensively Deepening Reforms", <http://www.chinausfocus.com/china-news/the-decision-on-major-issues-concerning-comprehensively-deepening-reforms-in-brief/>, 2014.03.20

reality, it is impossible for the government to have sufficient information. In this why we see ghost towns everywhere, while so many migrant workers cannot find decent housing in urban areas. In what follows, reasons will be given to show why it is a mission impossible for the government.

First, in the absence of a true land market, the government will not be in a position to know from whom it should take land away and to whom it should give land in a way that will result in the emergence of more efficient and growing modern farms over time. It is also impossible to allow the rural finance to develop because rural land, without clear definition of ownership and financial responsibilities, cannot be used as collaterals. In the absence of a land market, even most efficient tenants have no secured tenancy. Most of them only have an oral contract, and can lose the land that they rent in any time to those who rented out their land in order to work somewhere else but now returned for various reasons. The termination of tenancy before the maturity of contracts is an occurrence from time to time in China (Huang & Wang, 2008; Li, 2009).

For these reasons, the most capable peasants, being unable to expand their operation scale in a secure way through fair competition and acquisition, and through rural financing, choose to leave rural areas. This is why China's farming sector is now run increasingly by the aged, weak, sick, female, and handicapped (Zhu & Yang, 2011; Zhou, 2008). As a result, the modernization of agriculture is still a remote dream for most peasants.

In the absence of a land market, it is impossible to compensate fairly the farmers whose land is taken by the government. Without a land market, there is no equilibrium price that can be used as fair and well-grounded reference for compensation. Ironically, the current land tenure system even does not allow more efficient cooperatives to emerge to replace less efficient ones, because it does not allow members of the existing collectives to exit with their share of land from the collectives no matter how inefficient and corrupt the collectives might be. Therefore, more efficient peasants cannot form new cooperatives if they do not want to lose their share of land. This is very much against the market principle of free exit and free entry. From time to time there are reports about frictions between peasants and abusing village cadres. Some of the frictions escalate into violent confrontations (Wang etc., 2009; Wu, 2012). When members of collectives have no exit rights from corrupt cadres, this is often the expected result.

In the absence of a land market, it is impossible for rural plots to be converted to urban land efficiently based on their true opportunity costs, resulting in very inefficient land allocation in urban expansion. It is impossible for a city to grow endogenously and to determine its natural physical boundary. Because of the monopsony in land demand and monopoly in land supply, the government can manipulate both the land price and housing price. The physical expansion of the city is not driven by agglomeration effect, but by the drive to reap the monopoly rent (often called land financing, i.e. to get financial resources through selling land by the local government) from the land taken at low price from the rural communities. Since the cost to take land from rural collectives is low, the government can afford to allocate most of the land to industrial parks and charge very low rents to attract investments, especially FDIs, and allocate very small fraction of land taken from the rural communities to residential and commercial use. Given the strong demand for residential housing and commercial buildings, the government can collect monopoly rents from this source. As a result, the cost for commercial activities and the cost of living for migrant workers are greatly inflated, and the urbanization is pushed exogenously by the government in its pursuit of urbanization of land rather than urbanization of people.

In urban areas there is no way to know the true value of a piece of land or of a land-based property because there is no competitive land and housing markets. The seriously inflated land price and housing price in urban areas do not provide a solid ground to calculate property taxes and other land related taxes. Although the Central government realizes that the land financing⁷ is not only unfair to the rural communities and causing a lot of social confrontations and instabilities, but also cannot sustain in the long-run when urbanization is approaching completion and land financing cannot sustain, it can do very little without thoroughly reforming the current land tenure system. In the long-run, the maintenance of the existing urban infrastructures will be impossible once the government cannot finance the maintenance through selling land. However, given that the current prices of land and housing are too distorted to serve as fair tax bases, a very strong resistance is expected even if the government has the political will to impose the property tax on urban residents.

⁷ Land financing mean the local government get an important source of local revenue by expropriation of rural land from peasant at a low price and selling through urban land market at a high price.

The government is also facing the following problem in dealing with property taxes. Since all the land is either owned by the state in urban areas or the collectives in rural areas, there is a very weak legal basis to impose property taxes on residents who only get the use rights to the land for 70 years and have already paid to obtain such rights. Since what they really own are physically depreciating apartments, not the appreciating land underneath, it is an open question if taxing something depreciating is fair and legal. Sooner or later the government must face this legal question, if the government is really serious about imposing a property tax system to replace the predatory land financing.

Many are puzzled why, despite the land price and housing price are so inflated relative to the average income in China (Ding,2013;Su,2013), and many expected that China's housing bubbles are soon to burst (An,2014;Cui,2014), up to now this prediction has not been materialized. The uniqueness of China's housing bubbles lies in the following facts. First, in places where there is a true land market, housing bubbles are a result of loose money supply; but in China's context, there is one additional dimension—the monopoly of land supply by the government, as we discussed above. The government therefore can prevent land and housing price from collapsing by tightly controlling land supply temporarily. Therefore, the burst of bubbles will take a much longer time. Second, the down payment ratio in China is usually much higher than in the rest of the world.

