



ECFIN *Economic Brief*

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Reform of the hukou system: a litmus test of the new leadership

By A. Melander and K. Pelikanova

1. Introduction

China's new Premier, Li Keqiang, is well-known for being a strong advocate of urbanization. In the early 1990s - then a student at Peking University and a rising star in the party - he wrote his doctoral thesis on the role of urbanization in economic development, with one of the key issues being the reform of China's household registration system¹. Almost two decades later when he became China's Premier, urbanization naturally moved to the forefront of the political agenda, and so did the expectations for finally putting an end to the formal divide between urban and rural society inherited from the Mao's era.

In the context of a reduced demographic dividend and increased urbanization pressure (figure 1), the hukou reform is an increasing

economic and political necessity. While recognizing the mitigating impact of local reforms since the late 1990s, the number of migrant workers in the cities exceeded 260 million in 2012, the equivalent of about one third of total urban population (figure 2). Migrants are often barred from formal sector employment, social services and public welfare. With the urbanization rate expected to increase by 1 percentage point every year², the country's urban underclass could, in the absence of reform, reach 500 million by 2030, or about a half of the urban population, which would be socially and politically explosive³.

² The official 2013 urbanization target is 53.4%, or a 0.8 pp increase from 2012. However, given that the urbanization ratio grew on average by 1.4 pp between 2000 and 2012, most analysts expect urbanization to continue to advance at more than 1 pp a year. See for instance: Miller, T. (2013) "Faster or Better Urbanization", *DragonWeek*, GK Dragonomics, 11 March.

³ Miller, T. (2012) *China's Urban Million*, Zed Books

Summary

The reform of China's "hukou system" seems to be gathering momentum. The hukou system is a household-registration system, which splits the population into urban and rural residents. It basically gives rural hukou holders access to land while granting social entitlements to urban hukou holders. Migrant workers, crucial for the "Chinese miracle" over the past three decades and amounting to one third of the urban population by now are at risk of "falling in between".

Since the release of the 12th Five-Year Plan in 2011, a hukou reform is mentioned as a possible tool to promote labour mobility, boost incomes, rebalance the growth model towards consumption and create a stable urban society. While there has been a lot of "talk of reforms", concrete proposals remain scarce so far (beyond some experiments at the provincial level).

In the context of growing urbanization pressures in China, a hukou reform is increasingly becoming both an economic and political necessity - and expectations are rife that it will be included in the new urbanization plan due by the end of this year.

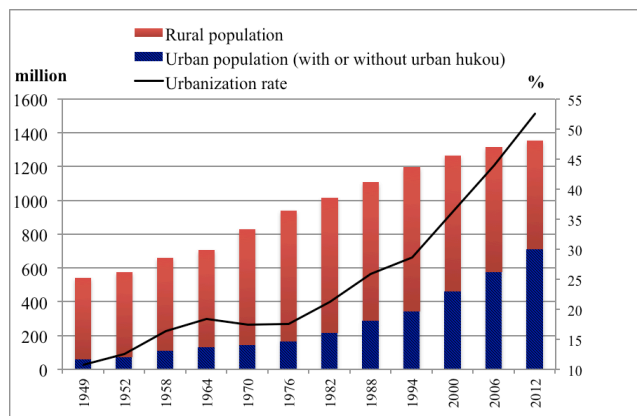
Recognising how the different systems interact, however, it would appear crucial to address the highly sensitive issues of land-use rights and the impact on public finances at the same time. Some vested interests will also need to be tackled. In view of its complexity and heavy fiscal implications, the hukou reform appears as a litmus test of the new leaders' willingness and capacity to undertake reform.

¹ Li Keqiang (1994) *Lùn wǒguó jīngjì de sān yuán jiégòu* (On the Ternary structure of China's Economy), Peking University.

However, there are also significant economic challenges associated with the reform process. In this sense, the reform of the hukou system is a test for the new leadership's reform-credentials and their capacity to navigate the complexity of this issue.

Figure 1: Urbanization in China is accelerating

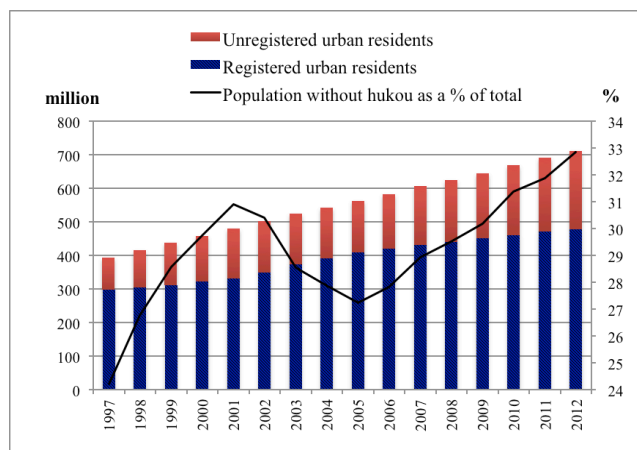
China's urban and rural breakdown (1949-2012)



Source: CLSA, CEIC

Figure 2: The share of urbanites without full rights is on the rise

China's urban population by registration status



Source: Gavekal, CEIC

2. The Hukou system: a ghost of the Mao era

In 1958, the Chinese government formalized a new household registration system modelled after the Soviet style internal passport and the traditional hukou used in imperial China. It introduced a strict division between rural and urban population with the official objective of "consolidation of socialist

system and public interests"⁴. In addition to the goals of social and political stability, most experts point at the economic rationale behind such a control system: restricting rural-urban migration was necessary to push the heavy-industry-oriented development strategy under the condition of dual economy. At the time of Mao's rule, China was a largely agrarian country. The state maintained artificially low prices for agricultural products while overpricing industrial products in order to ensure sufficient financing flows to the secondary sector. The stringent migration controls served to maintain this economic configuration⁵.

Box 1: What is hukou?

Hukou is a synonym of official registration in China. Originally, the hukou system divided the population into four types depending on (i) *occupational aspects* (agricultural/non-agricultural) and (ii) *locational aspects* (living in urban areas/rural areas), largely according to the place of birth and the hukou status of the parents. The rural hukou status entitled the holder to access to land (namely the right to use construction land, farmland and contracted forestland), while the urban hukou status provided for a variety of social benefits (including pensions, medical care, education and other public services). The match was not exact, but the majority of population living in rural areas had an agricultural hukou.

The distinction between agricultural and non-agricultural hukou became obsolete in the 1990s with the end of food grain rationing throughout China, but the dichotomy between the access to *land* for rural hukou holders and *social entitlements* restricted to urban hukou holders remains the key feature of the system until today.

The system was applied stringently until the early 1980s when the "reform and opening-up" policy created pressure for increased labour flexibility. In 1984, the government introduced a system of temporary residence permits that allowed people with an agricultural hukou to move to urban areas as long as they could provide for their food and lodging. This measure unleashed a massive flow of

⁴ Decree of the President of the PRC, *Zhonghua renmin gongheguo hukou dengji tiaoli* (Regulations on Household Registration in the PRC), January 9, 1958, in Chan, K. W. and Zhang, L. (1999). "The hukou system and rural-urban migration in China: Processes and changes", Center for Studies in Demography and Ecology of the University of Washington, p.3.

