

Achieving Comprehensive *Hukou* Reform in China

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About the Author

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Introduction

The reform of China's household registration system—or *hukou* in Chinese—is a major issue for the country's future development. China has less arable land than the United States, yet more than 200 million Chinese still depend on agriculture for their livelihood and more than 800 million citizens are registered with the government as having a rural *hukou*.¹ For China to further develop, it is inevitable that it will need to pursue systematic urbanization. And in doing so, the government will also have to allow migrant workers who have left rural areas for cities to become genuine urban citizens.

Such a policy change will involve much more than simply altering a citizen's *hukou* category from rural to urban in the registration record. Rather, it means allowing migrant workers to gain permanent residency in Chinese cities, and thus to be covered by the urban public service system in their place of work. In effect, China's migrants need to become full urban residents.

Of course, such a major transformation cannot be achieved overnight. Instead, a workable plan that promotes incremental and comprehensive *hukou* reform, with some breakthroughs, needs to be designed.

At present, China's urban population includes 230 million of so-called "floating population": residents of cities who lack a local urban *hukou*. Among these, more than 10 million are college graduates, including junior college.²

The floating population is growing rapidly. Indeed, while the urban floating population in 2000 was only 130 million, this category increased by 100 million people in just 12 years. As illustrated

in Figure 1 below, the gap between the de facto urban population and the urban *hukou* population—

that is, the floating population—has widened since the 1980s, a trend that is far from ideal. If this trend continues, it would not be a surprise if China's floating population reaches as high as 300 million in ten years.³ And the fact is, "second-class" citizenship of such magnitude will be a big threat to social stability in China.

The challenge for China's policymakers, therefore, is to "reverse" the problem: if, instead, only one-third of the floating population of more than 300 million gains middle-class spending power, this will increase the middle-class consumer group in China by 100 million, almost half of the country's current middle-class population of more than 200 million. Since China's policymakers are determined to increase the share

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of consumption in the economy, the power of a new class of spenders of this magnitude cannot be ignored.

Since the natural urban population growth rate in large cities,⁴ among households with urban *hukou* status, is currently very low (and has even been negative in some years),⁵ it is difficult to imagine how China can achieve a substantial increase in the urban middle class population by relying solely on that part of the population that is currently—and legally—registered with an urban *hukou*. So to promote domestic demand as a growth driver, China must principally rely on the urbanization of rural migrant workers, thus expanding the country's middle-class population.

How can such *hukou* reforms be implemented?

In March 2014, China's central government released its "New National Urbanization Plan" (hereafter "the Plan"), which proposes "granting approximately 100 million rural migrant workers and other long-term residents a local urban *hukou*" by 2020 (see Figure 1). The priority group is migrant workers with stable work in urban areas, but other groups are included: graduates of universities and vocational and technical schools, workers from other cities, and local population with a rural, rather than urban, *hukou*. This means that over

the next six years, about 17 million people will be granted a local urban *hukou* each year, among which the number from the floating population granted an urban *hukou* will see a substantial increase, reaching perhaps 10 to 12 million annually. The Plan envisages that by 2020 the floating population as a percentage of China's total population will decline by two percentage points, from the current 17 percent down to 15 percent.⁶

At the end of July 2014, the State Council released its "Opinions on Further Promoting the Reform of the *hukou* System" (hereafter "the Opinions"), which proposes an all-out opening of *hukou* restrictions in towns and small cities, the opening of *hukou* restrictions in an orderly fashion in medium-sized cities, reasonably determining conditions for *hukou* registration in large cities, and the strict control of population sizes in very large cities. Differentiated policies for urban *hukou* registration were also specified.⁷

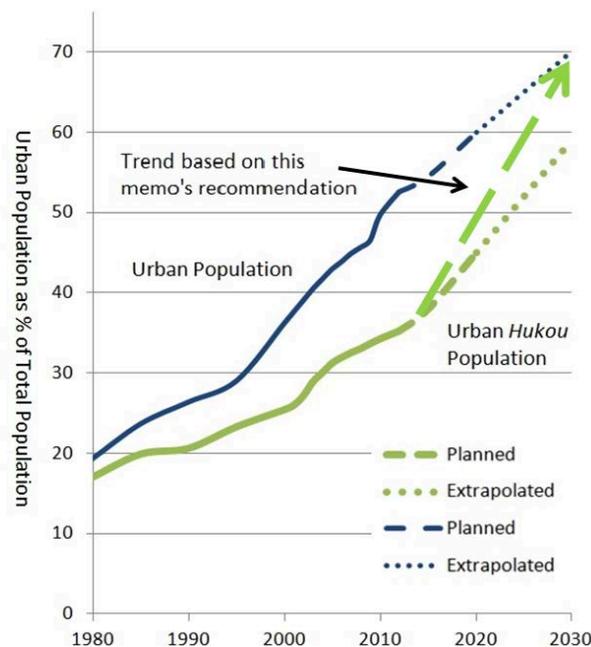
The Plan and the Opinions represent an important first step in *hukou* reform, and exemplify the Chinese central government's resolve to alter the current system. The Opinions offer more clearly defined principles for how citizens who leave their permanent *hukou* residence to live in a city for half a year can gradually attain rights to basic public services in the city.

