

Can Rural Income Growth Accelerate?

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Since the beginning of rural economic reforms in the late 1970s, rural incomes and living standards in China have improved dramatically, most notably during the early 1980s when productivity increased rapidly following the return to family farming. Real rural per capita incomes were nearly six times higher in 2000 than in 1978 (fig. N-1). However, income growth began from a very low base, and was uneven over time. Urban incomes grew even faster over the reform period, and China now has one of the largest urban-rural income disparities on record anywhere. According to China's official statistics, rural incomes in 2000 were only 36 percent of urban incomes on average, compared with 77 percent in the United States. The growing urban-rural gap is partly attributable to policies historically biased in favor of urban areas, such as extractive rural procurement and taxation policies, biased investments, and a strict resident permit system that clearly divided urban and rural populations. The gap also is the result of rapid industrial growth in urban areas and restrictions on labor mobility

that have prevented rural workers from benefiting fully from that growth.

As China enters the new century, there is growing concern about whether the country can maintain momentum in increasing rural productivity and incomes. These concerns are punctuated by slow rural income growth in the late 1990s, the recent decline in employment in rural industry, and concerns that China's entry into the World Trade Organization (WTO) will weaken the country's agriculture. The recent relative stagnation of rural incomes in comparison with urban incomes highlights the importance of taking active steps to stimulate rural income growth. If effective, such steps will affect not only the welfare of millions of Chinese citizens but also the structure and competitiveness of the country's agriculture and trade.

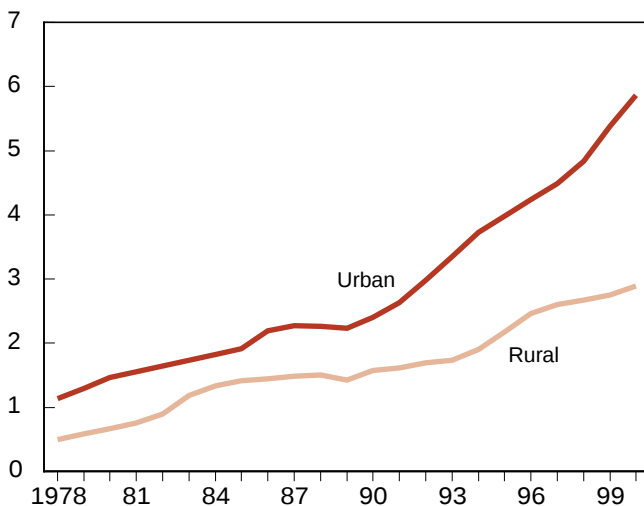
Supporting Structural Change

As a developing country, China is in the midst of rapid structural transformation, a process that will likely accelerate with WTO entry. Although two-thirds of China's population still live in rural villages and agriculture still accounts for the majority of rural income, the country continues to rapidly urbanize and the share of labor and output accounted for by agriculture continues to fall steadily. Increases in productivity per rural worker and growth in per capita incomes will require *accelerating* this process of transferring agricultural labor to nonagricultural jobs, as well as making appropriate complementary investments to raise labor productivity in agriculture (see "Agricultural Labor: Where Are the Jobs?" in this report).

China will be challenged to generate new jobs to draw labor out of agriculture. Employment in rural enterprises has fallen in recent years, reflecting the difficulties such enterprises have faced due to intense competition, slower overall growth, and poor credit access. Many cities have severe unemployment problems associated with painful enterprise restructuring that may limit their ability to absorb rural labor.

Figure N-1
Urban and rural real per capita income, 1978-2000

Yuan (1,000)



Note: Deflated and converted to 2000 RMB yuan using China's Consumer Price Index.

Source: *China Statistical Yearbook* and *China Rural Household Survey Yearbook 2000*.

Foreign competition after China's WTO accession may put further pressure on enterprises to minimize labor costs to remain competitive, dampening employment growth. On the positive side, in recent years China's small private sector has been the largest generator of new jobs in urban areas, and this labor-intensive sector stands to benefit from more open trade. Thus, policies that support private enterprises and promote more open labor markets could help create more jobs for rural surplus farm labor. On the supply side, reforms of the land-tenure and grain-quota systems that now tie rural people to the land could significantly increase the mobility of rural labor (see "Does China's Land-Tenure System Discourage Structural Adjustment?" in this report).

Modernizing Agriculture

Another aspect of raising rural labor productivity is modernizing agriculture, transforming it from traditional semi-subsistence household production to larger scale, more commercialized and specialized production, especially in export-competitive sectors, such as the production of horticultural products, fruit, and livestock. The government should encourage policies that increase the ratio of land and capital per worker and allow farmers to realize economies of scale (e.g., consolidate small plots, promote mechanization). Rural financial institutions must provide financing for necessary capital purchases, which could be facilitated by land reforms that allow farmers to collateralize land ownership or use rights.