⁵ Justin Yifu Lin, Fang Cai and Zhou Li, *The China Miracle: Development Strategy and Economic Reform*, Hong Kong: Chinese University Press, 1996.

migrants into the cities, with more than 60 million migrants coming to Chinese cities within the first 10 years of its application.

In the late 1990s, China experimented with a variety of reforms to further ease mobility restrictions. In 1997, the State Council initiated a nationwide relaxation of the conditions for hukou conversion in small towns and cities, followed by permission to transfer the hukou status for family cases (notably spouses and children). The reforms further accelerated in the early 2000s with the deepening of schemes such as the 'blue-stamp' hukou (comparable to the 'green card' in the United States as it can be converted to a permanent hukou after a certain period of time) and a general lowering of thresholds for granting of temporary residence permits (equivalent to a working visa).

The modalities of reform vary greatly across provinces and municipalities as a result of the devolution of the responsibility for hukou controls to the local government in the late 1990s. More than half of the provinces have experimented with a unified residence permit operating independently from the national hukou system (i.e. merging the urban and rural hukou, although generally below the province-based level). In addition, most cities adopted a set of criteria for obtention of local urban hukou, generally a combination of a residential permit and a stable source of income for small and medium cities and a whole set of stringent conditions (purchase of housing, higher education, tax payment requirement and others) in the case of large cities⁶. However, the ambitious plans in areas such as Chongqing or Chengdu are in stark contrast to the situation in Beijing or in Zhengzhou where permanent migration of peasants has become even harder than before⁷.

Overall, the reform of the hukou system remains an unfinished agenda. The easing of mobility restrictions has been variable across cities and provinces, with progress being particularly slow in the largest cities where migrants are most concentrated. To add a layer of complexity, reform features have varied depending on the type of migration, with the less stringent criteria for rural to urban migration within the same locality and gradually increasing thresholds for intra-provincial and inter-provincial migration. Finally, the measures have not been coupled with adequate reforms of

social entitlements and land rights issues. Since 2011, the government has recognized the need to move beyond the sub-national level and started to prepare a national plan for a hukou reform to be released as a part of the urbanization plan by the end of 2013.

3. Hukou system as a drag on economic growth

For many years that followed the "reform and opening-up" policy, the hukou system actually brought a significant contribution to China's dramatic growth. By shifting its function from a major obstacle to mobility to a determining factor of social entitlements, it allowed for a formation for a massive supply of cheap labour, underpinning high productivity in the country's manufacturing industry over several decades. However, this effect has now been reversed. This part focuses on its current impact on labour market (supply side) and on consumption (demand side), arguing that a reform has become an economic necessity. From the political-economy perspective, the hukou system also contributes to income inequality and injustice, which can have a serious impact on the country's social stability in the long term.

3.1. A barrier for effective allocation of labour

For the past three decades, the dual urban-rural system allowed China to industrialize on the cheap. In the late 1990s, migrant workers accounted for 70-80% of the workforce in the special economic zones⁸ and they still represent the absolute majority of the workforce in manufacturing, construction sector and basic services (cleaning, restaurants)⁹. By providing a massive supply of low-cost labour, migrant workers deeply contributed to the Chinese economic miracle, which in turn enabled China to lift over 500 million people out of poverty.¹⁰

However, as China is approaching the Lewis turning point¹¹, the hukou system is becoming a serious

⁶ OECD (2013): China Economic Survey, March, pp. 94-98

⁷ Chan, K. W. and Buckingham, W. (2008), 'Is China Abolishing the Hukou system?' *China Quarterly*, 195, September.

⁸ Rothman, A. & J. Zhu (2013): "Hukou reform. Household registration revamp to drive growth", *CLSA Asia-Pacific markets*, China Macrostrategy, May.

⁹ International Labour Organization, *Promoting Decent Employment for Rural Migrant Workers*, ILO, 2011.

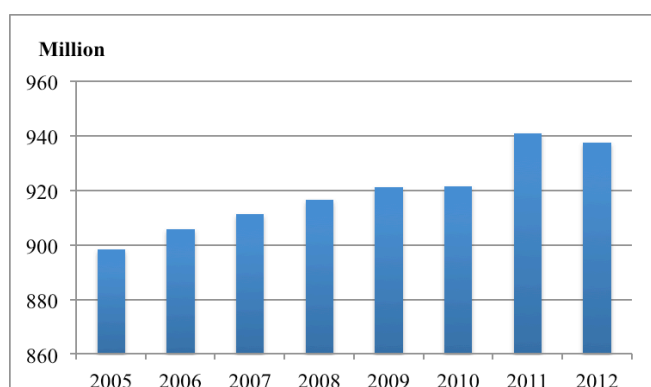
¹⁰ World Bank & the Development Research Center of the State Council of the People's Republic of China (2012) "China 2030: Building a Modern, Harmonious, and Creative High-Income Society, Washington & Beijing, p.XV.

¹¹ The 'Lewis turning point' describes a particular stage in the economic development of emerging/developing countries: when excess labour in agriculture sector is (close to) fully absorbed in the industry and further capital accumulation begins to cause a more sustained and rapid

stumbling block in the economy. The latest figures by the NBS suggest that China's working age population had declined for the first time in 2012 by 3.45 million, equivalent of 0.4% (figure 3). The UN's Population division estimates that, starting from 2010, the number will decrease by 15 million by 2020 and by 50 million by 2030 (figure 4). As a result, many areas of China's labour market have started to experience labour shortages. Anecdotal evidence from companies in the coastal regions is corroborated by the most recent labour market report by the MOHRSS (figure 5)¹².

Figure 3: Working age population started to decrease in 2012

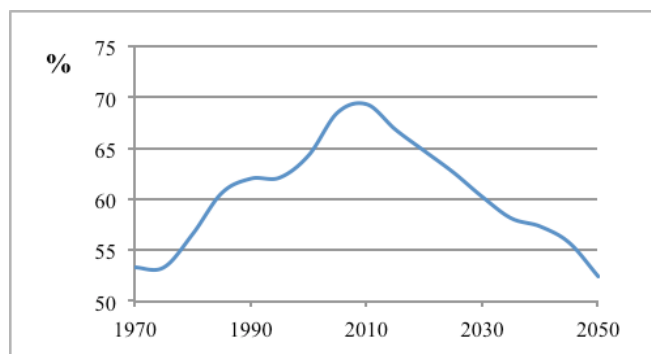
Working-age population (15-59 years old)



Source: NBS

Figure 4: Decrease in working-age population is a part of structural changes in the labour market

Working age population (15-59 years old) as a % of total



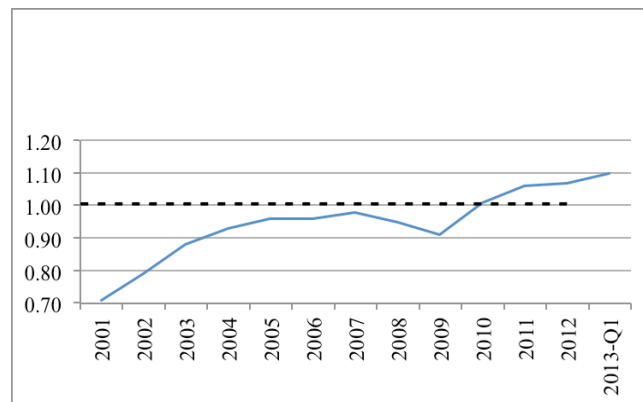
Source: UN, own calc.

increase in wages. This model has recently gained wide circulation in the context of economic development in China.

