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**URBANIZATION IN CHINA:  
EXECUTIVE SUMMARY**

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# **URBANIZATION IN CHINA: POLICY ISSUES AND OPTIONS**

## **EXECUTIVE SUMMARY**

### **INTRODUCTION**

Over the past three decades, China has achieved enormous economic growth, accompanied by a growing number of large and quite livable cities. In the coming years, urbanization will become increasingly an opportunity as well as a challenge to the country's effort to sustain rapid growth and maintain harmonious development. Thus, the eleventh Five Year Plan recognizes urbanization as a policy priority in the coming years.

This report first examines the role of urbanization in international development and identifies unusual features of China's urbanization compared to experiences in other countries. It then discusses a number of challenges and policy issues for the coming decade and suggests options for addressing them

### **WHY ARE CITIES SO CRITICAL TO SUCCESSFUL MODERNIZATION?**

Urbanization is an integral element of industrialization and rapid income growth in all countries. Most manufacturing and service production is more efficient when undertaken in urbanized areas where firms can more readily copy best practice in technology and management from more advanced firms, and more easily access skilled workers as well as transport services and other intermediate inputs. As places where innovations are incubated and sophisticated skills developed, cities are engines of growth. Research shows that "knowledge accumulation" in urban environments leads to higher worker productivity. In the course of economic development, the largest cities evolve to become financial and business service centers, while industrial production decentralizes to small- and medium-sized cities. Such cities tend to be highly specialized in market economies (e.g., in standardized production of steel, autos, textiles, apparel, wood products, and so on), so as to exploit fully industry-specific scale economies. Specialization in production in smaller and medium size cities extends to certain service products such as entertainment, insurance, and health care.

In the earlier stages of development, income inequality between the urban and rural sectors often increases. Surplus labor in agriculture moves to cities to seek higher productivity employment and urban incomes grow more rapidly than rural ones. However, the gap declines and eventually disappears as surplus labor shrinks and the rural sector modernizes. For example, in Korea, the urban-rural wage gap was eliminated by 1994; and in Sri Lanka and Taiwan, China the ratio was under 1.4 by 1995.

International experience shows that urbanization is typically accompanied by increased food security. As rural workers flow to cities, agriculture is ultimately transformed from peasant farming on small plots to modern, larger-scale farming with consolidated land holdings and high investments in land, farmers' education and mechanization.

Rapid urbanization has posed enormous challenges in many countries, especially as urbanization proceeds quickly while policy structures adjust slowly. Only conscious and rapid improvements in urban management and planning can address the danger that cities become overwhelmed by problems of congestion and pollution and by the development of urban slums breeding poor health, crime, and social unrest. This was the experience of many Latin American cities in the 1970s and 1980s. By the time Latin America was fully urbanized in 1990, the policies and institutional reforms needed to integrate former migrants into local society were long overdue.

## **DISTINCTIVE FEATURES OF CHINA’S URBANIZATION**

Several distinctive features of China’s urbanization, compared to other countries, help reveal the key urban policy issues facing the country in the coming decade.

**Comparative Rate of Urbanization** Urbanization – in terms of both the physical expansion of cities and the growth of population living in them -- has been an important feature of China’s remarkable economic transformation. Nevertheless, China’s annual rate of urban population growth, at 3-4% during 1990-2004,<sup>1</sup> was well below the 5-6% rates typically experienced by other developing countries during their periods of rapid economic growth, even though China’s overall economic growth was faster (Table 1).