Yet the Plan is merely a six-year program, and according to the rate of change outlined in the Plan, completely resolving the floating population issue—that is, bringing down the floating population percentage to zero—will probably require the work of another three or four decades.

Another problem with the Opinions is that it envisages little opening of *hukou* registration in very large cities, and thus does not really meet the longstanding earnest desire of university graduates, professionals, and entrepreneurs who do not have the local urban *hukou* to obtain one.

This policy memorandum recommends that *hukou* reform move more quickly and be opened more widely. The memo presents a plan that builds on the central government’s Plan and Opinions. It proposes comprehensive reform objectives, timetables, and concrete measures. Moreover, it attempts to take a longer term perspective, offering a vision of how various aspects of reform might fit together, and also how to give members of the floating population expectations and hope to plan for a potential future. Such faster and deeper reforms will, in fact, be beneficial for social stability.

Figure 1. Urban Population Growth Trends and Projections, 1980-2030



Sources: China Statistical Yearbooks; China Population Statistical Yearbooks; figures for 2013-2020 are from National New-Type Urbanization Plan; those after 2020 are the author’s.

Costs and Dividends of *Hukou* Reform

In considering how *hukou* reform is to be achieved, some believe that the urbanization of migrant workers will involve costs that the public—or more precisely, the government—cannot bear. In fact, this point of view is comprised of various misconceptions and blind spots.

In recent years, some relatively comprehensive estimates have concluded that granting an urban *hukou* to a typical migrant worker (including his or her dependents) will incur lifetime public expenditures of approximately 100,000 yuan (\$16,287) based on 2010 constant prices.⁸ This includes the major public welfare benefits and services: compulsory education, cooperative medical care, pension insurance, and other social security (such as subsistence allowance), as well as costs for city management and social housing.

Some media reports state that if the entire existing urban floating population of 230 million were assigned urban *hukou*, the total cost would be 23 trillion yuan (\$4 trillion),

an astronomical figure that China obviously could not afford.

But that arithmetic is flawed because it simply multiplies 100,000 yuan by 230 million. The 100,000 yuan in services for granting an urban *hukou* to one member of the floating population would not be spent in a year, but rather over a lifetime (approximately 40 years). That is,

the 100,000 yuan will be distributed over 40 years, which, based on a linear distribution, amounts to an average of 2,500 yuan (\$400) annually (in 2010 constant prices).⁹

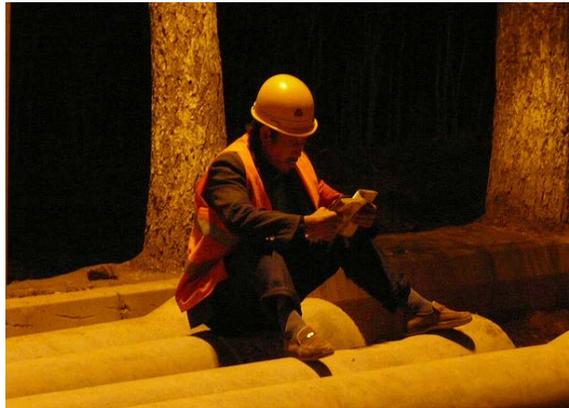


Photo: World Bank

So if, on average, 20 million people are given urban *hukou* each year, the total cost would be 50 billion yuan (in 2010 constant prices) per year, or 0.1 percent of China's current GDP. This ratio would increase incrementally each year—by the fifteenth year, the cost would amount to 1.5 percent of GDP—but these are costs that China should be able to bear.

However, these costs represent only the public expenditures, and thus do not account for the public revenue that would be generated by the

floating population through taxes and other channels of contribution. A healthy, well-designed public services system would be one financed by taxes of the users. In the long run, expenditures and revenue should offset one another.

The majority of the floating population is relatively young, thus the urban welfare required by them in the short term would not be much, and would mainly consist of some migrants requiring social housing, especially after marriage. In the medium term, the main service required by these migrants who have converted to holding urban *hukou* would be public education for their children. The largest expenditure, social security, including pensions and healthcare, would primarily be a cost over the longer term after 2030. So in the initial phase, urbanized members of the floating population would be net contributors, via taxes and other contributions, to public finance rather than net beneficiaries. Put differently, if only the first 15 years of the *hukou* reform plan are considered, expenditures for urbanization will not be as high as some predict. Urbanized members of the floating population will be net contributors—that is, the revenue they generate would exceed expenditures.¹⁰

At present, the urban *hukou* population, especially in very large cities, is aging rapidly, and under China's current pay-as-

you-go system for pensions and healthcare, the younger floating population's contributions to welfare could help to plug the urban public finance gap created by the aging of an urban *hukou* population. Under this proposed reform plan, in the initial stage, because mainly highly educated and higher-income groups are given *hukou*, their contributions to urban public finances should be even greater. In short, the public burden from more comprehensive *hukou* reform in the near term will not be as heavy as many predict.

But there is more to the case for *hukou* reform than just the issue of public

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spending burdens. Although the “costs” of urbanization should, of course, be considered, the enormous economic

dividends of *hukou* reform are equally significant.

When a migrant worker works in the city, the value of his or her output generated will be far more than the costs of public services. And the output will be far in excess of the costs of urbanization and workers' wages. In general, if China's floating population had local urban *hukou*, they would have the right to fully participate in urban public affairs, and to enjoy what other urban residents do with regard to choice of work, opportunity to play to their own strengths, and greater security and fewer worries. These would greatly improve productivity and boost domestic consumption

and demand, setting into motion a virtuous “urbanization-economic growth” cycle.