¹² The Ministry of Human Resources and Social Security (MOHRSS), through their Market Information Monitoring Center, created a database with information on the number of jobs and vacancies and job seekers from over 100 cities in China. It then calculated a demand-to-supply ratio data, where a number higher than 1 indicates labour shortage. These statistics are released on a quarterly basis.

Figure 5: Evidence of labour market shortages rises

Jobs-to-applicants ratio
(labour abundance <1; labour shortage >1)



Source: Government of Canada in China, with data from MOHRSS

The growing scarcity of labour raises costs for firms, but thereby also creates competitive pressure for companies to move-up the value chain and increase productivity. As the supply of migrants tightens, their average wages have been rising rapidly (at as much as 20% during 2010 and 2011), in parallel to a strong push by the central government to increase the minimum wage by at least 13 % annually in the years leading up to 2015¹³. Hukou reform can therefore limit the upward pressure on wages, allowing companies in manufacturing and construction sectors to adjust their processes more gradually. In addition, it should improve productivity via a reduced turnover. According to a recent CSLA note an average migrant works less than 10 months per year and returns back to their rural hometowns after only seven years, and before they attain the highest possible levels of skill in their field of work¹⁴. Hukou reform would allow migrants to bring their families to the cities and foster their integration in the urban community, which would significantly reduce the phenomenon of seasonal migration and allow them to settle in the cities on a longer-term basis, if not permanently.

The hukou reform can help to unleash the potential of Chinese labour market, provided that it takes into account the absorption capacities of the various provinces and ensures appropriate matching. Given the difficulties of China's exporting industry due to weak demand from its trading partners in Europe

¹³ "The State Council Issued the Employment Promotion Plan (2011-2015)", February 8, 2012, www.gov.cn/jzwgk/2012-02/08/content_2061165.htm

¹⁴ Rothman, A. & J. Zhu (2013): "Hukou reform. Household registration revamp to drive growth", *CLSA Asia-Pacific markets*, China Macrostrategy, May 2013, p. 15-16.

and in the United States (and rising competition from other low-cost producers in key market segments), some observers suggest that the positive effects of removing mobility barriers would be limited. Indeed, in this view the challenge for the government is not to restore the manufacturing and construction sector in the Eastern provinces to its former *grandeur* by lowering labour costs, but to adjust the industrial structure by moving up the value chain. In parallel, policy should leverage the potential of the Central and Western provinces and developing the services sector, conforming to the country's strategy to achieve a more balanced growth from the supply side.

3.2. Adverse effects on consumption

As a general rule, urbanization boosts consumption. When moving to the city, migrants have to pay for their rent, utilities, food and transportation, which immediately pushes consumption to substantially different levels than in the rural areas where most of the farmers live (albeit not entirely) a subsistence lifestyle. Also, the higher income and the greater availability of goods and services associated with life in the cities drive discretionary purchases. Of course, urbanization also requires substantial investment in infrastructures, but the impetus on consumption is likely to become dominant in the medium and long term. Premier Li Keqiang has repeatedly emphasized his belief that urbanization is going to become the greatest source of domestic demand in the years to come, playing a crucial role in the rebalancing of China's economy towards a more consumption-led growth model.

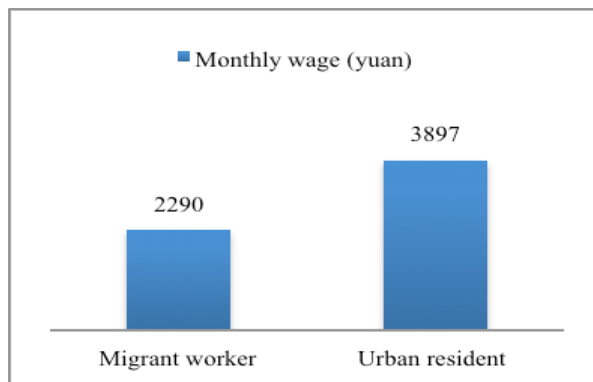
However, the country can only unleash its consumption potential if the migrants attain a sufficiently high level of income and sense of economic security. During the past three decades, migration has created a so-called 'urban underclass' rather than a middle-class of consumers:

- The migrant income is lagging behind the average urban income. With the average income of 2,290 yuan (\$370) as of 2012 according to the latest NBS figures, migrant workers wages lag behind the average urban wage (figure 6), ranking only at the bottom quintile of the urban population¹⁵. The capacity of migrant workers to consume durable goods may be even lower than the data suggest, since they have to dedicate considerable amount of their income for social security in the city and do not have access to housing subsidies. On the positive side, in 2010 and 2011, the average

monthly wages of migrant workers were rising more quickly than the average (figure 7). Despite the sharp slowdown in the 2012 when the increase in pay nearly halved to 11.8 %, this figure still compares favourably with the trends in various consumer cohorts¹⁶.

Figure 6: Migrant workers earn significantly less than their urban counterparts

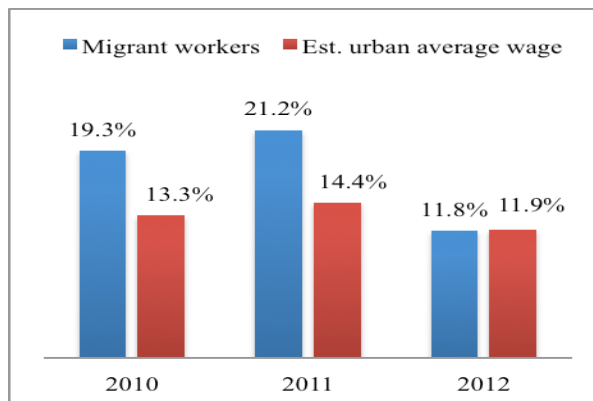
Comparison of wages of migrant workers and urban units



Source: NBS, CEIC¹⁷

Figure 7: Migrant wages recently grow faster than the average urban wages

The growth rate of migrant wages compared to wages in urban units



Source: NBS, CEIC

¹⁶ FT China Confidential (2013) "New labourers' take the stage", Custom Research, survey conducted in August 2012, Published in March 2013. <http://www.ftchinaconfidential.com/migrant2013>.

¹⁷ While the NBS issues a relatively clear set of data on migrant wages every quarter, their data on urban wages are far from being straightforward. A possible way is to use their annual *urban unit* data. However, urban unit employment is a narrow (and more formalized) subset of urban employment and account only for about a half of urban employment. We calculated the urban average by dividing the annual figure of 46769 yuan by twelve. This gave us 3897 yuan (Figure 6), but the actual figures are probably lower.

¹⁵ Miller, T. (2012) *China's Urban Million*, Zed Books

- Despite depressed incomes, migrant workers have a high saving propensity. According to the 2011 survey conducted by the National Population and Planning Commission, migrant workers save around 50% of their income¹⁸, compared to the urban household average of 30%¹⁹. Traditionally, migrant workers have come to the city in the pursuit of a higher-paying job that would allow them to sustain their family in the countryside and save enough money to compensate for the lack of social entitlements reserved to urban hukou holders (notably pensions and health insurance). While the remittances arguably fed into consumption in rural areas, the sense of economic and social insecurity represent a limiting factor for a significant increase in consumption of durable goods needed for the desired rebalancing of the economy on the demand side. Another explanatory factor is what we could call the 'spatial exclusion': the cheap accommodation in which many migrants live is far from modern urban markets, which makes it more difficult for migrants to consume goods and services even if their disposable income would allow them to make discretionary purchases.