**Table 1. Growth of Urban Population during Periods of Rapid Economic Growth**

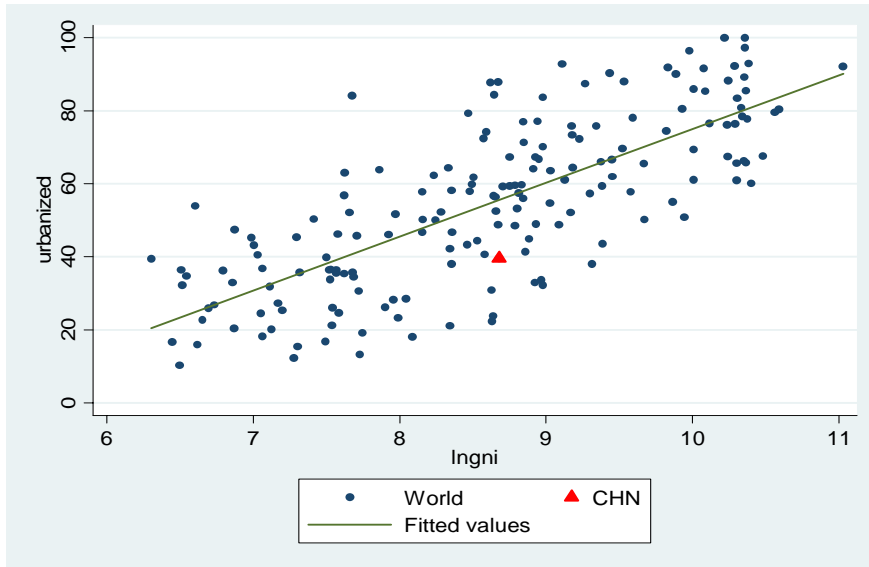
	<b>China</b>	<b>Brazil</b>	<b>Columbia</b>	<b>Korea</b>	<b>Indonesia</b>
<b>Annual growth rate of urban population</b>	1990-2004 3.6%	1950-1970 5.2%	1951-1973 4.9%	1960-1970 6.1%	1980-1995 4.8%
<b>Annual growth rate of real GDP per capita</b>	1990-2004 9.1%	1965-1975 6.3%	1965-1975 3.1%	1965-1975 6.7%	1980-1995 5.0%

Correspondingly, China’s level of urbanization in 2004, 40-45%, was below the 55% level typical for a country with China’s level of real income per capita (Figure 1), and far below the 70-85% for developed economies. There is no doubt that rapid urbanization will continue, and probably accelerate in China over the next decade or so.

**Large and Growing Urban-Rural Income Gap** Through the *hukou* system and other policies, China has maintained a strict separation of the urban and rural sectors, making rural-urban labor mobility more difficult than in other countries. Studies show that the threefold income gap corresponds to a labor productivity gap of the same magnitude. The strict separation of the urban and rural sectors has made income inequality in China the highest in Asia today. The existing urban-rural income gap implies that there are enormous potential gains in China’s national income achievable by further increases in urbanization -- by integrating national labor markets so people can more readily move from low-productivity rural occupations to high-productivity urban ones. Increased urbanization is critical to reducing rural- urban income inequality.

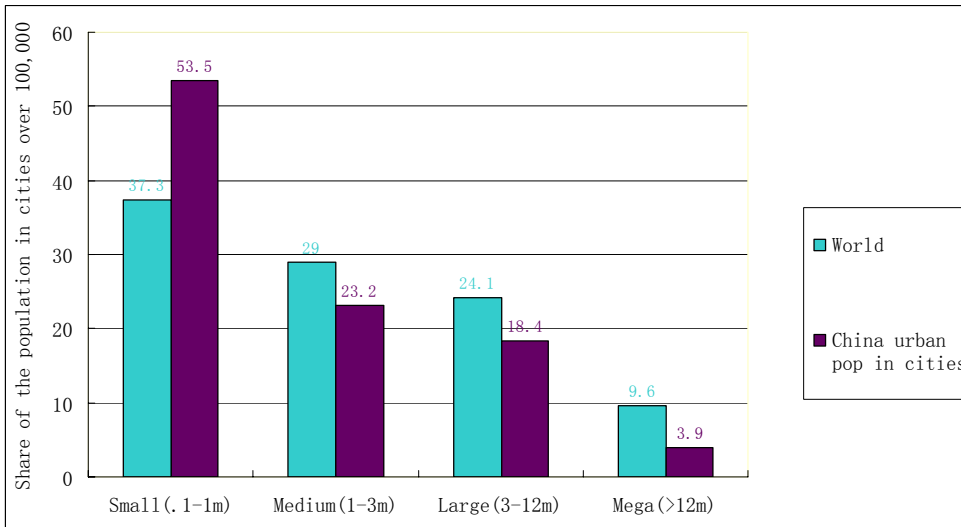
<sup>1</sup> Given differences in Census urban population definitions between 1990 and 2000, urban population growth rate numbers are estimates, where most estimates suggest a number around 3.6% a year.