Meanwhile, a recent quantitative study by the Institute of Population and Labor Economics¹¹ notes that *hukou* reform will result in freer movement of labor, an expansion of the size of the labor market, more specialization of labor, and a substantial increase in the total factor productivity of the urban economy. This study estimates that if 17 million people are granted an urban *hukou* each year, the resulting economic net gains would be considerable. Between 2015 and 2020, the annual net economic gains would amount to approximately 1.6 to 2 percent of GDP, equivalent to several times and up to dozens of times the costs of urbanization over the same period.

There are also other indirect, hard-to-quantify benefits. For instance, receiving an urban *hukou* will stabilize the expectations of residency of a migrant. This will enable him or her to gradually transfer the unused residential land and arable land in rural areas, in turn, greatly improving the utilization efficiency of such land for production and residence. This is especially important for China, where land is scarce.

This is also the logic behind why proper urbanization will produce a net profit and promote economic

and social development. This is different from certain urbanization in some Latin American countries, where migrant workers enter the city but cannot find a job, resulting in urban blight and other challenges. Looking at a longer time horizon, human beings have progressed on the path of urbanization for more than 200 years. Of course there are problems, but overall, urbanization—the transformation of the rural population into an urban population—has resulted in greater productivity, higher quality-of-life, and a more promising future for mankind.¹²

But over the past 60 years, China has been travelling down a somewhat different road, pursuing an “incomplete” urbanization and focusing too heavily on the short-term benefits of industrialization and stressing the “costs” of urbanization, while ignoring the interests of rural citizens as well as the long-term interests of China’s people as a whole.¹³

Presently, a major source of resistance to *hukou* reform is local governments. Local governments, fixated on expanding business (since enterprise taxes are a major source of local finances) and pursuing short-term boosts to GDP, view the welfare of the floating population merely as a “cost” that should be written off as much as possible.

But the current *hukou* system (as well as the broader urban-rural dual structure) has produced a large army of “second-class citizens.” They have provided cheap labor that is crucial to China’s continued growth of production and GDP. However, this approach has also generated a large “debt” in terms of social welfare. Moreover, the current system

allows local governments to legally expropriate the land from farmers cheaply and in turn to siphon off large amounts of land revenue. Further, and as noted above, another source of resistance to *hukou* reform comes from some who have overestimated the fiscal costs of urbanization. These sources of resistance to *hukou* reform can be mitigated and managed.

Next Steps in *Hukou* Reform

China's current *hukou* system not only divides people into different classes, causing social inequality, but is also completely incompatible with the market economy that China is establishing, as the system hinders the free movement of labor and severely reduces economic efficiency.

In setting up a market economy, China also needs to simultaneously protect social equality. Eventually, China should aim to be a country where the population can move freely, with place of residence and *hukou* registration determined by individual choices.

As an essential component of the workforce, members of the floating population cannot be forever adrift. This memo sets a concrete but realistic timetable to complete *hukou*

reform within 15 years: By 2030, the *hukou* issue could be resolved for all members of the floating population. By 2031, *hukou* registration would be completely open, so that China would be in the same situation as the vast majority of other countries in the world—that is, people would be able to move and settle down freely throughout the country, and the absurd phenomenon of Chinese people who are legally considered to be members of an “outside”

population within their own country would no longer exist.

Such reforms would be carried out in two steps. The first step focuses on granting local *hukou* to non-local university graduates, professional and technical personnel, and business managers. Then, in the second step, local *hukou* would be granted to other groups, mainly migrant laborers, in a gradual and orderly manner so that eventually all members of the floating population have urban *hukou*.

Such an approach is similar to China's current policy, but the pace of opening would be much faster. More important than just speed is the comprehensive

nature of the proposed approach: all cities and towns should undertake to open *hukou*

registration. And this is especially the case for large cities, which should take on a greater role in the reform plan.

Hukou Reform Targets, Sequence, and Specific Measures

How might the government achieve this?

Rough projections show the floating population will reach about 300 million by 2030. Granting urban *hukous* to 300 million people over 15 years amounts

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to covering approximately 20 million people annually, or about twice the rate in the government's current proposal.

Opening *hukou* registration in this way would enable the government to tackle the easier cases first and difficult cases later. For example, in the first phase of reform (2016-2020), urban *hukou* could be granted to more straightforward cases, such as university (including junior college) graduates, technicians (including skilled workers), and business managers (as well as spouses and children living with them). By focusing on these groups, the objective would be to resolve the *hukou* issue for 100 million people in a class of the floating population who can readily contribute to economic growth in cities.

Some large cities in China already have experience with granting *hukou* to university graduates and professionals. So implementation could simply be accelerated without much difficulty. Meanwhile, during this initial phase, planning for the next phase (2021-2030) would continue. In the second phase, efforts would be focused on resolving the *hukou* issue for other migrant groups. Such a sequence of action should be in line with China's financial situation and public expectations.