- The new wave of migrants has a higher spending propensity than the migrants born in the 1970s and 1980s, however. According to the recent survey by FT China Confidential, migrants born after 1990 spend 52% of their monthly income, compared to 47% and 38% for the 1980s and 1970s cohorts respectively (figure 8)²⁰. This disparity is driven by a mix of demographic, social and cultural factors: migrants born after 1980s have not lived through the upheavals of the late Mao's era, and are also better educated and more integrated in the city. While they still spend about half of their income on food and housing, they dedicate a considerable part of their income to leisure and entertainment. Many of them represent literally a second generation of migrant workers: often born and raised in the cities, they have limited or no agricultural experience and are therefore likely to remain urban residents. Their expectations are fundamentally different from their parents who never, or rarely, adapted to the city culture and consume only when there is a good eco-

nomical reason to do so, in the hope of returning back to the countryside.

Figure 8: Younger migrant workers have higher spending propensity than the first wave of migrants

Generation	Proportion of monthly income spent (%)
1990s	52.0
1980s	47.2
1970s	38.3

Source: FT China Confidential, 2013

Despite some positive signs (i.e. the upward trends both in income and spending propensity indicators), the hukou system contributes to holding back migrant workers' consumption well below its potential. According to the estimates by China Institute for Reform and Development, when moving to the city, migrant workers spend on average 171% more than in the countryside. If they become permanent residents, their expenditure rises by 214%, and if 150 million migrant workers became urban citizens by 2020, it would unleash 5 trillion yuan (\$815 billion) in domestic consumption²¹. In the absence of the hukou reform, the government may well pursue its ambitious urbanization targets by extending the geographic boundaries of the city or by forcing people to 'urbanize', but this strategy would fail to unleash the country's full consumption potential²².

3.3. Major source of inequality and social tensions

The hukou system has been an important driver of urban-rural gap in China, creating a system of 'cities with invisible walls', or even what some scholars call as urban-rural 'apartheid'²³. While it has to be acknowledged that economic dualism along the urban-rural divide is characteristic of most developing countries, the existence of such large-scale institutional obstacles makes China's experience distinctive

¹⁸ National Population and Family Planning Commission (2011): *Liudong renkou fazhan baogao 2011 (Report on Development of China's Migrant Population)*, Zhongguo Renkou Chubanshe, Beijing.

¹⁹ Urban savings rate is calculated using per capita disposable income and consumption, The figure of 30% refers to 2011; the savings rate has grown up to 32% in 2012 (NBS, CEIC and Conference Board).

²⁰ FT China Confidential (2013) "New labourers' take the stage", Custom Research, survey conducted in August 2012, published in March 2013. <http://www.ftchinaconfidential.com/migrant2013>.

²¹ Chi Fulin, President of the China Institute for Reform and Development, in He Wei, "Starting with the urban-rural divide", *China Daily*, 17 May 2013, http://www.chinadaily.com.cn/cndy/2013-05/17/content_16505614.htm (accessed on 19 May 2013).

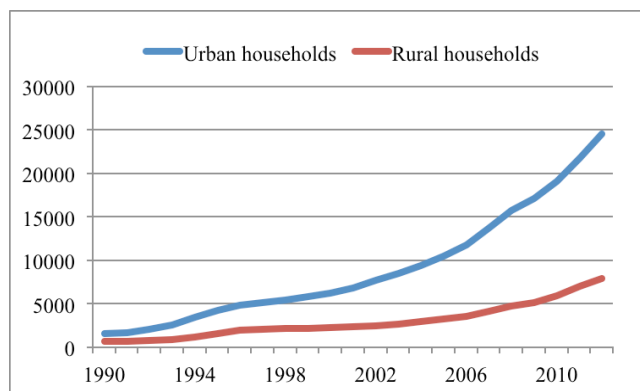
²² 'Urbanizing' a 50-year-old farmer without any urban skills and no consumption habits while preventing a young migrant to spend more or even forcing him out of the city because of the lack of social entitlements is an example of the perverse effects that the hukou system can have on consumption levels despite the progress of urbanization.

²³ Chan, K.W. (1994) *Cities with Invisible Walls: Reinterpreting Urbanization in Post-1949 Era*, Hong Kong, Oxford University Press; Alexander, P. & A. Chan (2004) "Does China have an apartheid pass system?" *Journal of Ethics and Migration Studies*, Vol. 30, No. 4.

(figure 9). The slight drop in the urban-rural income ratio since the peak in 2009 (from 3.3 back to the 2002 level of 3.1, figure 10) reflects the effects of various income distribution policies that the government adopted in the recent years, but it also demonstrates the limited impact of reform which does not tackle the root causes of the skewed income distribution.

Figure 9: Urban-rural income gap in China, a structural divide partly driven by the hukou system

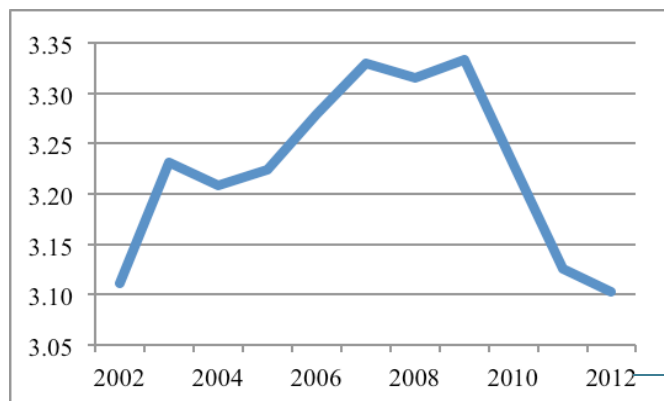
Per capita income of urban and rural households (1990-2012)



Source: CDRF, 2013

Figure 10: Urban-rural income gap narrowing over the past three years

Urban-rural income ratio (2002-2012)



Source: CDRF, 2013

To a lesser extent, the hukou system has also contributed to intra-local inequality and to regional income disparity. According to the latest NBS statistics, migrant wages reached 2,290 yuan (\$370, an increase by 11.8% on the y-o-y basis), compared to the average urban income of 3,897 yuan (see figure 6). The average monthly income in the poorest province of Gansu is still only about two-thirds of China's richest province of Zhejiang and slightly

more than a half of the levels of Beijing or Shanghai municipalities. However, the China Development Research Foundation found that only a small part of the urban-rural differential is attributable to the hukou status alone (accounting only for 5% as of 2010, down from 11% in 2001²⁴). They further argue that other factors like demography, education levels and working experience are predominant in determining the income level. As for the impact of the hukou system on *regional inequality*, the latter seems to be more closely related to the unbalanced development strategies in 1980s and 1990s. These arguments are not clear-cut as the education and skills differential, especially in the case of intra-local inequality, may have been affected by the hukou status in the first place.