However, as long as there is no automatic adjustment to housing prices in China, as we see in places where there is land market, then the housing bubble will continue to grow. Therefore, it is inevitable that bubbles will burst, as long as the automatic correcting mechanism of land market is not allowed functioning.

3.4 The impact of the current land tenure system on urban-rural income disparity

Once it was believed that the current land tenure system at least can prevent slums from emerging, given that the government can directly own and control land. In reality, new slums, often taking the form of urban villages, are mushrooming in the outskirts of almost every city. As it is shown above, the current land tenure system has played a very active role in contributing income distribution in favor of urban residents who have urban household registration. First, this system allows the government to take land at very low price from farmers, and then auction its

use right to developers at very high price in order to get the difference. This difference should be viewed as monopoly rent. According to Chen (2012), in 2011 alone, this monopoly rent amounts to 3.3 trillion Yuan, a lost income that otherwise should go to farmers. The government then uses this source of income to finance the renovation of urban infrastructures and the welfare programs that are mainly targeted at urban people. One can argue that farmers can also benefit from the greatly improved urban infrastructures. Unfortunately under the Hukou system, migrant workers are not allowed to settle down freely where they are working. Actually even if there were no Hukou system, they still would not have been able to settle down in urban areas as a result of the prohibitively high housing price and rental price. As is pointed out above, the current land tenure system allows the government to play the roles of monopsony and monopoly at the same time, therefore, the prohibitively high price of housing and rental price are inevitable, forcing many of the migrant workers to return to their native villages after spending their prime time in urban areas, or to stay in slums where the rentals are much lower, although the sanitary conditions and public services are much poorer.

3.5 Urban villages.

Urban Villages (Chengzhongcun) and their “housings with incomplete property rights” (Xiao Chanquan Fang) are concepts that are often difficult for outsiders to understand. It is especially true with the concept of urban village. It can refer to very different urban phenomena. For instance, in urban planning literature it refers to an alternative, often more humane concept in contrast to the once popular modernist approach to urbanization. In China’s context, it refers to collectively owned enclaves surrounded by state-owned urban areas, and inhabited mainly by indigenous rural villagers as landlords and migrant workers as their tenants. These urban villages are autonomous to a large extent by default, because the urban planning officials do not think it their business to regulate the spatial configuration of these collectively owned villages. These officials view such villages as the dark side of China’s urbanization, hotbed of crimes, de facto slums that should be eliminated as soon as possible.

The very existence of urban villages and the legality of the housings within these villages have been controversial because of two reasons. First, the rapid expansion of urban areas in recent decades was obviously something not expected when the 1982 Constitution was being drafted, as is pointed above. Even after China adopted the Fourth Amendment in 2004, Article 10 of the

Constitution still contains two contradictory regulations (Cai etc., 2013). In one hand, "land in the cities is owned by the state"; in the other hand, "the State may, in the public interest and in accordance with law, expropriate or requisition land for its use".⁸ Such stipulations can only apply to a situation where urban areas are not expanding. In a situation when a city is growing physically, and demanding more and more rural land for urban commercial and residential development, it is not clear if the city can do so without violating the Constitution. In reality, the local governments are ignoring the public interest clause and only emphasizing the clause on all the newly acquired urban land should be owned by the State. It thus provides the legal argument for the local governments to demolish some of the urban villages in order to regain the state-ownership of the land within these villages.

The governments of various localities for the same argument also refuse to recognize the full ownership and property rights of the housings within the urban villages. They label these housings as ones without complete property rights (Xiao Chanquan Fang in Chinese). These housings are much cheaper partially because they are not protected legally by the government. However, according to Article 10 of the Constitution, only for public interest and with compensation the government can expropriate or requisition land from people. This implies that as long as the government cannot establish that an urban project is for public interest, land expropriation or requisition from urban villages is illegal and these villages should be left to exist legally.

Despite the weak legal status, these villages have played an indispensable role in providing affordable and accessible housings to migrant workers during the last 30 years when the government neglected their housing needs to a great extent. In addition, the high population density and very low rentals provide fertile soil for services of all types at affordable prices to thrive in and around these villages, offering badly needed services and low-skilled job opportunities to newly arrived migrants. Therefore, the urban villages provided a more friendly transitional space for migrant workers and their families to gradually adapt themselves to otherwise strange, often hostile urban environment (Saunders, 2010). It is not an exaggeration to say that had the urban villages not provided the low-rental housing, and friendly transitional

⁸Constitution of the People's Republic of China,http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content_1372963.htm, 2014.03.10

environment to accommodate so many migrant workers, it would have been impossible for China's urban areas to achieve impressive regeneration, rapid expansion, and unprecedented prosperity that we observe today.

Therefore, urban villages should be viewed as a necessary connection and transitional areas between rural and urban areas. It is true that the urban planning within the villages is relative backward, but it is not their own fault. The government chose to neglect such responsibilities to regulate all the urban land by discriminating the collectively owned urban land. The renovation of these villages should be limited only to the parts that clash with well-defined public interests such as public safety, public welfare, and public health.

