
3. New Urbanisation as a Driver of China's Growth

Cai Fang, Guo Zhenwei and Wang Meiyang

Introduction

The Chinese economy has experienced a substantial slowdown in growth since 2012. Colligating its pace, extent and duration, this slowdown is unprecedented since reforms were initiated in the late 1970s. A massive stimulus package implemented by the Chinese Government during the 2008–09 Global Financial Crisis had some shock impacts on growth but had no effect on the growth trend. China's gross domestic product (GDP) growth rate fell from its peaks of 14.2 per cent in 2007 and 11.3 per cent across the Eleventh Five-Year Plan (FYP) period (2006–10) to 6.9 per cent in 2015 and 7.8 per cent across the Twelfth FYP period (2011–15). Critically, this slowdown has not yet bottomed out in a manner consistent with usual macroeconomic fluctuations.

The slowdown of the Chinese economy—like the slowdown of the world economy—has thus become a topic of focus and increasing concern among economists. The matter is also important given China's particular stage of development—that is, upper-middle income status. China's capacity to tackle the challenges raised by the slowdown will determine whether it avoids or falls into the 'middle-income trap'—an even bigger theme in development economics. Adopting sound policies to navigate through the slowdown requires clear and prescient judgement of the economic situation.

Based on conventional wisdom and analysis, both international and domestic economic advisors to the Chinese Government tend to attribute the slowdown to a cyclical phenomenon caused by demand-side shocks. This idea is comparable with previous macroeconomic events that have occurred since reforms began in 1978, leading to a prescription of loose macroeconomic policies in hopes of stimulating investment. Lin (2011) cites two reasons for supporting this type of policy. First, he links the sharp decline in China's exports to the sluggish growth of the world economy and global trade, and notes that these are both external, demand-side factors. Second, by drawing comparisons between China's present development stage (per capita GDP as a percentage of the US GDP) and other East Asian economies at a similar point in per capita income history, he asserts that the window for achieving catch-up growth remains open to China, as does, therefore, potential for high growth. This relates to the fact that China's present

per capita income—at 20 per cent of the per capita GDP of the United States—is only the equivalent of Japan in 1951, Singapore in 1967, Taiwan in 1975 and South Korea in 1977. For these economies, across the 20-year period after reaching this same share of US GDP per capita, the annual growth rate was 9.2 per cent in Japan, 8.6 per cent in Singapore, 8.3 per cent in Taiwan and 7.6 per cent in Korea. It is believed China, too, will be able to maintain this regional historical growth potential of at least 8 per cent.

This method of drawing development stage comparisons between East Asian economies does, however, overlook the effect of population on economic growth. In China's case, this means 'growing old before getting rich', whereas the other economies got rich before the population aged. Incorporating demographics into this type of comparison of East Asian growth precedents may shift the relative growth potential in the years after China reaches GDP per capita levels that are one-fifth of those of the United States.

Taking the year in which the working-age (15–59 years) population peaks (and falls thereafter) as the reference point,¹ China is not far behind its advanced East Asian counterparts. Specifically, China in 2010 is equivalent to Japan in 1990–95 and on par with Korea in 2010–15 and Singapore's forecast for 2015–20. Adding in the dependent population tails allows for comparison of the population dependency ratio—the ratio of the population aged 14 and under and 60 and over to the working-age population—which is commonly used as a proxy indicator for the demographic dividend. Comparing China's population dependency ratio trend with that of advanced East Asian economies, there are evident turning points from a fall to a rise in those economies—but these came when GDP per capita was much higher than the same dependency ratio levels in China (Figure 3.1). In Japan, the dependency ratio reached a point of inflexion in the early 1970s and did not rise significantly until the 1990s. However, in the case of China, South Korea and Singapore, there is relative synchronicity in the movement of the total population dependency ratio.

In sum, so far we have underscored that relative to China's cross-country per capita GDP level experience, its demographic transition has taken place much more quickly. As a result, China exhausted its demographic dividend much earlier in the development process than did today's high-income East Asian economies. Therefore, in assessing China's growth potential herein, the relatively rapid exhaustion of the demographic dividend—which was an important factor in 30 years of rapid GDP growth—should be taken into account. Accounting for the impact of demographic transition trends on the factors spurring economic growth, Cai and Lu (2013) estimate China's GDP potential growth. The estimated average potential growth rate is 9.66 per cent over the period 1979–94,

1 Data used for the comparison are from UN (2011).

10.34 per cent over 1995–2010, 7.55 per cent over 2011–15 and 6.20 per cent over the period 2016–20. According to their methodology for calculating the growth rate, supply-side factors—such as labour supply, human capital accumulation and total factor productivity (TFP) growth—and not demand-side factors produce this growth slowdown.