Why begin with university graduates? Simply put, university graduates are an

important source of human capital, major contributors to economic productivity and growth, and thus should be prioritized. In the United States, many state (and city) governments and companies recognize that developing a high-value local economy requires a large number of university graduates. Retaining local graduates, attracting university graduates from other states with work opportunities, and recruiting some qualified foreigners who have graduated from US universities, are all important and relatively common American policies. Indeed, young

university graduates also represent a major source of the American middle class.

But in China, due to *hukou* problems, the majority of the more than 10 million non-local university graduates—such as those referred to in Chinese as being part of an “ant tribe” (*yizu*) in very large cities—often struggle at the fringes of urban society. It is difficult, for example, for them to set up a family and live a stable life in cities, which in turn greatly dampens their morale and restricts such graduates from assuming productive roles within urban communities. Specifically, due to the long period of “ant tribe” status before an urban *hukou* can be acquired, they cannot truly join the consumer class.

It is quite obvious that granting young university graduates an urban *hukou* would be mutually beneficial for all parties in China. Because university

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graduates are major tax contributors to social welfare expenditure, the opening of *hukou* registration to non-local university graduates so that they can settle should result in tangible social and economic benefits. Such measures for the more educated should be implemented as quickly as possible.

However, until now, the requirements for obtaining a *hukou* for non-local university graduates, such as in Shanghai's residence point-based system and Dongguan's point-based *hukou* granting system, have been set too high. And this has meant that the number of people newly registered annually is very limited (only several hundred to several thousand).

Relative to the more than 100,000 non-local university graduates that live in each very large Chinese city, such measures are truly inadequate. Only Shenzhen, in the last two years, has put significant efforts behind *hukou* reform. Through a point-based *hukou* granting system, Shenzhen gave urban *hukou* to more than 100,000 university graduates in 2012, and to a similarly sizeable number in 2013.

The key to *hukou* reform is to gradually lower the thresholds so that some migrant workers can be granted urban *hukou* as quickly as possible. The logic and rationale for granting *hukou* to university graduates are basically also applicable to policies for skilled migrant workers. For China to move up the value

chain in its industries, large numbers of educated, highly skilled personnel, as well as technical personnel with the ability to operate high-tech equipment, are urgently needed. Employers need these people and want to retain them. These are workers who can earn higher wages and also have the capacity to pay for urban social welfare through taxes and other methods of contribution. So urbanizing them is basically also a win-win situation for the employers and employees.

Conferring urban *hukou* to skilled migrant workers will also send a strong message to large numbers of migrant workers to learn to become skilled workers. Put simply, this will effectively incentivize workers who do not yet have *hukou* to invest in themselves so that they can work towards obtaining an urban *hukou* in the near future. In the long term, this will help raise the overall technical proficiency of Chinese workers and benefit China.

Specific measures in this category could include the following:

First, the central government should clearly define the scope of the three groups of the floating population specified above, so that local implementation can be carried out accordingly. Then, each city should develop a plan to grant *hukou* to these three groups over the next five years based on census population data, supplemented by surveys and estimates.

The plan would be broken into annual plans for implementation. With regard to method of operation, the point-based *hukou* granting system currently used in certain cities can be extended.¹⁴ This method is relatively flexible since it allows qualifications for *hukou* to be adjusted each year as needed. For example, those who have resided locally for many years can be given priority over newcomers.

Under this scenario, beginning in 2021, *hukou* registration would basically be totally open for the three groups named above. These three groups are mostly concentrated in

large cities of more than 3 or 4 million, and especially in very large cities of more than 5 million. Therefore, these very large cities should play a more substantial role in offering *hukou*. In line with their proportion in the urban population, these very large cities should absorb more people and not close the door on *hukou* registration. As a strategy to jump-start the *hukou* reform program, China may give precedence to opening *hukou* registration in the second-tier of its large cities (see Table 1).

Beginning in 2021, China could then begin to turn to the *hukou* issue for the

Table 1. Population Growth Rates by City Size, 2000-2010

Cities Based on “Urban Population” in 2000*	No. of Cities	Weighted Mean (%)		Median (%)	
		10-Year Growth Rate	Average Annual Growth Rate	10-Year Growth Rate	Annual Growth Rate
First Tier**	4	51.8	4.3	55.0	4.5
3-6 Million	11	43.0	3.6	40.7	3.5
2-3 Million	10	38.2	3.3	37.4	3.2
1-2 Million	36	53.4	4.4	37.6	3.2
National	653 cities and 19,410 towns	45.0	3.8	NA	NA

*“Urban population” refers to the de facto population in the urban areas (as defined by National Bureau of Statistics) in the city districts of a city. Based on that definition, for example, the urban population of Shanghai was 13.46 million in 2000 and 20.22 million in 2010. For a detailed explanation of this definition and its usage, see Chan (2007). To maintain comparability, the population size of some cities in 2000 has been adjusted to reflect merges of cities between 2000 and 2010. For example, the population of Foshan in 2000 includes those of Shunde, Sanshui, and Nanhai.

**refers to Shanghai, Beijing, Guangzhou and Shenzhen.

Source: 2000 and 2010 Censuses.

remaining 200 million migrant laborers (and their family members).

By that time, due to the overall higher education level of the population, the self-effort of migrant workers, as well as a smaller cohort of younger people as the population ages, the number of unskilled workers with low education levels will greatly decrease. With China's growing economic strength in the next ten years, the government would be able to put more financial resources behind achieving greater social equity.