**Figure 1. Percent Urbanized vs. Log (PPP Income per Capita): World Countries 2004**



**Too Many Cities, Too Few People** China’s urbanization is highly contained within regions and provinces, with relatively little long-distance migration compared to other large countries such as Brazil and the USA. In the 1990s, half of China’s increased urbanization simply involved the reclassification of “rural” areas as cities. Most cities in China have too low populations to properly exploit the scale benefits of clustering local economic activity, thereby limiting urban productivity gains and economic growth. As Figure 1 illustrates, relative to the rest of the world, China distinctly lacks cities in the range of 1-12 million in population. While Shanghai, Beijing and Guangzhou, for example, are suitably sized, recent research suggests that many prefecture-level cities are about half their efficient size. The research indicates that a doubling of the population in such cities would lead to a 20-35% increase in output per worker.

**Figure 2. Share of Each Category of Metropolitan Area of the Urban Population**



**Economic Structure of Cities** Compounding the problem of under-sized cities is insufficient concentration and specialization of individual industries in cities. This pattern is inherited from the central planning era which favored the production of a wide range of manufactured products in most cities, often at an inefficiently small scale. Another issue is that officials in large cities in China, based on their training in the planning era and work experience in state owned enterprises, may favor industry. They may perceive fiscal incentives to retain manufacturing which generates a share of VAT revenues. Also they may perceive that promoting the industrial base will lead to city growth, in a context where the political status of city and its mayor depends on city population size. Such biases hinder the decentralization of industrial activities to more specialized medium- and small-sized cities as seen in most other countries at China's stage of development. Today in China, manufacturing should be decentralizing from the largest cities to medium- and small-sized cities. The comparative advantage and future growth potential of the largest cities lie in business and financial services.

## **POLICY OPTIONS FOR URBANIZATION IN THE NEXT DECADE**

International experience demonstrates that cities are growth centers for technologically complex industries and modern services. The rapid urbanization forthcoming in the next decade provides China with enormous opportunities to maintain high growth through more efficient uses of its existing resources (rather than just more investment), through increased growth of higher value manufacturing and services, and through increased domestic demand relative to export demand as hinterland cities accelerate their growth. Realizing these potentials will require substantial reforms of urban policies and institutions.

A first priority must be to integrate the urban and rural sectors. In creating a national labor market, the key is to remove the barriers to labor mobility between the rural and urban areas caused by the *hukou* system and other legacies of the central planning era. To a considerable extent, the remarkable growth of the Chinese economy has been fueled by the emergence of labor markets within both the rural and urban sectors and by the flow of migrants to cities who arrive with relatively high skills compared to migrants in other countries. Severe barriers still exist to labor mobility between the rural and urban sector, however. Removing barriers and encouraging local labor bureaus to promote freer flow of labor and job training for migrants will lead to more efficient migration and labor usage, enhancing economic growth. And only through the free movement of laborers will the urban-rural income gap be reduced and perhaps eventually eliminated. Policy should recognize that the bulk of rural-urban migration is permanent and irreversible.

Conservation of natural resources – energy, water, land and the environment -- must be a priority of urbanization policy in China. This can be best achieved by subjecting the use of these resources to the discipline of the market. This is particularly urgent for land. Recognition of the property rights of peasants over their rural leaseholds and village lands, and of enterprises and other institutions over urban lands, will facilitate the modernization of agriculture through land consolidation, redevelopment of land for new uses within cities, and containment of urban expansion into prime agricultural land.

International experience shows that China can significantly improve grain production in the next decade, with large reductions in farm population and declines in the amount of agricultural land. Such improvements require transformation of agriculture, with relaxation of policies restricting sales of rural leaseholds, to encourage consolidation of land- holding, along with improvement in rural education and investment in agricultural mechanization. And food security could further be enhanced by discouraging over-encroachment of cities on farm land.