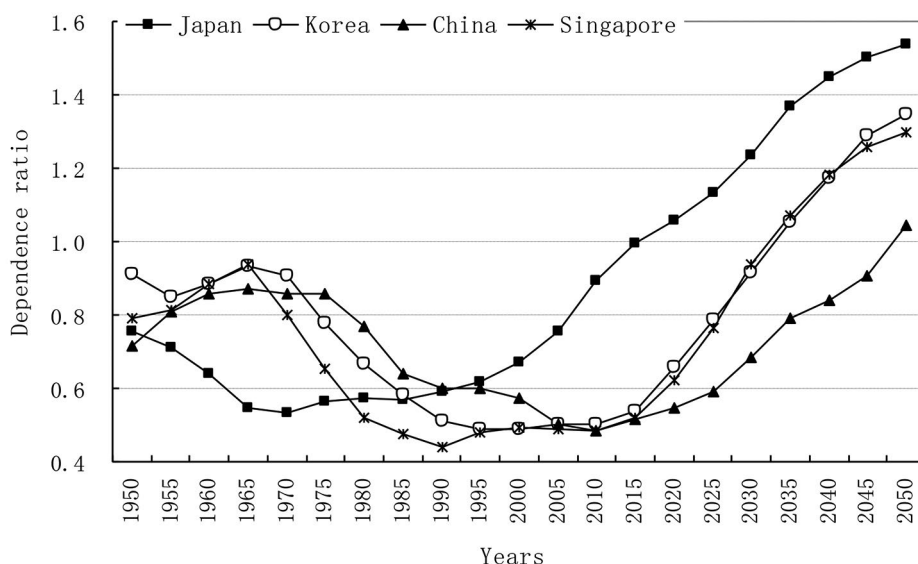


Figure 3.1 Comparison of population dependency ratio changes in selected countries

Source: UN (2011).

Some economists explain the slowdown of the Chinese economy by applying a convergence framework, which builds on the idea that as income levels converge towards high income, the opportunities for catch-up-style rapid growth diminish. Barro (2016), for example, asserts that no country, including China, can forever escape the ‘iron law of convergence’ of a 2 per cent growth rate. He thus predicts an imminent plunge in China’s growth rate, from 6 per cent towards 3–4 per cent. In that case, China is unlikely to meet its official growth target, which is set to enable the country’s per capita GDP to cross the threshold from upper-middle income to a high-income economy in the near future. Pritchett and Summers (2014) also predict that China’s growth rate will revert to the world mean—namely, 5 per cent in the period 2013–23, followed by an average of 3.3 per cent over the decade starting in 2023. Despite some researchers having sought to identify country-specific factors (for example, Eichengreen et al. 2013), most predictions are part of an attempt to reveal a universal slowdown law, and thus generally ignore China-specific factors, including by failing to identify

China's potential to sustain a reasonable level of growth in the near future. Most forecasters, even if unintentionally, tend to offer pessimistic theses and negative bets on China's near-term growth potential.

So far, we have presented China-specific data and research on the supply-side factors that help to contextualise and explain the growth slowdown. In turn, we argue that policymakers in China should not seek a V-shaped rebound akin to expectations of recovery that follow classical business cycle theories. Instead, they should seek to eliminate institutional barriers that deter labour supply and TFP growth and target a growth rate that aligns with China's development stage. Such a rate would decline over time as smoothly and gradually as possible. The level and rate of decline should be sufficient to guarantee an L-shaped growth trajectory such that China completes the transition from upper-middle income to high-income economy status.

One intended structural driver of this type of economic growth is urbanisation and, in particular, reform of the residential registration (*hukou*) system. In 2014, the Chinese Central Government (CPC and the State Council 2014) issued a national plan promoting a new round of urbanisation. As it defined a people-centred urbanisation rather than focusing just on the expansion of urban areas, it was called 'new urbanisation'. The demand-side role that new urbanisation can play in stimulating growth has been studied intensively within China. In *The government work report, 2016*, Premier Li Keqiang (2016) notes that new urbanisation offers the highest potential to drive domestic consumption and growth. Wang and Cai (2015) quantified the potential contribution of consumption and saving shifts that would take place were migrants given full access to local public services and market opportunities in their adopted cities—that is, if migrants were granted full urban *hukou*.

This chapter views this 'new' urbanisation as an important component of supply-side structural reforms. It specifically discusses the potentially significant role that urbanisation, and *hukou* reform especially, can play in enhancing labour force participation and TFP growth, and hence in preserving China's growth momentum.² The next section of this chapter outlines the role that urbanisation and migrant workers have played in China's reform-era growth so far. The third section explores more deeply the dynamic composition and contribution of those migrant workers. Importantly, it draws attention to the impact of China's *hukou* system, which is inhibiting Chinese migrant mobility and security and, in the presence of rising labour supply constraints and rising dependency ratios, is increasingly inhibiting China's economic growth.

2 Unless specifically cited, population figures used in this chapter are the predictions of one of the authors. For details of these predictions, see Guo (2016).

Urbanisation in China's reform-era growth miracle

China's unprecedented growth since reforms began in the late 1970s offers a story of successful Lewis-type dual-economy development. Decomposition of growth sources over this period identifies the distinctive properties of China's growth: an unlimited and therefore guaranteed labour supply, accumulation of human capital, a high savings rate, high return to capital and allocative efficiency of resources via labour mobility (contributing greatly to TFP increases) (Cai and Zhao 2012). Because these sources of growth arise from a favourable stage of demographic transition, they are recognised as forming a demographic dividend. Less well recognised is the fact that this demographic dividend-supported growth was accompanied by an equally transformative process of urbanisation. In 1978, China's urbanisation rate was 17.9 per cent. This had increased to 54.8 per cent by 2014, meaning an annual increase of 3.2 per cent. This reflects the largest peacetime population movement in human history (Roberts et al. 2004).

This transfer of labour from the agricultural sector and rural areas to non-agricultural sectors and urban areas in China also underwrote the world's fastest sustained period of economic growth in the past three decades. To understand China's urbanisation experience, one has to understand the millions of migrant workers and the institutional settings in which they conduct their lives. In what follows, we more closely examine China's recent urbanisation and labour migration from the perspective of their capacity to drive economic growth.