In this way, favorable conditions can be created for resolving the *hukou* issue for ordinary migrant workers and providing welfare to low-income workers.

In the point-based system for granting *hukou* to ordinary migrant workers, one year of stable employment could be taken as a basic condition. In the beginning, due to the very large numbers of ordinary migrants in this category, other conditions could be added—such as the length of time of residence in a given locality, education level, and work experience—so as to allow the issue to be resolved in an orderly fashion.

In later stages, these conditions could be gradually loosened—for example, employment and residence for six months could become the prerequisite

for obtaining a *hukou*. Of course, after 2030, once *hukou* registration is open, this condition can be lowered to three months. Specific methods of operation will still need to be further designed and refined over the next three or four years.

Opening Hukou Restrictions in Large, Medium-Sized, and Small Cities

Presently, the specific *hukou* policy measures stipulated in the Opinions is to “open small cities and control big cities”—that is, to lift immediately *hukou* restrictions in towns and small cities, lift *hukou* restrictions gradually in medium-sized cities, and to strictly control *hukou* registration conditions in large cities and very large cities. This approach is informed by a longstanding

misreading that such policies represent a path of “urbanization with Chinese characteristics,” which will allow China to avoid the “urban diseases” of blight and slums.

To the contrary, this strict policy follows rather than breaks from the early 1980s policy of “controlling the population of large cities” and the outdated pre-reform policy of controlling the growth of large cities. Such a policy is not based on the actual pattern of population migration in China.

The fact is, after more than 30 years, China's investments are still primarily

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skewed toward large cities, resulting in their faster development. The majority of the floating population has not followed the official policy and moved to small cities and towns. Instead, they moved to large cities anyway in response to job opportunities, even though the members of this floating population have not, as a consequence of their choice, been able to receive most of the social welfare and services in large cities because they lack urban *hukou*.

In recent years, *hukou* registration policies have already been loosened in many small and medium-sized cities, but such a loosening has not actually attracted many migrant workers. And this is mainly because the capacity of small and medium-sized cities to absorb employment is limited.

So there is no connection between *hukou* policies and the movement of migrants. Moreover, under current circumstances, where local finances depend primarily on land revenues, local governments lack the capacity to develop small cities and towns, because the land in those areas does not sell for a high price. It is well known that over the last two years, many newly built apartments in these second-tier and third-tier cities have remained vacant.

The population statistics of China's cities are complicated and confusing. Many people misunderstand them and make a number of errors.¹⁵ Based on my many years of research, under

present circumstances, the “urban population” (*chengzhen renkou*) used by China's National Bureau of Statistics in each city administrative region can generally represent the *functional* urban population.¹⁶ Table 1 displays the central tendencies (mean and median) of population growth rates for different groups of cities based on data from China's 2000 and 2010 censuses. Because variations in the growth rates of small cities are considerable, the median is a better indicator than the mean to show the “average” trends of the growth rates.

The data show that in the period 2000-2010, the median growth rates of the urban population of China's cities have been correlated with city size. In other words, first-tier cities (China's largest) grew the fastest.

This trend is likely to continue over the next 20-30 years because agglomeration in very large cities will continue to be an important driving force in economic development. For this reason, the key to *hukou* reform is to open the door to *hukou* registration in very large cities.

The rapid growth of China's very large cities can be attributed not just to policy factors but also to the fact that in China's current phase of development, agglomeration economies will favor the very large cities. Agglomeration brings many benefits and reduces business transaction costs, a point that has been widely accepted by economists.¹⁷

In addition, many scholars studying China's urban economy believe that the number of very large Chinese cities is too few, not too many.¹⁸ China's expanding service industries also benefit greatly from agglomeration economies in very large cities. These cities are the centers of wealth because they are hubs of scientific and technological development and finance. This is yet another reason why rational urbanization and urban development promotes economic development.

Agglomeration in very large cities has been an important driving force of Chinese economic development over the last 30 years. And China's urban development will continue along this road in the next 20 years. For example, further development of tertiary industries will no doubt be tied to further agglomeration in very large cities and a corresponding decline in some small cities and towns. Land in China is scarce, so urban development will have to be of high density.

This compact urban development model is also more compatible with China's pursuit of low-carbon development. And to provide public services to large numbers of the low-income floating population, it is also necessary to

focus on lowering unit cost through economies of scale. Small cities are simply not a good choice for this.

Ultimately, the agent for achieving agglomeration effects should be the market, not the government—in other words, companies and urban and rural residents, rather than government policies, should be the driver. That is, because officials do not possess all the relevant information, they do not know which companies do better in large or

small cities and thus where they should be located. Nor can officials know if a certain migrant is “better” situated in a large or small city for the simple reason that the specific conditions of each individual are different.



Photo: World Bank/Freedom House

In the end, such decisions should be left to companies and workers themselves based on market conditions, not determined by an across-the-board policy to control the population of very large cities and encourage migrant workers to settle in small cities.

Today, very large Chinese cities such as Beijing, Shanghai, and Guangzhou experience a host of urban problems, including serious traffic congestion and housing shortages. The main reason for these problems is not because of

their large populations but because of poor urban planning, ineffective use of space, inequitable distribution of housing (e.g., many people own multiple units), unreasonable prices for public facilities,¹⁹ and other factors.