Even more importantly, the hukou system contributes to social injustice in China. The annual surveys by the Ministry of Human Resources and Social Security suggest that, despite some improvements, the working conditions of migrants are lagging behind. Rural migrants often take dirty and difficult jobs in construction, cleaning, domestic services or restaurants, while also working longer hours on average than their urban counterparts. Most importantly, the hukou system results in highly unequal access to social entitlements. With more inclusive social policies adopted in the recent years, notably the new rural pension and medical insurance schemes, the disparity in access to basic social services has narrowed significantly, but the quality of the service remains largely inferior to entitlements in the city areas²⁵. The situation of migrant workers is more peculiar: with limited portability of entitlements, rural migrants have to subscribe for urban insurance scheme if they want to benefit from social security, and they often lose their rights when they move to another city or province. The access to stable jobs with a generous welfare package typical for China's public institutions is almost exclusively reserved for local

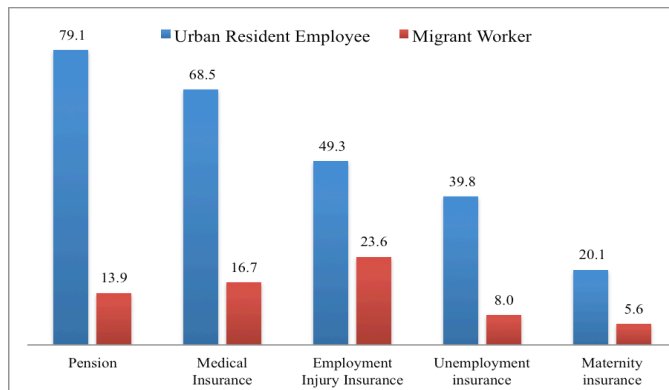
²⁴ China Development Research Foundation (2013) "The Turning Period of China's Income Distribution: An Impact Assessment on Income Distribution-related Policies in China" (Executive Summary), p.5.

²⁵ The difference in quality of the public service between urban and rural areas in China is a common knowledge, but it is also extremely difficult to quantify. Some studies engaged for instance in comparing the average payments for medical services between urban and rural areas and found out that rural residents on average pay more for the same service. Others engage in comparing the teachers qualifications across various provinces. Some elements of this reflection can be found in: Schrader, A., Amy Liu Abel and Xiaoqin Li (2012) *Reading the Tea Leaves: The Impact of China's Twelfth Five-Year Plan in Human Capital Challenges*, Conference Board Research Report.

hukou holders²⁶. As a result, migrants often choose informal jobs (almost 44% of migrants do not have a labour contract according to the last official figures), which further feeds into the sizeable disparity in access to welfare and to basic security between migrants and the urban resident employees.

Figure 9: Disparity in access to social welfare system

Percentage of migrant population that receives social insurance coverage (2011)



Source: NBS, own calculations²⁷

The provision of education for children of migrant workers is a particularly serious concern. At present, the parents have the option of either paying the 'out-of district fee' at the public schools (out of reach for most of the migrant workers) or turn to privately operated migrants schools with dubious quality²⁸. Most of the parents (56%²⁹) decide to leave their children with their grandparents at the countryside, at the risk of harming their performance at school and undermining their future educational prospects³⁰. With the number of left-behind children soaring to 61 million this year (equivalent

to roughly 38 % of rural children and 22 % of all Chinese children), there is a serious risk of missing the opportunity to create a better-educated generation of citizens³¹. A related concern is the national college entrance exam, the so-called *gaokao*. The admission rates have been skewed towards local urban hukou holders. Recognizing that the hukou system limits the possibility for rural hukou holders to access the institutions of higher learning in line with their full potential (this is a particularly serious concern for the 44% of migrant children that remained with their parents in the cities and that have to return to their home village to pass the exam), most provincial and municipal governments introduced a reform in the last December. For the first time this year, a number of migrant students were allowed to pass the exam in the city in which their parents work and live, but this is still subject to some restrictions that need to be further lifted³².

It has been argued that despite its contribution to the skewed income distribution, the hukou system has allowed China to industrialize without creating slums. While it is reasonable to claim that the street poverty in China does not reach the levels of other developing cities in South Asia or in Latin America, some experts have started to challenge this mainstream thinking and pointed to the existence of 'shanty areas' at China's urban suburbs³³. Interestingly, the migrants living in these *chengzhongcun* (literally 'villages in towns') have not shown major signs of discontent or public anger to date. However, multiple factors suggest that the hukou system, if not reformed, may be a triggering factor of instability in the future:

- There has been a growing sense of social injustice among migrant workers, especially the second generation of migrants who was raised in the city. While the first generation of migrant workers still relate their current experience to the living conditions in the countryside, the younger generation - eager to seize education opportunities, access formal jobs and benefit from subsidized housing and other social entitlements - increasingly resents their status of second-class citizens. The availability of social media is an additional tool in spreading public anger, notwithstanding the government efforts to control such communication channels.

- The current urban hukou holders are increasingly reluctant to further welcome migrant

²⁶ "Shiyè dānwèi hùjī qíshì:99%Bèi diàochá dānwèi yāoqiú bēndì hùkǒu" (Hukou discrimination is common in public institutions recruitment: 99% have a local hukou), May 29, 2013.

²⁷ Medical and maternity insurance coverage is calculated as a proportion of urban population, while the pension, work-related injury and unemployment insurance figures relate to the urban working population.

²⁸ According to surveys by NBS, 88% of migrant children attend separate schools for migrant children and 83% of them leave school before entering high-school, largely due to the incapacity of the parents to bear the fees (in Rothman, A. & J. Zhu, "Hukou reform. Household registration revamp to drive growth", *CLSA Asia-Pacific markets*, May 2013, p.7)

²⁹ Rothman, A. & J. Zhu (2013), *ibid.*

³⁰ Besides the arguable lack of moral and emotional support, the performance of school-aged children at school is compromised by the need to dedicate considerable amount of time to housework and farming. Zhao Litao & Courtney Fu Rong (2010) "China's hukou reform: the Guangdong and Shanghai's cases", EAI Background Brief No. 551. August 13, p. 8.

³¹ *China Daily*: "Number of left-behind children passes 60 m", by Zheng Xin, May 13, 2013.

³² *China Daily* (2013) "Gaokao opened to migrant students", by Qiu Quanlin and Wang Hongyi, June 8.

³³ Miller, T. (2012) *China's Urban Million*, Zed Books, p.19.

workers in the city. One element is the reluctance of urban parents to see their children mixing with their rural migrant counterparts in schools. Equally important, increasing competition for formal jobs, general strain on infrastructures and social benefits, environmental impact, and finally also tensions over the one-child policy when living side by side (rural hukou holder being in principle allowed to give birth to two children) are all seeds for further discontent.

- The accelerated pace of urbanization may lead to a rise in street poverty. In the absence of reforms, one out of two urbanites (a total of 500 million) will be a "second-class citizen" by 2030. With limited employment opportunities for youngsters and the inadequate or absent pension and medical system for aging migrants (not to speak of the reluctance of the local governments to bear the costs of additional social housing and the absorption capacities of the cities in general), the situation may become explosive.