Contribution to labour supply

Urbanisation driven by labour migration in China has, first, helped the country meet the strong demand for labour across the urban sectors. The unlimited flow of labour has been embodied in the outflows of surplus agricultural labour on one hand and inflows of migrant workers to urban sectors via urbanisation on the other. Given that the population ages at a faster rate in urban areas than in rural areas (which have a higher total fertility rate) and that the urban sector expands more quickly than the agricultural sector and rural economy in general, labour migration from rural to urban areas is inevitably related to economic opportunity.

In fact, in parallel with a peak in the working-age population, the number of urban workers with local *hukou* peaked in 2010, and has been declining since. In turn, any observable increase in total urban employment comes from the

contribution of continual rural-to-urban migration. Utilising a variety of statistical sources and by making some necessary assumptions,³ we summarise the composition of urban employment over the period 2001–14 in Table 3.1.

Table 3.1 Composition of urban employment (million)

	Covered by official statistics				Not covered
	Urban <i>hukou</i> (1)	Migrants (2)	Total (3)	Annual change (4)	Migrants (5)
2001	232.33	7.07	239.40	-	76.92
2002	239.04	8.76	247.80	8.40	95.94
2003	245.53	10.86	256.39	8.59	103.04
2004	251.33	13.43	264.76	8.37	104.80
2005	256.71	16.60	273.31	8.55	109.18
2006	274.74	21.56	296.30	22.99	110.56
2007	282.56	26.97	309.53	13.23	110.00
2008	287.53	33.50	321.03	11.50	106.91
2009	291.57	41.65	333.22	12.19	103.68
2010	294.94	51.93	346.87	13.65	101.07
2011	294.74	64.40	359.14	12.27	94.23
2012	291.34	79.68	371.02	11.88	83.68
2013	284.04	98.36	382.40	11.38	67.74
2014	271.99	121.11	393.10	10.70	47.10

Source: Cai (2016).

The data in Table 3.1 identify trends that may clarify some common points of confusion about China's urban employment figures. While Column 1 shows the decline in the number of employed *hukou*-holding urban residents from 2011, the number of migrant workers included in urban employment statistics increased (Column 2). The resulting change in total urban employment, shown as the percentage difference between Columns 2 and 3, increased from 3 per cent in 2001 to 30.8 per cent in 2014. The absolute contribution made by migrant workers to the urban worker pool that has in turn sustained the absolute expansion of total urban employment (Column 3) accounts for annual growth of urban employment in the range of several million to more than 10 million workers (Column 4). Column 5 presents the difference between the total number of migrant workers and those who are statistically included, suggesting there

3 For details, please see the explanation on Table 3.2 in Cai (2016).

remains a large though declining share of migrant workers outside official urban employment statistics, which continue to understate the migrant contribution to urban employment.

A scrupulous person may, however, identify a statistical trick in the urban employment numbers—that is, the inclusion of a higher share of migrant workers in the official statistical pool that drives recent numerical increases in urban employment. Otherwise, the current natural growth of the economically active population (3.8 million in 2014) could not support the expansion of urban employment. This does not necessarily imply that official statistics are evidence of data fraud. In reality, in recent years, as more and more migrant workers have signed employment contracts that increase their job security and participation rate in social insurance programs, they are more likely to be viewed as formal employees by their employers and be reported as such to statistical authorities. Such a change in statistical categorisation implies two things. One, as a result of strengthening labour market regulations, the formality of migrant workers' employment in urban sectors has increased. Two, since some of the increased number of urban workers are not really 'new entrants', but are reclassified migrant workers, the increase in urban employment reflected in the statistics does not indicate high growth prospects.

Preventing diminishing return to capital

Urbanisation has helped sustain China's high savings rate and therefore high return to capital (for example, Bai et al. 2006), making an overwhelming contribution to high-speed growth (Cai and Zhao 2012). Compared with rural workers who remain in rural areas and local urban workers, rural–urban migrant workers are, on average, significantly younger—for two reasons. First, the general experience of labour migration indicates that migrant workers are more advantaged in human capital endowment and other demographic features when compared with workers who remain in rural areas. Second, because China's demographic transition towards an ageing population has taken place earlier in urban than in rural areas, urban residents holding local *hukou* are significantly older than newly arriving rural–urban migrant workers. Attracted by the more productive and more developed urban sector (which has a higher per capita income), rural–urban migrants have helped to shape a more productive population structure by lowering the urban dependency ratio and helping to maintain a higher savings rate for the economy as a whole.

Using data from China's sixth national census, conducted in 2010, we compute and then compare the age structure difference between urban residents with local *hukou* and migrants without urban *hukou* (Figure 3.2). The data show that while the native urban population has aged rapidly, migrant arrivals have

helped to mitigate the scale of urban ageing. Our calculations suggest that the native population produces a dependency ratio of 0.43, and migrants have a dependency ratio of 0.18. Bringing these figures together, current migration can reduce the urban dependency ratio to 0.35.