The most direct way to increase agricultural productivity is through investments in agricultural research, for which most agree there are high potential returns. China's agricultural research system has provided important breakthroughs but needs increased funding. Higher yields will also help China meet its food security goals in an era of more open trade. During the reform period, agricultural productivity growth has had the broadest impact on raising rural incomes and alleviating poverty. Another key aspect of raising rural productivity is increasing investments in rural infrastructure, which still accounts for a very low share of government expenditures (see "How Might China Protect Its Agricultural Sector?" in this report). Part of the necessary infrastructure investments are those that make land use more sustainable over time, especially in China's interior regions. The Western Development initiative may help reverse the urban bias in rural investment.

Developing agricultural processing and vertical coordination in the supply chain could play a role in promoting capital investment and technology transfer in rural China. Contract arrangements with processors can help farmers obtain loans, modern inputs, and technical assistance. New investment and trade opportunities after China's WTO accession could help support such vertical linkages. China's government structure must be adjusted to coordinate vertically linked production activities that involve both agriculture and industry.

Educational Access and Quality Uneven

In a world of increasing globalization and technological sophistication, investments in human capital become increasingly important, especially when workers, whether in agriculture, industry, or services, switch jobs frequently in response to changes in economic structure or in the international trading environment. In China, the returns to education have continued to rise over time, especially in the nonagricultural sector, and this will continue as the labor market becomes more developed. Primary education has become nearly universal in China's rural areas and China's Education Ministry is committed to raising school effectiveness and to achieving universal minimums of 9 years of education for the population. However, institutional inertia is strong, and budget shortages, fiscal decentralization, and rising regional income inequalities have led to growing inequities in educational access and school quality, leaving the poor and minority populations particularly vulnerable.

Limited Access to Capital

Although China's financial system has become more commercially oriented in recent years, rural financial institutions are still hampered by restrictions on interest rates, lending, and borrowing that constrain their institutions' ability to provide ready credit access to rural enterprises and farmers. Studies have documented how financial reforms in the mid-1990s made borrowing more difficult for both enterprises and households. Credit is important for facilitating the purchase of necessary capital to start new ventures or expand existing businesses, and thus is critical for realizing rapid structural adjustment in response to shifting comparative advantage. Rural finance supports more capital-intensive agricultural production and rural enterprise growth, both essential aspects of raising rural labor productivity. Interest rate liberalization would likely increase available funds for rural households, although at a higher price,

What We Need to Know

How will migration and urbanization affect the agricultural sector?

What are the payoffs to rural infrastructure investments?

How can village governance be reformed to maintain stability in the countryside?

How flexibly can China's rural economic structure adapt to new market opportunities and competition in a world of more open trade?

and would provide higher returns to savings, which are another key source of finance for new projects. Improving bank governance and management in rural financial institutions also should be a priority to increase available funds by reducing nonperforming loans. Innovative microfinance programs are expanding loan access to some of the rural poor, but only on a very small scale. Foreign bank entry following China's WTO accession is unlikely to lead quickly to direct foreign bank lending to rural households, but greater financial competition should benefit private, labor-intensive enterprises and reduce the share of state bank lending to state-owned enterprises, potentially freeing up funds for rural lending.

Urbanization Will Increase

China's degree of urbanization is lower than would be expected given its level of economic development, probably as a result of strict controls on population movement. Cities are important for realizing the advantages of agglomeration, such as economies of scale, concentrated markets, and greater specialization in production. Because earlier policies restricted rural-urban migration and supported inefficient, relatively capital-intensive enterprises in cities, much of China's industrial employment growth was in rural enterprises. However, in the future more rural labor is likely to migrate to cities, and China will need to find ways to accommodate more urban migrants. Chinese authorities project a 50-percent urban share of population within the first two decades of the 21st century. To facilitate this process, the Chinese government seeks to channel the rural-urban migration stream into small towns and small cities. The government has promised investments in such towns and cities and recently announced the relaxation of its strict resident permit (*hukou*) system in such areas. However, distance from markets, lack of technology,

low skills, and poor infrastructure will pose significant challenges in creating jobs in new small towns in central and western regions. China will need to allow population to move freely in response to incentives rather than fully plan the urbanization process.

Taxation and Governance

Excessive taxation of farmers through ad hoc fee and tax assessments remains a significant problem in many rural areas, occasionally leading to farmer protests. To adequately meet local development needs, local leaders need discretionary authority to tax and spend, especially when fiscal authority and responsibility have been decentralized. But discretion is easily abused without accountability, and governments in poor areas with few revenue sources have little recourse but to tax farmers to pay wages. For this reason, reform of rural local government institutions and public finance has become one of the most pressing issues in China's rural development. Upper levels of government must take measures to ensure adequate budgetary resources for poorer regions. Whether through village elections or through other forms of participatory decision-making, reform efforts to incorporate local voices into government decisions deserve high priority.

Further Reading

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