The probability of massive social upheavals in China is still relatively low - in the absence of other triggering factors. This analysis is confirmed by the most recent survey by the Pew Research Center, pointing at the skewed income distribution and the access to the social safety net (both linked to the hukou reform) as issues of growing public concern, alongside the soaring food and housing prices, corruption, food safety and pollution³⁴. Most of the migrant workers do not show signs of serious dissatisfaction as they realize that their situation still compares favourably with the conditions in the countryside. The risk comes from the second generation of migrants that was raised in the city. Educated to some degree, with the prospects of (or already occupying) less-stable, lower-paying jobs than the established urbanites, their frustration will grow as they approach the age of 25 when they need to marry (in about 5-10 years), also taking into account a growing gender imbalance resulting from the one-child policy. With the party's traditional focus on order and stability, linked to the uncertainties about the country's future growth trajectory, the Chinese government clearly takes the hukou reform very seriously and has decided to move it up in their political agenda.

4. The reform path: the way forward

This final section on the brief explains the place of the hukou reform in the overall urbanization

strategy, before analysing the lessons from provincial experiments and outlining the possible features of the nationwide reform that is currently being prepared by the central government.

4.1. The place of the hukou reform in the overall urbanization and economic rebalancing strategy

The acceleration of national hukou reform is closely linked to the growing importance of urbanization on the central government agenda. The 12th Five-Year Plan released in March 2011 is the first one to specifically mention household registration reform in a stand-alone chapter on urbanization. The need to accelerate the hukou reform to advance urbanization was further emphasized at the 12th National People's Congress in March 2013³⁵. With the detailed urbanization plan to be released by the end of this year, a genuine hukou reform seems to be gaining momentum.

The preparation of the urbanization plan involves a variety of ministries and governmental agencies, notably the National Development and Reform Commission (NDRC). According to the NDRC guidelines submitted to the NPC Standing Committee in the end of June, the hukou reform should be one of the four main strategic priorities for promoting a 'healthy urbanization', alongside the focus on clustering within a network of cities, promoting sustainability and low-carbon solutions and integration of urban and rural development³⁶.

A genuine hukou reform cannot be carried out in the absence of major transformations in other, equally complex, policy areas. It is closely related to infrastructure building and land reform, which are all direct elements of any urbanization strategy, but it also touches on inequality, education and social welfare provision, and especially on reform of public finances. For this reason, some observers may find it surprising to expect a comprehensive reform of

³⁵ To advance urbanization, the government should "accelerate reform of the household registration system, the social management system and related institutions; register eligible rural workers as permanent urban residents in an orderly manner; progressively expand the coverage of basic public services in urban areas to all their permanent residents; and create an equitable institutional environment for freedom of movement and for people to live and work in contentment" (Wen Jiabao, *Report on the Work of the Government*, March 2013)

³⁶ National Reform and Development Commission (2013) "Guówùyuan guānyú chéngzhèn huà jiànshè gōngzuò qíngkuàng de bàogào" (Report to the State Council on urbanization plan"), presented by Xu Shoashi at the NPC Standing Committee meeting, July 26, http://www.npc.gov.cn/npc/xinwen/jd gz/bgjy/2013-06/27/content_1798658.htm.

³⁴ Pew Research Center, "Growing concerns in China about inequality, corruption", October 16, 2012.

the hukou system coming from the urbanization plan. It is certainly worth mentioning that the importance of the hukou reform has been stressed at various occasions by the State Council since 2011 and that it was also included among the 35-points of the State Council's plan for reducing income inequality released (after multiples delays) in February 2013, without moving beyond the general statements. However, there are also reasons why the 'buzz' about the urbanization plan can be seen as justified. Firstly, given the government's urbanization drive and the centrality of the hukou reform in the urbanization strategy, many observers hope for a reasonably detailed proposal. Secondly, the shift from a 'numbers-driven' approach to 'quality-first' urbanization raises hopes that the government is willing to think about hukou reform in a broader context and that it realizes its key role in the overall rebalancing strategy. The real question though is whether the government is able to close the gap between the plan and its implementation.

Overall, putting the national hukou reform under the urbanization umbrella opens the possibility of tackling the directly related issue of land usage, while also providing an entry point for a new round of measures regarding labour market, consumption, education and social welfare provision and the much needed financial and fiscal reform. While these interconnections should certainly be regarded as an opportunity to rebalance China's economic model, there are also substantial challenges which requires a detailed look on the lessons learnt on the provincial level and may limit the scope of the reform plan in a first stage.

4.2. The lessons from provincial reforms

Like with many other major reforms, the Chinese government experimented first with a variety of pilot programs on a smaller scale before introducing substantial policy changes (a strategy known as "crossing the river by feeling the stones"). While recognizing the variety of experiments with the hukou reform on the local level (see annex), it is possible to identify a number of challenges:

- Local hukou reforms have progressed most in small cities, and least in the big cities that are the most desired destinations for migrants. The large cities currently have the highest concentration of migrant population. However, the hukou conversion in large cities is subject to very stringent criteria (high requirements on skills, education, income, residence or investments – often a combination of all) and remains out of reach for an absolute majority of migrants. At the same time,

social services, protection and education opportunities for children in small and medium cities tend to be less generous than in the first-tier cities, making them less attractive. This disparity significantly limits the positive impact on labour market and fails to address the sense of exclusion among the largest migrant populations.

- The reforms have failed to address migration outside of local areas. The ambition of some provinces to abolish the distinction between urban and rural altogether translated only into unification within towns, cities and city districts, not across provinces. Interprovincial migration (46.8% of the total migrant population) remains largely untackled. This is largely due to the lack of incentives and financial capacity of local authorities to deal with extra-provincial migrants.

- The resistance from vested interests has significantly limited the scope of the reform. First of all, local companies are reluctant to change since the current hukou system allows them to hire migrant workers without contributing to their social security scheme. Secondly, the reform faces opposition from the current urban residents who are concerned about the downward pressure on wages as well as the potential knock-on effect on the quality of public services and social entitlements due to the costs of reform. Finally, with local government finances being largely dependent on land sales, there has been very little progress in the land use rights reform, seriously impacting the willingness of migrants to change their hukou, as explained below.

- The migrants themselves have in general been reluctant to relinquish their land rights due to the uncertainties and potentially high opportunity costs. According to the 2011 Survey by the National Population and Family Planning Commission, only 26% of migrants would accept to convert to a city hukou if they had the choice. For the migrants living in the city, land is a security safeguard: in case they lose their jobs, they can always return to the countryside and live cheaply from their land. A possible solution could be to allow for a try-out period during which migrants would be granted an urban hukou without relinquishing their land rights like in Chongqing (see annex). However, even in this innovative municipality, meagre compensation, unsatisfactory resettlement conditions and the lack of urban skills that affects the prospects for the farmers of finding a new job in the city make it difficult to meet the conversion targets.