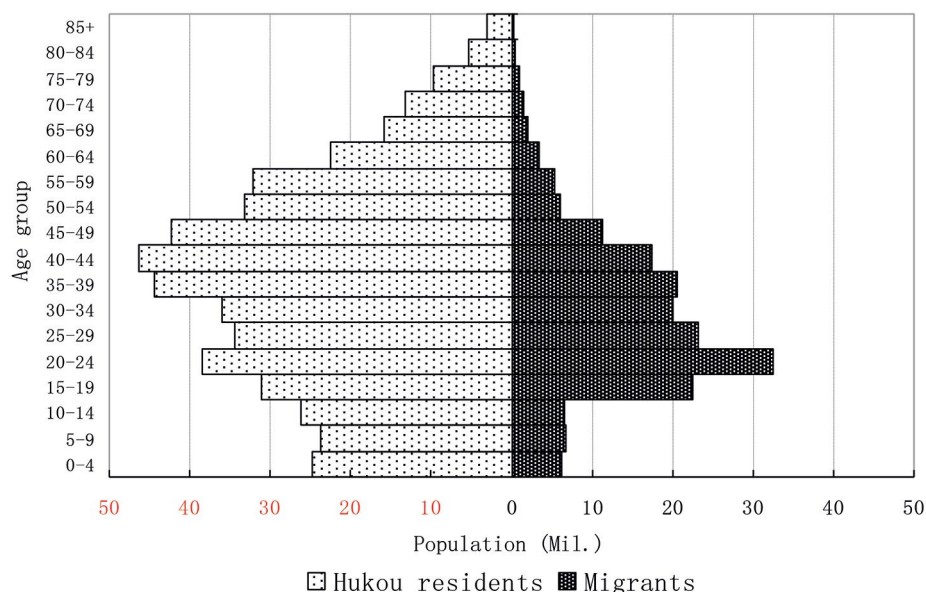


Figure 3.2 Age structures of *hukou* residents and migrants in urban areas, 2010

Source: NBS (2011).

Massive internal labour migration has helped the Chinese economy enjoy an unlimited supply of labour during most of the reform period, until the ‘Lewis turning point’ arrived in the early 2000s (Cai 2016: 3), preventing the phenomenon of diminishing return to capital of neoclassical growth theories and commonly seen in developed economies. In turn, studies have shown that throughout the reform period, Chinese growth produced a high return to capital (Bai et al. 2006) and that, as a result, physical capital accumulation made an overwhelming contribution to economic growth (Cai and Zhao 2012).

Improving the human capital of the urban workforce

In general in China, the contribution of migrant workers to enhancing levels of human capital in the urban labour force has been neglected. This relates to the common observation that migrant workers are, on average, less educated than the native residents and generally are able to assume only unskilled work. On average, it is statistically evident that, in China, migrant workers do indeed have fewer years of schooling than their urban counterparts. According to the

China Urban Labour Survey (CULS)⁴ data, the average years of schooling for a migrant worker were 9.5 compared with 12.1 for local urban workers. The difference of 2.6 years is statistically significant.

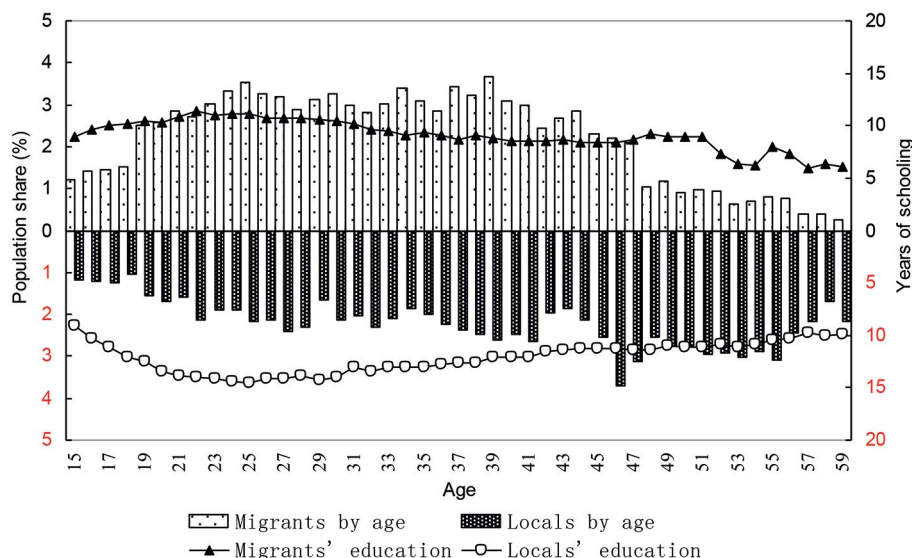


Figure 3.3 Population and education by age: Migrant and urban local workers

Source: Based on authors' calculations using CULS data.

Taking into account the different age distribution structures of the two groups of workers provides an alternative conclusion as to the contribution of migrant workers to the human capital of the urban workforce. For example, within the CULS study, the median age of the sample is 33 for migrant workers and 40 for local urban workers. Figure 3.3 shows the two groups' age distribution and years of schooling by age. Divided around a base point of zero, the upper part of the figure presents information on migrant workers and the lower half offers local urban worker information. As migrant workers are relatively young—and since younger groups in China have generally attained more years of schooling than older workers—migrant workers are displacing older urban workers with a level of education lower than the arriving migrants. This in turn serves to improve the overall human capital of the urban workforce, even though young migrant workers are less educated than young urban native workers. For example, if a migrant worker aged 21–25 years, who has, on average, attained 13.3 years of

4 The China Urban Labour Survey (CULS) was conducted in Shanghai, Wuhan, Shenyang, Fuzhou, Xi'an and Guangzhou by the Institute of Population and Labour Economics at the Chinese Academy of Social Sciences in 2010. In each city, a proportional population sampling approach was used to select 700 households of urban residents and 600 households of migrants in a two-stage procedure. In our analysis, only observations of migrants without urban *hukou* were included.

schooling, takes a vacancy created by a retiring local urban worker aged 55–59 years with average attained schooling of 10.1 years, the net human capital gain to the urban working population can be substantial.