More generally, China needs to consider an urban policy framework with appropriate incentive structures for decision making by public officials, rather than relying on increasingly ineffective directives and quantity targets imposed from above. Key institutional reforms should include reform of the urban administrative hierarchical system, a new role for mayors, and restructuring of urban finances. These reforms will provide incentives for improved management of cities and urban living conditions.

### **Achieving an Efficient Population Distribution and Improving the Conditions of Migrants.**

- **Hukou reform** Creation of an integrated national labor market requires reform of the *hukou* system, so that *hukou* status is divorced from the right of access to urban public services and markets. The basics can be accomplished now by granting migrants the same access as residents to urban labor and credit markets (including mortgages), to urban social insurance and social security, to schooling for children, to job training for adults, and so on. More general reforms currently under experimentation should be considered for implementation nationwide:
  - Accelerate the adoption of policies granting local *hukou* rights to migrants and their families whenever the household head has secured employment in a city. Grant urban *hukou* to rural migrants with post-secondary technical education (not just college graduates), given those with technical education are in short supply.
  - restructure the *hukou* system so that rights of access to services, schooling, jobs, etc. are applicable throughout a given province. Liberalizing migration within all provinces would foster urban agglomeration generally, but also divert migrants from highly populated national cities such as Beijing and Shanghai.
- **Other policies** Other measures to achieve efficient migration and improve living conditions of rural migrants include the following:
  - *Strengthen property rights of rural residents.* As in other countries, rural migrants should be free to sell their rural land holdings (or leaseholds) and shares in local rural enterprises, so their wealth is portable and they can transfer it to cities to buy housing, start

businesses, and integrate into urban civil society. A lack of rural property rights also impedes food security, as noted above.

- *Invest far more in rural schooling and health care.* This will better prepare migrants for the urban workplaces of the future, raising their productivity and national economic growth. Improved rural education is also a key to agricultural productivity growth.
- *Integrate “urban villages” into city administration to improve their living conditions and prevent slum formation.* Urban villages should have access to the full range of city services, be subject to all municipal taxes, and be subject to city zoning plans governing future redevelopment. In return, property rights of existing urban users should be respected.

### **Promoting Efficient Land Use**

The incentives faced by urban managers encourage excessive conversion of farmland to urban use and over-dependence on automobiles which promotes urban sprawl. The main instruments of control are those of the old command economy i.e., directives from above which, for example, “prohibit” agricultural land conversion and/or require cities to meet some arbitrary minimum population densities. These across-the-board directives limit the flexibility of individual cities to meet their differing needs and are difficult to enforce. Efficient land use between the urban and rural sectors and within cities should be encouraged through more market-oriented policies which improve property rights and incentive systems and regulate emerging urban land markets.

Some specific policies options include the following:

- *Ensure that cities face the true cost of taking of agricultural land.* The range of compensation for farmers set in the land administration law may need to be raised. Actual compensation should be approved by the village as a whole, not left as a personal decision for the village head or elites. Villagers whose land is taken should be given urban *hukou*. Developers who purchase the leaseholds for such lands should face the true costs of their projects, paying for necessary infrastructure (e.g., secondary roads and sewers,) or paying impact fees imposed by the city.
- *Strengthen the property rights of existing urban land users, so as to encourage redevelopment of (“brown-field”) land for new uses within the city, instead of (“green-field”) conversion of farmland.*
- *Have urban residents pay the true social costs of operating vehicles, including their congestion and environmental costs.* Raising the gasoline tax will align better the price of vehicle travel with the social costs of travel. Raising vehicle operating costs and encouraging use of public transport systems in larger cities will promote more compact cities with higher population densities.

- *Institute zoning law to strengthen urban land use regulation.* As in more developed countries, cities in China have master plans for land use, sometimes referred to as “zoning plans” in China. But these plans do not have legal force, as do zoning plans in developed countries, which regulate land allocations to coordinate public and private land use and transport systems. The operation of the private land market should be subject to zoning laws which restrict property rights, limiting the legal right to build in a location to particular types of use and intensities. Zoning helps prevent disorderly patterns of land use. Plans are amended periodically as long-term demand conditions change. For China, a key step would be to have master/zoning plans approved by the local People’s Congress to give them legal status.