What is more telling whether an urban village is functioning well or not lies in whether or not it is providing stepping stones for social mobility to its residents so that they can move up into the urban middle class in one or two generations. It is true that such urban villages have failed in this regard so far since their first emergence in the 1980s. Blame should be put mainly on the Hukou system and the current land tenure system. These two systems made it impossible for the urban villages to gain legality and to provide social mobility to most migrant workers, because under these two systems, the local governments at various localities do not have obligations to provide proper urban planning, public services including medical, educational and housing facilities, and good sanitary conditions to most of the residents there, viewing them as illegal or temporary. (Wen 2013)

IV. Conclusion

The Hukou system and the land tenure system that prevailed during the period when mainland China was under the reign of the Central Planning System are still prevailing today to a great extent, as is shown above. The two systems actually define why China's current economic institutions are still very different from that of the early East Asian model, and explain why China's performance in terms of income distribution is significantly different from that of the early East Asian model, despite the fact that China has abandoned the Central Planning system by opening up and by launching market-oriented reforms since 1979, therefore, achieved high growth rate for a period that is even longer than its East Asian neighbors in their comparable development stage. By causing serious distortions at labor market and land market respectively

in mainland China, the Hukou system and the land tenure system have been the institutional causes of the rural-urban divide that enabled China to grow rapidly at the expense of rural areas and of residents with rural Hukou, despite the fact that mainland China now in most other domains looks much more similar to that of its East Asian neighbors in their early development period before 1980s.

As the analysis above shows, both the Hukou system and the land tenure system have made urban areas exclusive to migrants from rural areas. As a result, despite the fact that China's agriculture as a share of GDP has fallen below 10%, the share of the population with rural Hukou remains higher than 60% (Du & Cai, 2013). In other words, China's social transformation is seriously lagging behind China's economic transformation. This is the root cause of why China has the highest income disparity between rural and urban areas in the world (Wen 2012).

The prevailing Hukou system and land tenure system in China seem to be very different in their applications, one dealing with population, one dealing with land. As we mentioned before, in reality, they share one hidden commonality—both deny exit right to rural residents from a rural community. Under these two systems, rural residents are not allowed to exit freely from collectives without losing their entitlements in their original rural communities, such as their rights to using collectively owned land and their land-based properties such as their houses. They are neither allowed to sell their houses, nor allowed to sell their rights to contracting a piece of land according to their population share in a particular collective where they register their households. In addition, they cannot automatically get an urban Hukou and all the entitlements associated with it at a locality where they are currently working and living.

In order to avoid such an unpleasant and potentially explosive situation, the "Decision" adopted by the recently convened Third Plenary session of the 18th Congress of the CPC provides some hope to dismantle these two systems. The "Decision" emphasizes the decisive role of factor markets in resource allocation by pointing out that "We must deepen economic system reform by centering on the decisive role of the market in allocating resources, adhere to and improve the basic economic system, accelerate the improvement of the modern market system, macro-control system and open economic system. We must accelerate the transformation of the growth model, and make China an innovative country. We must promote more efficient, equal and sustainable

economic development.”⁹ The same Decision also emphasizes the importance of improving the property rights protection system by pointing out that “Property rights are the core of ownership. We need to improve the modern property rights system with clear ownership, clear-cut rights and obligations, strict protection and smooth flow. The property rights of the public sector are inviolable, as are those of the non-public sector.” The Decision promises that China “will narrow the scope of land expropriation, regulate the procedures for land appropriation, and improve the rational, regular and multiple security mechanism for farmers whose land is requisitioned.”¹⁰

The “Decision” quoted above represents a major policy shift since 1979 and will make the economic institutions much more similar to that of the early East Asian model. If being implemented, this shift represents the most significant effort to address the root cause of urban-rural divide and will bring mainland China back to the rank of East Asian economies known for their relatively low Gini coefficient values. It is interesting to see how soon and to what extent these market-oriented reforms can be implemented so that the Hukou system and the current land tenure system as two middle income traps can be eliminated. As it is shown above, the combined effect of the two systems has led to serious distortions in labor market and land market respectively, resulting in rampant discriminations against migrant workers and their families, sprawling and exclusive urbanization, lasting housing bubbles together with mushrooming urban villages (slums), and depressed domestic demand among other negative consequences.

The above-mentioned distortions have not only further consolidated the existing urban-rural divide and made the urban-rural income disparity much more difficult to reduce, but also created new divide between those with urban Hukou and those with rural Hukou within urban areas, as embodied in the long neglected legal rights of the residents in numerous urban villages. As the number of migrant workers has reached two hundred sixty million, there is no way the government can continue to ignore their integration into urban communities as equal citizens. However, unless these two systems discussed above are thoroughly reformed, the residents with rural Hukou will be trapped in their relatively lower income level as a result of being excluded

⁹ “Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform”, <http://lawprofessors.typepad.com/files/131112-third-plenum-decision---official-english-translation.pdf>

¹⁰ *ibid.*

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institutionally from having equal rights to share the agglomeration effect of urbanization, be they living and working in rural areas, or in urban areas.

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