Reallocative efficiency of resources

According to Kuznets (1957), the central purpose of sectoral reallocation is to move resources from low-productivity sectors to high-productivity sectors, and therefore to increase allocative efficiency. In the context of this chapter, the transfer of surplus labour from lower productivity agriculture to more productive employment in non-agricultural sectors, in general, reflects a Kuznets progress that improves productivity (see Aoki 2012). This type of reallocation of labour up the productivity ladder underlies the recent relatively good performance of productivity in Asia (McMillan and Rodrik 2011), and specifically forms an important part of China's reform-era labour productivity growth (Bosworth and Collins 2008). It thus contributes significantly to the story of China's growth over the period (Du 2014).

To understand the allocative efficiency of labour in China, one first must understand the allocation of labour among sectors. There have been questions about National Bureau of Statistics (NBS) data on agricultural employment. Thanks to Du and Wang (2010), there is reason to believe that the official statistics overstate the share of the workforce that is in agriculture. They modify the definition of an agricultural labourer from the yearly base to a monthly base and the result of the recalculation is that the estimated share of rural labour in 2009 decreases by 13.4 per cent. Thereafter, Cai (2016) constructed an agricultural labour force data series spanning the period 1978–2014 (Figure 3.4). This shows that, by 2014, the actual share of agricultural labour was at least 10 percentage points lower than what the NBS had reported.⁵ In Figure 3.4, we treat the difference between the estimated and officially reported numbers of agricultural labourers as a 'residual'. In reality, such a residual of labourers is likely to divide itself between serving to enlarge the secondary and tertiary sector labour pools or returning to the agricultural sector when macroeconomic shocks hit the job market in urban areas. As a result of rapidly enhanced mechanisation and rising labour productivity in agriculture, however, the primary sector serves less and less as a pool for absorbing surplus labour. It is thus more likely that residual labourers are absorbed into the secondary and tertiary sector labour pools.

⁵ This estimate is almost identical to the results of similar work using a different data source by Brandt and Zhu (2010).

To summarise, this section has provided an overview of the mechanics of and selective issues in the transfer of labour over 30 years in China. That transfer—from low-productivity regions and sectors to higher productivity sectors and regions—was complemented by relative high population growth in rural areas and the fact that the young across China are, on average, better educated than the old. Thus, although young rural workers are, on average, less educated than urban workers, rural–urban migrants tend to be young and often replace older, less-educated urban workers. This also helps to lower the dependency ratio in China's higher productivity urban areas, and so is a more efficient allocation of labour resources. Advancing modernisation of the agricultural sector also increases the push factor of rural labour into the urban sector, where it has proven easier to find industrial and service sector jobs during periods of negative employment market shocks.

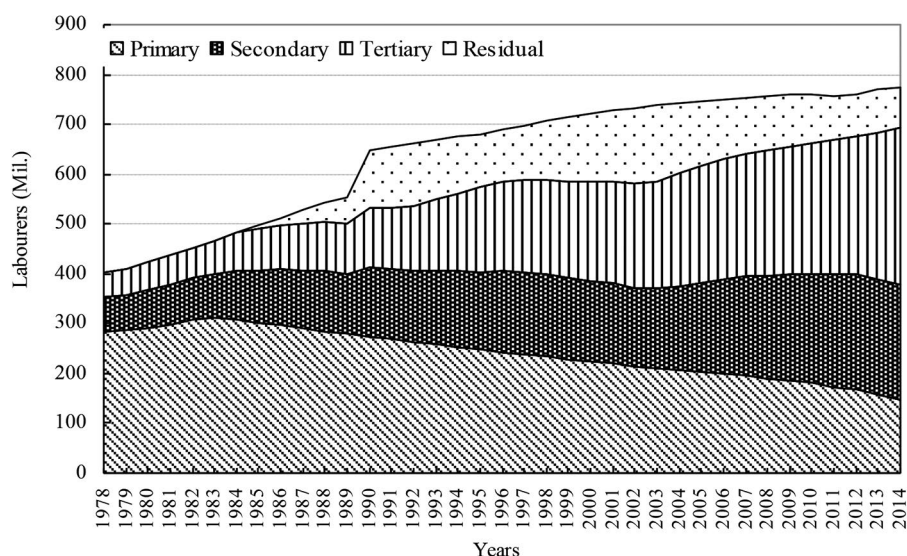


Figure 3.4 Estimates of actual labourers by sector

Source: Authors' estimations based on NBS (various years [a]) and Du and Wang (2010). For technical details, see Cai (2016).

Decomposing urbanisation's migrant foundations

Urbanisation—as the relative expansion of the share of urban population against the non-urban population—has two sources of growth: natural population growth (of the native population) and mechanical growth (of migrants). As China's urban areas are characterised by low birth rates relative to rural

areas, the urbanisation process is in turn heavily dependent on rural–urban migration. The scale of this migration is a unique feature of China’s demographic and economic transitions, and is embodied by a tide of migrant workers pushing forward the boundaries of urban residence.

The official definition of ‘resident urban population’ refers to those who live in cities for at least six months and migrant workers who have left their home township for at least six months. Since 96 per cent of migrant workers enter various tiered Chinese cities, they are statistically counted among (de facto) the urban resident population, though they are not de jure urban residents as they do not hold the associated local and urban residential permit, known as a *hukou*. By comparing official urbanisation data with migrant worker survey data, we can roughly sketch the contribution of the growth in numbers of migrant workers to total urban resident numbers.

According to data published by the NBS (various years [a], [b]), in 2014, there were 749 million de facto urban residents, including 168 million migrant workers and 581 million residents holding an urban *hukou*. This produces an official urban residency rate of 54.8 per cent. Among these urban residents, *hukou*-holders contributed 42.5 percentage points to the urbanisation rate and migrant workers contributed 12.3 percentage points. That is, between 2004 and 2014, migrant workers made up 24.2 per cent of the increase in the de facto urban population.