There are also some who believe that the populations of the very large cities have already exceeded their carrying capacity, and thus more *hukou* cannot be granted there. In fact, the carrying capacity of cities should not be based on the static capacity of natural resources

such as water. A more important factor is the carrying capacity of social infrastructure, which is ultimately a question about financial resources: who provides them, who uses them, and who pays for them.

Consider, for example, that although Beijing's land area is three times as large as Tokyo's, Beijing's population is only two-thirds that of Tokyo.²⁰ Beijing's GDP is one-tenth of Tokyo's, and yet Beijing's urban problems are far more serious than those of Tokyo. This illustrates that natural resources are not the most important factor in determining the capacity of large cities. In fact, high-density urban development of very large cities enables greater economies in using natural resources.

What turns out to be a more important factor in explaining the serious

congestion in these very large cities is the lack of consideration and provision in urban planning and supply of social services for migrants (such as housing, transportation, and children's education) over the last two to three decades. All along, the floating population has been treated as merely a temporary workforce.

But even if floaters are temporary workers, they are still human beings who need to live their lives (even if their needs are modest). When the floating population finally rises to

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account for one-third of a city's total population (as is the case in Beijing, Shanghai, and Guangzhou), or even

more than one-third (as in Shenzhen) today, then long-term neglect naturally yields serious problems such as overcrowding and congestion.

The central problem these cities face is not a lack of land or water per se, but rather a huge debt in the supply of social services for the migrants.

It is essential, therefore, that *hukou* reform be carried out in all cities, irrespective of size, including very large cities such as Beijing, Shanghai, and Shenzhen. That is because very large cities are the places where the majority of China's floating population (including a large number of non-local university graduates) is concentrated and where work is most readily available.

Ultimately, this means that very large cities can make greater contributions to *hukou* reform than is the case under current government plans. Considering, however, that the current pressure of supplying public services in first-tier cities are considerable—and since population carrying capacity cannot be drastically expanded in the short term—launching *hukou* reform in very large cities that are not in the first tier could be a temporary measure to help generate momentum. But this would broaden current efforts beyond only medium-sized and small cities, and thus be a way of breaking ground on a more comprehensive reform of the *hukou* system.

Such very large but second-tier cities include Wuhan, Chongqing, Chengdu, Xi'an, Dalian, and Zhengzhou. These

second-tier cities enjoy the benefits brought about by the agglomeration economies of very large cities. And at the same time, they have the ability to accommodate and attract large numbers of people who are immediate targets for *hukou* reform.

For purposes of comparison: the urban population in the United States is about 250 million; the country has two “megacities” (metropolitan areas with a population of at least 10 million).²¹ Japan’s urban population is 110 million but also has two megacities. The urban population in China is about three times that of the United States, and can certainly accommodate six to seven megacities. But at present, there are only four.

Other Supporting Measures

Hukou reform is a large-scale, highly complex project, which requires coordination among many different components and agencies of government.

Role of the Central Government

Since *hukou* reform requires a comprehensive development strategy, strong leadership and overall coordination from the central government are needed. For instance, the further development of China's economy will depend on having a single domestic labor market and consumer market. And the task of establishing the underlying conditions for a unified, free domestic market is clearly a responsibility of the central government. And *hukou* reform is pivotal to this.

Again for purposes of comparison, consider the United States. The strength of the American economy has depended, for more than a century, on the federal government's efforts to combat local economic protectionism and create a domestic market in the United States within which both labor and capital can flow freely. Applying this logic to China, the central government would need to play a strong role in promoting

and coordinating national *hukou* policies, integrating specific measures across provincial lines, actively promoting reform and supervising implementation, and developing regulatory mechanisms in a timely fashion.

Hukou reform requires breaking through the limitations imposed by regional administrative boundaries so that migrant workers from one province can obtain *hukou* across provincial lines when they move. A large set of the current issues involved with granting *hukou* to the floating population is about general social welfare (such as public housing, education, social security, and land). Another set is about the sharing of fiscal resources and responsibilities between the central government and local governments. These two sets of issues urgently need the leadership of the central government.

Indeed, this challenge will only grow as China continues to develop its market economy with increased labor mobility. *Hukou* reform will inevitably need to take place across multiple localities, involving the complicated issue of sharing responsibilities and authorities among different local governments.

Since hukou reform requires a comprehensive development strategy, strong leadership and overall coordination from the central government are needed.

The central government should establish a *hukou* reform governing body. This may be a sub-agency of the National Development and Reform Commission (NDRC) and would have the power and responsibility to specifically focus on implementing *hukou* reforms.

Adjusting Local Tax Structure

Local governments are a major source of resistance to *hukou* reform, quite simply because the burden of paying for social services has primarily fallen on them. China's local governments depend principally on enterprise taxes, land sales, and debt finance (often through unofficial local finance vehicles). In short, local governments have not established a sustainable municipal finance system that is commensurate with population growth and a market economy.²²

Despite the rapid pace of China's urban development, large numbers of migrants have been excluded from the urban social services system. To keep pace with granting *hukou* to migrants, then, spending on local social services would need to be increased, which requires matching revenues.

As examined above, some social services involve general social welfare, such as compulsory education and retirement security. These would be best financed through fiscal transfers at the national or provincial level.