- Most importantly, the extension of public services to migrants and their families incurs

substantial costs³⁷. A number of ambitious reforms were suspended because of an overstretch of the local budget (e.g. Zhengzhou), which encouraged other provinces to caution. The Development Research Center, a government think tank, estimated in 2010 that turning one rural migrant into an urban citizen and providing them urban benefits and welfare for the next 20 years would cost around 80,000 yuan (13,000 USD).³⁸ With almost 500 million migrants to urbanize by 2030, the expenditure would be 2 trillion yuan, equivalent to about 5% of GDP at 2010 prices. For sure, this is just an estimate – the hukou conversion costs are extremely variable from one city to another depending on the current state of development and the extent of entitlements offered, and the regional distribution of the flows is difficult to predict. However, taking into account that the sub-national governments currently have to bear 80% of total budgetary expenditures, but only 40-50%³⁹ of these expenditures are financed through the tax revenue, it is clear that the hukou reform has to go hand-in-hand with a substantial reform of public finances. This would mean either reverting more responsibility for financing social services and public welfare to the central government, or allowing local governments to find alternative sources of financing (for instance through a municipal bond market). In parallel, there is a need for a fiscal reform, further underlining the complexity of navigating the hukou issue on the national level.

4.3. The possible scenarios

The attention that the hukou reform that has gained in Chinese and international media in the past few months hides that fact that very little is known about the content of the upcoming urbanization plan. The NDRC report to the State Council from the end of June was acclaimed by some Chinese observers as "the first clear statement" of the likely reform directions⁴⁰, but a closer look reveals that the guidelines remain very vague and that the con-

sultation process is still ongoing. While the actual draft proposal of the urbanization plan is likely to remain out of public domain, we expect further details to be available towards November this year, as the actual release of urbanization plan approaches⁴¹.

Despite this uncertainty, we can imagine three possible – but not mutually exclusive – ways of going forward with the hukou reform:

- **The conservative scenario:** Strict segmentation by small, medium, large and megacities. In this scenario, largely based on the vague information about the recent NDRC report to the State Council, the government would entirely open-up the small towns and cities to migrants with a stable employment and housing in the locality⁴². The entry conditions in medium cities would be progressively relaxed, for instance by reducing the required length of residence that in some cases extends to as many as 7 years. The government would commit to ease the restrictions in the large cities, without however aiming at a total liberalization. In the megacities like Beijing, Shanghai or Guangzhou, 'reasonable criteria' would be applied, but the pace of integrating new residents would inevitably be slow. *The advantages:* The main rationale of this scenario is to avoid overcrowding of the largest cities, promote a more balanced regional development and keep the costs of the reform low (although this latter would also depend on the level of social services and protection in the small cities). *The disadvantages:* The main problem is that it risks transposing the urban-rural divide into an urban-urban divide, creating segmentation between the 'cities-fortress' and the rest of China. Also, it is unclear how it would address the problem of inter-provincial migration. The impact on the labour market and the equity benefits would be limited.

- **The pragmatic scenario:** Extension of local residence permit schemes nationwide. In this scenario, the government would draw on the positive assessment of the introduction of residence permit systems (operating independently of the hukou system) in selected localities since 2009, extend them first to small towns and medium-sized

³⁷ Most authoritative sources indeed point out at the financing capabilities as probably the most important potential obstacle for reform. See for instance: World Bank and the DRC (2012), p. 366.

³⁸ Development Research Center (2011) *Nóngmín gōngshīmín huà zhìdù chuàngxīn yǔ dīngcéng zhèngcè shèjì*, China Development Press, Beijing, quoted in Miller, T. (2012) *China's Urban Million*, Zed Books, p.57.

³⁹ World Bank and the DRC (2012) "China 2030: Building a Modern, Harmonious, and Creative High-Income Society", Washington & Beijing, p. 55-56

⁴⁰ *HBTv.com.cn* (2013) "Guówùyuàn guānyú chéngzhèn huà jiànshè gōngzuò qíngkuàng de bàogào: Yào quánmiàn fàng kāi xiǎo chéngzhèn hé xiǎo chéngshì luòhù xiànzhì" (State Council on the report on urbanization: need to lift restrictions in small towns and cities), June 27, <http://news.hbtv.com.cn/2013/0627/404701.shtml>

⁴¹ Even in the case of further delays of the plan, it is reasonable to expect that the NDRC and the State Council will communicate further details about the intended reform to the EU counterparts at the approach of the EU-China High-Level Urbanization Dialogue, to be held prior to the EU-China Summit in November this year.

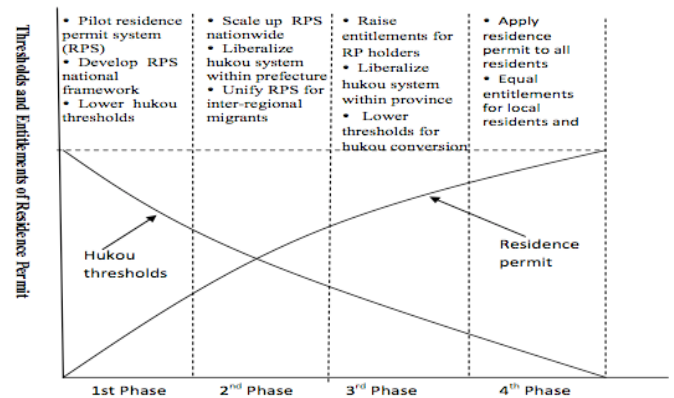
⁴² *Economic Observer Online* (2013) "State Council to move on the hukou reform", June 27, <http://www.eeo.com.cn/ens/2013/0627/245785.shtml>.

cities before including the large cities and finally reaching out to the metropolitan areas of Beijing, Shanghai or Guangzhou. The whole process could be completed by 2020. *The advantages:* Extension of the residence permits scheme is a way of providing access to basic services to migrants irrespective of the hukou status. It gives everybody an equal opportunity to choose their place of residence, including outside of their home province. This would have a strong positive impact on mobility via better matching, which could help correcting imbalances in the labour market. *The disadvantages:* The nationwide extension of the registration system does not equate to dismantling of the hukou system. The benefits granted by a residence permit are far less substantial than the benefits granted by hukou, meaning that there would still be a gap between residence permit holders and urban hukou holders. This scenario would also incur substantial costs, without however fully tackling the root causes of the problem.

- **The ambitious scenario:** Residence permit expansion, hukou unification and extension of social entitlements. In this scenario, the government would progressively expand the coverage of the registration permit systems and lower hukou conversion eligibility standards, with the ultimate goal of replacing the hukou system with a simple population registration system that is delinked from social entitlements. The 'phased expansion' advocated by the World Bank and the DRC in their influential and insightful report *China 2030*⁴³ provides a good basis for understanding the necessary sequencing of the various steps of reforms for the upcoming two decades (figure 11)⁴⁴. A truly ambitious scenario would also provide a clear list of pub-

lic services to which people should be entitled, their cost-assessment and detailed guidance on the split of financing responsibilities between the different levels of government, employers and individuals themselves. *The advantages:* By aiming to dismantle the hukou system, this scenario tackles the root causes of the problem. The gradual implementation should guarantee stability during the process. *The disadvantages:* The main shortcomings of this approach consist in the high costs and the slow pace of reform. Even if the different levels of government agreed on a detailed cost-sharing mechanism, it is extremely difficult to predict the real costs of the reform and the public budgets (especially at the local level) can therefore easily become overstretched. An additional difficulty is to 'get the timing right': the success of the various steps depends on the coordination with reforms in other areas, notably the reform of land-usage rights and public finances that have to be implemented at the initial stages (5-8 years) of the hukou reform.