In what follows, we provide a further breakdown of the constituent components of the urban resident population. We focus on the migrant workers’ contribution to urban population expansion by analysing the composition of China’s total urban population. As a result of data limitations, we focus on incremental population decomposition of urban residents in 2010, the last year for which census data are available.

We first break down increases in the urban population—namely, of de facto urban residents. This reveals that a process of mechanical increase led the rise in this type of urban residence. According to NBS data, the resident urban population increased by 24.7 million, of which the net natural increase was 3.9 million people—18.2 per cent of the total. The net mechanical increase, however, was 20.8 million, accounting for 84.2 per cent of the total.

Second, we decompose the mechanical increase of the urban population into non-*hukou* migration (mainly migrant workers whose *hukou* stays with their hometown) and *hukou* migration (where the *hukou* changes from rural to urban status). There are two scenarios for those who have changed their *hukou* status.

First, some residents changed their *hukou* status from rural to urban but did not change their residence geographically. Second, some people migrated from rural to urban areas and their *hukou* status change reflects this move.

From Ma et al. (2014), we find the relative distribution of migrant movement between places—rural-to-rural, urban-to-urban, urban-to-rural and rural-to-urban—within the total increase of non-*hukou* migrants. We then estimated there were 127.6 million non-*hukou* rural–urban migrants in 2009 and 133.9 million in 2010. The difference between the two numbers comprises an increase in non-*hukou* rural–urban migrants of 6.3 million people. In other words, non-*hukou* rural–urban migrants, the majority of whom are migrant workers and their accompanying family members, contributed to one-quarter of urban resident growth in 2010.

Third, we decompose rural–urban migrants who changed their *hukou* status. These migrants were the difference between the total mechanical increase in urban residents and the increase in non-*hukou* rural–urban migrants. They numbered 14.5 million and contributed 58.6 per cent to urbanisation in 2010. Based on population sampling data of one per 1,000 people in 2014 (Guo 2016), we extrapolated that in 2010 there were 1.23 million cross-regional migrants who changed their *hukou* and 13.2 million ‘in situ migrants’ who changed their *hukou*. ‘In situ migration’ with changed *hukou* refers to the phenomenon in urbanisation in which an outer suburban resident is granted an urban *hukou* even though the location of their residence has not changed. This typically happens when there is an alteration of the administrative division or rezoning.

Finally, we can additionally categorise the 7.53 million rural–urban (cross-regional) migrants into two groups: those with a *hukou* change and those without a *hukou* change. The estimation from the most recent census data shows that in 2010 there were 1.23 million migrants whose *hukou* changed, 16.3 per cent of the total, and 6.3 million whose *hukou* did not change, or 83.7 per cent.

Building on the estimation results presented in Table 3.2, we now summarise the findings. First, mechanical population growth is the dominant driver of urbanisation as measured by residency changes. Second, non-*hukou* migrants, who are mainly migrant workers, make up one-quarter of urbanisation-related residence shifts. Three, in situ migration, which is a change to *hukou* status by virtue of an administrative change, has also made a significant contribution to urbanisation, although typically it does not involve a job or a residence change for those ‘migrants’. Fourth, the existing *hukou* system still functions as an institutional obstacle by restraining individual migration behaviour and the broader migration process. Migrants with both *hukou* status and geographic

change, who apparently are not officially defined as migrant workers, account for only a small fraction of rural–urban migrants. This makes the present urbanisation pattern in China an atypical one.

Table 3.2 Composition of incremental urban population, 2010

Total: 24.66 m. (100%)	Natural growth: 3.9 m. (15.8%)			
	Mechanical growth: 20.76 m. (84.2%)	Non- <i>hukou</i> migrants: 6.3 m. (25.5%)		Cross-regional migrants: 7.53 m. (30.5%)
		<i>Hukou</i> migrants: 14.46 m. (58.6%)	Cross-regional migrants with <i>hukou</i> change: 1.23 m. (5.0%)	
			In situ migrants with <i>hukou</i> status change: 13.23 m. (53.6%)	

Source: Authors' estimations.

The characteristics of China’s urbanisation process outlined in Table 3.2 are broadly attributable to China’s *hukou* system, which is a legacy of the planned economy. On the surface, the impact of the *hukou* system is to divide Chinese residents into rural and urban groups, as well as into provincial and subregional identities. Closer examination of *hukou*-related residence dynamics, however, suggests that the *hukou* system also segments urbanisation itself as well as urban residents into unusual policy treatment groups, as outlined herein. This means urban residents have unequal access to jobs, job security, social security and other public services such as education. Ultimately, this impedes the Kuznets process, as characterised by labour migration. In other words, it impedes the very process of reallocation of resources that underpins structural change, which in turn supports economic growth.

New urbanisation as a reform dividend

Judging by both population trends and existing patterns within urbanisation, China’s urbanisation rate will slow in future years. *The national plan on new urbanisation (2014–2020)* (CPC and State Council 2014) predicts that the residential urbanisation rate will be about 60 per cent in 2020. Combining this projection with population predictions, it is possible to simulate China’s urbanisation scenario up to 2030 (Table 3.3).

Given trends in the movement of migrant workers around China, the assumption of an annual increment of several million—or even over 10 million—rural–urban migrants is unrealistic. Therefore urbanisation targets based on these forecasts are likely to end up being aborted.