## **Reforming City Governance and Management**

**Reform the urban administrative hierarchy** China is unique in its administrative hierarchy across cities where the “large lead the small,” from provincial-level cities down through layers of the hierarchy to county cities and urbanized townships. Higher-order cities, with their greater powers and resources, have an unfair advantage in competing for manufacturing and in setting up industrial parks to attract and retain industry, at a time when they should focus more on service sector development. Studies show that rates of return on capital investment in China are higher in smaller cities and rural areas, an unusual feature which indicates under-investment at the lower end of the hierarchy. Reform should try to create a level playing field on which cities compete and evolve -- each according to its economic conditions, whether the city be a global mega-city or a smaller specialized textile city. Each city, regardless of size, should have a well-defined administrative area over which it exercises autonomy. All cities and towns should have access to the same set of tax bases, revenue instruments, exemptions, and eligibility and formulas for inter-governmental transfers, as well as the same expenditure responsibilities. They should have equal access to capital markets, in an integrated national capital market. As an immediate step to full reform, the fiscal resources available to lower order locations should be *further* enhanced. As towns or cities grow, their administrative status should be upgraded promptly, the better to service their populations.

**Redefine the role of mayors** Improving urban living conditions will require mayors to focus more on the delivery of services to urban residents including migrants, and less on the outdated role of CEO in charge of local economic development as in the planning era. Changing the behavior of city managers will require direction from higher levels, with more attention to devising measurable standards to evaluate city managers on how well they deliver urban services and improve the quality of residents’ lives, including environmental protection. China needs to experiment with urban institutional reforms aimed at making mayors more accountable to the city residents for their performance.

**Restructure urban finances** Three specific reforms would provide further incentives to improve living conditions, to make better public infrastructure investments, and to encourage more efficient industrial composition:



- *Enforce a transparent accounting system covering all on- and off-book revenues, with strict separation of operating and capital accounts.* Transparency allows the center to assess more accurately the fiscal positions of all cities and make better informed decisions about inter-governmental transfer policies. It is also a prerequisite in credit markets for market-based debt finance, such as municipal bonds.
- *Allocate the proceeds from the government sale of leaseholds to the capital budget to match sales of assets to purchase of assets.* Currently, leasehold sales are a major source of operating revenue for cities. They allow transient public officials to sell off a city's long-term capital assets (its land) to finance current operating expenditures, depriving future generations of the income from these assets. A difficult issue concerns how to fund capital expenditures, not financed by leasehold sales. Intergovernmental transfers, governed by transparent formulas applied non-discriminatorily to all cities could be used to finance a portion of baseline infrastructure needs. Cities could also borrow from the central government but international experience suggests enforcing a hard budget constraint and repayment is difficult. Finally there are municipal bonds, once China has more developed municipal financial institutions.
- *Reform city tax bases to improve market incentives and operations, as well as enhance revenues.* Currently, municipal revenues in China are generated by the VAT and business taxes as well as leaseholds. These tax instruments encourage cities to attract business, but less so residents. One reform would be to adopt an *ad valorem* property tax on residential and business property. A tax on residences provides an incentive for cities to accept new residents and provides an explicit tax base to finance their services. A tax on business property provides incentives for firms to economize in land and space utilization.

## CONCLUDING REMARKS

This report suggests two general directions for policy reform to enhance the prospects for sustained growth and internal harmony in the face of the challenges of urbanization:

- Enact reforms to unify national markets for land, labor and capital – similar to the very successful reforms that were carried out in markets for industrial materials and products. Strengthening property rights and integrating these markets across the urban and rural sectors would allow factors to be employed in their highest and most productive uses. Labor mobility in particular will lead to a convergence of rural and urban incomes and enhance economic growth.
- Equally important reforms concern the administrative structure and management of urban regions. Rather than relying on obsolete command and control structures, incentive structures should be implemented so that city managers are induced to make appropriate decisions regarding city finances and land acquisition and usage, and to improve urban services for city residents, including migrants from the rural

sector. The administrative hierarchy across cities should be reformed so cities compete on an equal basis, facing the same tax base, financing and rate structures, and intergovernmental transfer formulas.

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