The other part of social services involves mostly local services, which can be mainly financed through local taxes on households, such as income, sales, and property taxes. These should be expanded in China to generate more revenue, so that those receiving services will also contribute to local revenue streams. For example, the property tax pilot program currently being carried out in two cities, Shanghai and Chongqing, can be expanded to many more.

Over the next twenty years, the majority of China's floating population will become new members of the urban workforce, consumers, and homebuyers, so they will also become new sources of income, sales, and property tax revenue. The crux of local tax reform is to create a tax base that grows with population. This way, expenditures on social services and revenues can expand in parallel to achieve fiscal sustainability at the local level.

Reform of the Agricultural Land Transfer System

Further urbanization in China will definitely require an increase in urban land, and this, in turn, will primarily be achieved by converting agricultural land to non-agricultural use.

After members of the rural population move to the urban areas, the agricultural land they leave behind

should be transferred to increase utilization efficiency. But in today's China, such transfers, and especially transfers into the market, present complicated issues of how to distribute revenue from land value appreciation and protect the interests of the rural population. Indeed, there are inherent defects in China's existing rural land property rights arrangements, mainly the ambiguity of collective ownership, which easily lends itself to abuse.

It was decided at the Third Plenum of the 17th Congress of the Chinese Communist Party in 2008 that China would gradually develop a unified rural-urban land market. This

was reaffirmed at the Third Plenum of the 18th Congress of the Chinese Communist Party in 2013. The latter Plenum further stipulated that collective construction land could enter the market.

But how should "collective land" be defined? There is widespread debate and discussion of this issue in China, but the general consensus has been to reform the current rural land expropriation system to allow the rural population to put collective construction land into the market. This should result in the same rights and prices for urban and rural land, hence protecting the interests of the rural population.



Photo: World Bank

This measure could be more easily implemented in developed areas, where the rural population can benefit from the protection of a better developed legal system and a greater general awareness of their rights. But in less developed rural areas, due to their inadequate legal system, it would be hard to ensure reasonable compensation for rural land transfer. Once members of the rural population lose their land, it can mean

forfeiting their livelihood, posing serious financial risks to themselves and society.

In the next stage of reform, then, China will need to turn to the question of how fair compensation and protection can

be provided after members of the rural population leave their land. This will be a critical issue in rural land reform.

Establishing a Unified Urban and Rural Social Welfare System

The basic problem of inequality of social services and opportunity created by the *hukou* system lies in the urban-rural dual social structure set up in the 1950s. To solve this problem, China needs to reestablish a unified society such that every citizen would have equal and reasonable access to social goods, including public education for children in cities where their parents work.

Currently, citizens of China's large cities enjoy better public welfare and services. And that is precisely why large-city *hukou* carry more value. Since very large cities have first-class education, healthcare, and other resources, as well as very high college admission rates, it is no surprise that so many Chinese, no matter where they are born, want to obtain *hukou* in these cities.

Rebalancing basic public services so that comparable services exist more equally in different locations, including smaller cities, will change incentives to migrate. Put differently: if the welfare, education, and healthcare services available in small cities are also improved, some migrants may be willing to move there instead of going to the biggest cities. For instance, it is conceivable that some retirees may find it attractive to go to small cities because of lower housing prices and better air quality, instead of crowding into China's big cities.

Under a unified rural-urban social welfare system, people would have the

right to move anywhere in the country for work or business, or to be with their children. One would only need to stay for three months (or six months) to qualify for a local *hukou*. Under that condition, the freedom for individuals to change their place of residence in accordance with changes in family life cycle or in employment would be greatly expanded. Only in this way can China develop a productive economy that allocates human resources efficiently. And China would also be a fairer society characterized by relatively equitable opportunity.

The Opinions has already outlined some of the related and subsidiary measures for a comprehensive *hukou* reform. These include developing a nationwide, unified basic pension insurance system for both urban and rural residents; a unified medical assistance system; the protection of equal education rights for migrant children; and a nationwide, unified *hukou* system for both urban and rural areas. These are important first steps, but they aren't sufficient.

Conclusion

This policy memorandum provides a preliminary sketch of the objectives, principles, and steps needed for comprehensive *hukou* reform. To be sure, many specific technical details must be worked out. But through a gradual yet still comprehensive approach, the vicious trend of an increasing gap between the urban resident population and the official urban *hukou* population could be reversed.

China's central government has well recognized the *hukou* problem. Yet it needs to have a roadmap that gets the two populations to converge over, say, 15 years, thus becoming a more unified and true urban population.

As in other countries, citizens anywhere in China should ultimately no longer be classified as "having a *hukou*" or "not having a *hukou*," but should be able to enjoy what former Premier Wen Jiabao, in his 2013 report to China's National People's Congress, called "freedom of movement and a satisfactory way of life for all citizens."²³

From 2016 to 2030, each year's difference between the urban resident population and the urban *hukou* population (or the floating

population) can be used as an indicator of overall progress toward comprehensive *hukou* reform. China's central government has already resolved to undertake comprehensive *hukou* reform but the pace remains too slow.

To summarize: This memo proposes a two-step *hukou* reform. The first step is to take a groundbreaking leap forward and commit to resolve

Through a more comprehensive hukou reform, the urban floating population can be converted into a productive resource for China's economic future.

the *hukou* issue within five years for the three groups mentioned above (most notably university graduates),

by opening the *hukou* door in China's very large cities, but especially its second-tier ones. In the second step, after 2020, the government would move on to resolve the *hukou* issue for other groups.