Table 3.3 Simulated prediction of residential urbanisation (million, percentage)

	Total population	Urban population	Urbanisation rate	Rural–urban migrants
2015	1,375	766	55.7	11.97
2016	1,382	782	56.6	11.25
2017	1,392	800	57.5	10.86
2018	1,400	817	58.3	10.78
2019	1,407	833	59.2	10.60
2020	1,413	848	60.0	10.29
2021	1,417	862	60.8	10.11
2022	1,421	875	61.6	9.80
2023	1,424	888	62.3	9.93
2024	1,427	900	63.1	9.43
2025	1,429	911	63.8	9.23
2026	1,431	922	64.5	8.94
2027	1,432	932	65.1	8.85
2028	1,432	942	65.8	8.33
2029	1,432	951	66.4	8.03
2030	1,431	959	67.0	7.64

Source: Authors' estimations.

Moreover, the characteristics of migrant workers themselves are also subject to change. In Chinese official documents, migrant workers are often called 'transferred agricultural labourers'; however, few contemporary migrants are transferring from agricultural production. Agricultural labourers are these days more likely to fall into a disadvantaged demographic category, and are less likely to enjoy the same opportunities as the average migrant workers, who, in contrast, are mostly junior and senior high school graduates from China's rural areas, aged between 16 and 19 years old. This population group, whether defined by residential location or *hukou* registration, peaked in 2014, and began to shrink in 2015. In Figure 3.5, we plot this demographic change by residential classification, which confirms the dramatic drop after 2014. Similarly, the growth in numbers of migrant workers will lose momentum—a transition that is also evident in Figure 3.5. According to NBS data, the annual growth rate of numbers of migrant workers declined from 4 per cent over the period 2005–10

to 3.7 per cent in 2011, 3 per cent in 2012, 1.7 per cent in 2013, 1.3 per cent in 2014 and 0.4 per cent in 2015. Such a trend will not only retard the momentum of urbanisation, but also further lower the potential growth rate.

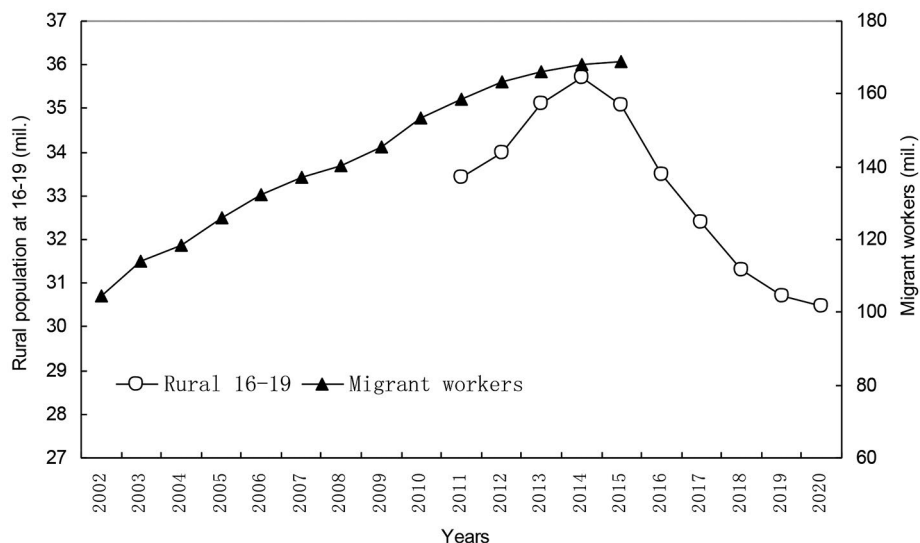


Figure 3.5 Changing trends of youth and outbound migrant workers in rural areas

Source: Authors' calculations based on NBS (2015[b]) and population predictions.

Constrained by the *hukou* system, the present flow of rural labourers to urban areas in China is not a one-way permanent migration but instead an iterative pattern of movement between two areas. The declining number of (younger) migrants means that soon the increasing number of (older) returning migrants will outnumber city-bound migrants. This inevitably will result in further labour shortages in urban sectors. The specific consequences could include: 1) more rapid convergence of China's manufacturing unit labour costs towards their counterparts in developed countries owing to wage increase pressures surpassing positive change in labour productivity; 2) slower human capital accumulation as a result of there being fewer new and relatively educated entrants to the labour market to replace the older, less educated workers leaving the labour market; 3) further diminished return to capital as the labour supply becomes more limited; and 4) a reverted Kuznets process that will suppress TFP growth.

Du (2014) reports that as China's urbanisation rate slowed, the contribution of labour reallocation to economic growth also decreased—from 27.2 per cent in 2001–03 to 9.1 per cent in 2010–12. For policymakers, the important line of inquiry is whether and how China's urbanisation rate will find its momentum

again and, in so doing, continue to support China's now moderately high growth rate. An alternative question is how China can engineer a higher rate of mechanical growth in urbanisation. Before answering that question, let us examine the conditions needed for the Chinese economy to sustain long-term growth, and how those conditions might be created.

Here we have presented the case that the ongoing slowdown of the Chinese economy reflects a decreasing potential growth rate that is itself a product of supply-side factors. Among these, the disappearance of the demographic dividend is important. In turn, all reforms that can eliminate institutional obstacles to labour supply and TFP growth are urgently needed. China's working-age population peaked in 2010. The economically active population is expected to peak in 2017. That turning point has several implications. One, as the momentum of quantitative growth of labour attenuates, the sectoral and regional reallocation of labour—for example, increasing non-agricultural labour force participation—is the only way to maintain labour supply. Two, given the present patterns of urbanisation are no longer sustainable, *hukou* reform that grants migrant workers and their family members legitimate local residency, including equal access to public services, will spur a more stable, socially insured and inclusive form of urbanisation. Three, any structural reforms that increase the labour supply will also improve reallocative efficiency (TFP). The three points all suggest that transforming migrant workers from guest workers to full local citizens via implementation of *hukou* reform and new urbanisation may help to generate a new type of reform dividend that can, in turn, instigate increased growth.