Figure 11: It will take time - an indicative trajectory for residence permit expansion and hukou unification



Source: DRC & World Bank, 2012

⁴³ World Bank, the & the Development Research Center of the State Council of the People's Republic of China (2012) "China 2030: Building a Modern, Harmonious, and Creative High-Income Society, Washington & Beijing.

⁴⁴ In the first phase, the government would evaluate the lessons from the existing pilot programs and establish a nationwide framework for residence permit extension, while lowering the thresholds for hukou conversion (albeit keeping the segmentation by the size of the cities). In the second phase, it would scale up the residence permit system nationwide and unify the criteria for inter-provincial migration, in parallel to scrapping down the hukou system within provinces. Thirdly, it would extend the scope of entitlements for the residence permit holders, unify the hukou system on the provincial level and lower the thresholds for hukou conversion in the largest cities. Finally, residence permit system would apply to all residents (by 2020) and the entitlements granted to migrant workers would align with the benefits granted to urban hukou holders, making the hukou system entirely obsolete by 2030.

Summing up, with China's development path at a crossroad (in view of the significant structural shifts looming), urbanization has the potential of being an important growth driver for many years to come, if well managed. Addressing the main short-comings of China's hukou system is a necessary, but not sufficient, step on a road towards a more sustainable and balanced growth model. The way in which the hukou system is reformed is a first test of the new leadership's willingness and capacity to undertake reform (and could thus give a first indication of if/how China can escape the middle-income trap so many countries found themselves stuck in at an equivalent level of development).

Annex: The modalities of hukou reform in various localities in China*Table 1: Extent of hukou reform by province*

	Year of the most recent reform	Scope of application for hukou by size of locality	Unified registration between local urban and local rural hukou	Type of province
Anhui	2001	Large, medium, small	No	Central
Beijing	2002	Small	No	Municipality
Chongqing	2003	Large, medium, small	Yes	Municipality
Fujian	2001	Large, medium, small	Yes	Eastern
Gansu	2003	Large, medium, small	No	Western
Guangdong	2001	Large, medium, small	Yes	Eastern
Guizhou	1998	Small	No	Western
Hebei	2003	Large, medium, small	Yes	Western
Heilongjiang	2008	Medium	Yes	Central
Henan	2003	Large, medium, small	Yes	Central
Hubei	2003	Large, medium, small	Yes	Eastern
Hunan	2003	Large, medium, small	Yes	Central
Inner Mongolia	2000	Small	No	Western
Jiangsu	2002	Large, medium, small	Yes	Eastern
Jiangxi	2002	Large, medium, small	No	Central
Jilin	2001	Large, medium, small	No	Central
Liaoning	2002	Large, medium, small	No	Eastern
Ningxia	1998	Small	No	Western
Shaanxi	2005	Large, medium, small	Yes	Western
Shandong	2004	Large, medium, small	Yes	Eastern
Shanghai	2009	Large	No	Municipality
Shanxi	2007	Small	Yes	Central
Sichuan	2002	Medium and small	Yes	Western
Tibet	2001	Large, medium, small	No	Western
Xinjiang	1998	Small	No	Western
Yunnan	2008	Large, medium, small	Yes	Western
Zhejiang	2002	Large, medium, small	Yes	Eastern

Source: Du (2011), OECD China Economic Survey (2013)

Note: Data for Guangxi, Hainan, Qinghai, Tianjin: not available

Table 2: Examples of innovative experiments in hukou reform

	Modalities	Impact
A point-based system for hukou conversion	In 2009, the government of the Guangdong province introduced a score system to manage the hukou conversion. This scheme is focused primarily on intra-Guangdong migrants, while the residence permit system regulates the entitlements of other migrants. Applicants are awarded points based on criteria such as education, skills, years of social security contribution and voluntary work and must gain a total of 60 points to qualify for a urban hukou (65 points for a hukou in the capital city of Guangzhou).	The impact to date has been rather limited: according to the World Bank's China 2030 report, only 100,000 migrants out of the three-year target of 1.8 million conversions were successfully 'urbanized' during the first year of the program. Moreover, only a few of these urban conversions occurred in large (and the most desired) cities of Guangzhou and Shenzhen due to higher thresholds (and possibly also to a large proportion of extra-provincial migrants who are not eligible).
Resident permits entitling to equal public service as the urban residents	Shanghai was the first city to introduce the residence permit system that is open to all migrants regardless their province of origin and entitles the holders to equal public service as the urban residents, but the qualifying conditions are among the most stringent. It is heavily oriented towards better-skilled and wealthy workers. It also requires, among other criteria, seven years of social insurance contributions prior to applying. On the other hand, the prefecture city of Suzhou introduced in 2011 a system of residence permits with loose eligibility criteria so that any migrant aged above 16, with a place to live and a stable living condition, can apply free of charge.	Shanghai has a tight overall quota on hukou conversions, and the number of conversions has to date been very low. The situation in Shanghai is representative of the strategy of the large cities that decided strictly control migration under the risk of overcrowding. However, this comes in stark contrast with the situation in Suzhou – by mid-2012, the prefecture had distributed 6.1 million residence permits, covering almost the entire migrant population, according to OECD figures. This shows that an ambitious hukou reform is possible, although at a smaller scale.
Localized hukou conversion through exchange of rural and urban entitlements (allowing for a 3-year trial period)	In 2010, the Chongqing municipality set up an ambitious goal of doubling the urban population between to 20 million by 2020 and engaged in a radical experiment in the hukou reform in small cities and towns under the slogan of 'exchanging three rural clothes for five urban clothes'. The "rural clothes" consist of homestead land, farm land and contracted forest land, while the "urban clothes" are pension, medical insurance, housing, employment and education. Those converting from rural to urban hukou can keep farm and homestead land and forest for three years but must give it up thereafter if they wish to retain their urban hukou.	The reform rolled out in two phases. In the first phase of the programme (2010-2011), it targeted students and rural migrants working and living in the satellite cities. The respective objectives of 700 000 and 2.3 million were comfortably met, according to local press reports. The implementation of the second phases (2012-2020) aiming persuading 7 million rural farmers to move to the city is likely to prove more difficult. This is due to the sense of economic and social insecurity of the life in the city, widely spread among farmers who are generally older, live further in the countryside and have limited or no urban experience or skills.
Hukou conversion of local residents without exchange of rural rights	Starting from 2003, Chengdu slowly loosened various restrictions and cancelled the annual quota of rural residents allowed to transfer their residency to urban areas. In 2010, it also introduced a residence permits system with two types of permits: temporary (for migrants staying between one month and one year) and permanent (for migrants staying over a year). The residence permit and hukou conversion is only open to those who are already residents of rural areas of Chengdu prefecture. Local migrants will be issued residence permits if they have contracted jobs, register for business, purchase housing, or are dependents of residence permit holders. Residence permit holders enjoy more public services and welfare than temporary residence holders and are eligible for hukou conversion.	The first phase of the reform (2003-2010) proved to be very successful, with a record of some 2 million conversions (largely driven by introduction of innovative measures such as land-credit trading). In the second phase, the local government set up ambitious targets of converting 5 million farmers into hukou holders, but the actual hukou conversions have not stood up to the expectations (some 200 000 as of March 2012).

Source: Own assessment, based on Wang and O'Keefe (2011) and DRC & World Bank (2012), OECD (2013) and consultation with colleagues from the Canadian Embassy

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