In addition to human capital accumulation, a fertility rate rebound and other potential reform dividends, Cai and Lu (2013) especially identify the labour force participation rate and TFP as key drivers to substantially raise the potential growth rate in China. Their simulation, based on a production function model, provides two scenarios in terms of prospective reform dividends across the period 2011–20. First, an annual increase of 1 percentage point in the non-agricultural labour force participation rate could add a 0.88 percentage point to the potential annual growth rate. Second, a 1 percentage point increase in the average growth rate of TFP per annum could lift the growth rate by 0.99 percentage points.

Conclusion and policy recommendations

China's rapid urbanisation has contributed to unprecedented economic growth during the reform period. The failure to grant rural–urban migrants permanent urban residency has, however, left this important transformative group of workers in a vulnerable limbo with respect to access to public services.

It has also undermined the stable flow of labour into urban sector vacancies. Therefore, while the population growth-driven demographic dividend may be beyond its contemporary peak, in the ongoing absence of *hukou* reform, the demographic dividend and the role played by urbanisation retain uncaptured efficiency gains. As China's demographic transition deepens in the direction of ageing, urbanisation will inevitably slow, and possibly even stagnate, and thus no longer support economic growth as it did before.

With appropriate policy adjustments, however, China is positioned to make more of its demographic potential. Earlier, we outlined how urbanisation can be driven by population growth and also by structural policy approaches. Acceleration of the transformation of migrant workers into full and equal urban residents will in turn help to capture the benefits of this next phase of urbanisation in China, and thus become the next driver of economic growth.

Reform of the *hukou* system has long been a topic in academia, and there is now wide consensus that it should be at the top of the reform agenda among policymakers. Why, then, has the reform process so far made little progress? In what follows, we try to explore the reasons for the slow pace of reform, which we believe have implications for other areas of reform.

First, the dividend attached to such reforms has not been truly recognised. Central and local governments are immediately concerned about growth rates. Demand-side stimulus policies are considered to offer a tangible means of generating quick returns, whereas supply-side measures—say, structural reforms—often take longer to prove effective and that effectiveness is also difficult to link to particular policy action. In this context, Chinese governments, central and local, tend to encourage urbanisation's economic growth dividend in relatively selective and traceable ways. One, boosting urbanisation by stimulating investment offers more tangible incentives to local governments. Such motives, however, may tempt governments to overorientate their stimulus policies towards the demand side. Two, urbanisation policies that directly affect the incubation of local middle-income groups and also the expansion of domestic consumption motivate governments to push forward with reforms. Some vested interest groups may even resist *hukou* reform, preferring instead to enjoy a more exclusive urban environment. Three, the benefits of enhancing labour force participation and TFP via *hukou* reform are simply not understood or fully appreciated.

Second, respective responsibilities for different levels of government in any *hukou* reform process have not been clearly defined. This leads to problems, such as agreeing how to share costs and benefits. The Central Government has begun open discussions about the issue of splitting the costs of *hukou* reform. In *The national plan on new urbanisation (2014–2020)*, for example,

one chapter outlines the division of administrative rights and corresponding fiscal expenditure responsibilities, and also how various levels of government should be responsible for providing public services, especially in the case of areas where relatively high numbers of migrant workers have settled as residents (CPC and the State Council 2014). Unfortunately, the statement remains general, even vague, and has not explicitly allotted the potential costs and benefits among central, provincial and municipal governments in accordance with their expenditure responsibilities. Moreover, it gives no explicit indications as to the relevant participants in the reform, and therefore means local governments lack the necessary incentives and have even been denied their institutional ability to implement *hukou* reform.

Third, these misunderstandings and incomplete directives serve to encourage local governments to revise their own more local decisions about where to draw tangible and intangible urban boundaries. For example, China's larger cities, which are the main destination for labour migration, typically provide better basic public services, which means the costs of *hukou* reform for these governments would be heavier. In addition, these costs are borne at the municipal government level, but such governments cannot enjoy all the benefits delivered by the entry of migrant workers. They therefore lack the incentive to permanently settle migrant families as local citizens with equal rights. All the while, the Central Government has formulated several urbanisation principles, such as placing strict restrictions on the expansion of municipalities with a population size of more than five million people and on any large city increasing in size; it is also encouraging the development of medium-sized and small cities. On that basis, local governments are expected to direct urbanisation by strengthening *hukou* restrictions in large cities, while relaxing *hukou* settlement only in small cities.

To accelerate China's next phase of urbanisation, the Thirteenth FYP calls for a raising of the *hukou*-holding rate in urban areas—that is, increasing the proportion of the long-term resident population holding a local *hukou*. If the incentive mechanisms do not change, however, local governments may attempt to meet this policy directive simply through in situ migration, which is the result of a geographic boundary redrawing, rather than physical migration. In situ migration is the opposite of the intention of new urbanisation as an ongoing driver of economic growth.

In general, economic history points to high urbanisation levels being an outcome of development and thus indicative of modernisation. For countries in the transition from middle-income to high-income status, urbanisation is a useful way of sustaining economic growth and dynamism. For China in particular, the proposed new urbanisation is expected to deliver a return to several areas of structural reform that aim to correct institutional distortions

in resource allocation. But, like any process of reform, this new urbanisation requires design and input at the highest levels, which would solve all three problems mentioned above, and therefore unlock the related growth dividend.

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