To date, China has spent almost two decades in talking about *hukou* reform, but little has been achieved. There is no time to waste. If *hukou* reform is successful, both the urban floating population and China as a whole will benefit. Through a more comprehensive *hukou* reform, the urban floating population can be converted into a productive resource for China's economic future—an engine that powers the next round of the country's economic development.

Affirmative movement toward the complete abolition of the class differences brought about by the *hukou* system will not only pay dividends for China's economy and help perpetuate the Chinese

“economic miracle,” but also establish a fairer society and a modern nation. That is critical if China is to realize what President Xi Jinping has termed the “Chinese dream.”

Endnotes

¹ Chan, Kam Wing, 2012. “Crossing the 50 Percent Population Rubicon: Can China Urbanize to Prosperity?” *Eurasian Geography and Economics*, Vo1.53, No.1, pp.63-86.

² Estimates based on China’s Population Census in 2010.

³ Chan, Kam Wing, 2013. “An Investigation of the Path to Hukou Reform,” ed. Cai Fang, Reports on China’s Population and Labor, No. 14, pp. 111-125.

⁴ In this memo “large city” generally refers to a city with a population of more than one million, and includes “very large cities” (those with a population of more than five million). The State Council recently referred to a “very large city” as a city with an urban population of more than five million (State Council, “Opinions on Further Promoting the Reform of the Hukou System,” July 30, 2014).

⁵ Xie Lingli, Lu Gui, 2008. *Population Development in Shanghai Toward an International Metropolis* (in Chinese), Shanghai People’s Publishing House. *Beijing – 60 Years, 1949-2009* (in Chinese), China Statistics Press, 2010, Table 5-4.

⁶ “National New-type Urbanization Plan,” State Council. March 17, 2014. http://www.gov.cn/zhengce/2014-03/16/content_2640075.htm.

⁷ “Opinions on Further Promoting the Reform of the Hukou System,” State Council, July 30, 2014.

⁸ These estimates come from the following Chinese sources: Investigation Group of the Ministry of Construction, 2006, “New Demands on Cities as a Result of Migration,” *Research Report on Chinese Migrant Workers*, China Yanshi Press. Chinese Academy of Sciences, Sustainable Development Strategy Study Group, 2005, “China Sustainable Development Strategy Report,” Beijing: Science Press, 2005. Zhang Guosheng, “The Urbanization of Migrant Workers Based on Social Cost Considerations: Perspectives and Policy Choices for a Developing Country in Transition,” *China Soft Science*, 2009, no. 4. China Development Research Foundation, 2010, “China Development Report 2010: China’s New Urban Strategy of Promoting Human Development.” Development Research Center of the State Council, 2011, *Urbanization of Migrant Workers*, China Development Press.

⁹ This figure is very close to the annual per capita cost of urban public services (2,211 yuan) estimated by Qu Xiaobo and Cheng Jie using municipal fiscal data. Refer to: Qu Xiaobo and Cheng Jie, “Estimates of Cost of Hukou Reform,” Forum on Urbanization of Migrant Workers and Higher-Quality Urbanization, Beijing, Aug. 16, 2013. For detailed analysis refer to: Chan, Kam Wing, 2013. “An Investigation of the Path to Hukou Reform” (in Chinese), ed. Cai Fang, Report on China’s Population and Labor, No. 14, pp. 111-125. Assuming

an interest rate of 3%, the annual average will be 4,200 yuan. However, as a ratio of GDP, the ratio would be about the same when GDP grows at the same rate as the discount rate. Since GDP would likely grow faster than the discount rate, the ratio will likely decline over time.

¹⁰The logic of the abovementioned analysis is similar to what is used in the U.S. Congressional Budget Office (CBO) analysis of revenues and expenditures that would result from legalizing undocumented immigrants. One can expect that, at least over the first two decades of granting hukou to the floating population would result in a net inflow of revenues to the public coffer, rather than a net outflow. See “CBO: Immigration Bill Would Profit U.S.,” *The Seattle Times*, June 16, 2013.

¹¹Du Yang, Cai Fang, Qu Xiaobo, Cheng Jie, 2014. “The Continuation of the Chinese Miracle: Harvesting Dividends from Reform of the Hukou System” (in Chinese), *Economic Research*, No. 8, pp. 4-13.

¹²Edward Glaeser provides an insightful discussion on this topic; refer to: *Triumph of the City*, Penguin Books, 2011.

¹³Chan, Kam Wing, “China Should Proceed Along Normal Path of Urbanization” (in Chinese), *Caixin*, 2010-12-8, <http://policy.caing.com/2010-12-08/100205422.html>.

¹⁴At present some cities employ a “residence certificate,” as a “preparatory” hukou for those who do not yet have a local hukou, and is functionally similar to a hukou. In view of simplifying the application procedures and complexity of the hukou system, this memo does not recommend using the “residence certificate”. This will save time and reduce opportunity for rent-seeking.

¹⁵Chan, Kam Wing, 2010. “China’s Current Urban Population Statistical Issues and Their Impact on Economic Analysis” (in Chinese), ed. Cai Fang, *Report on China’s Population and Labor*, No. 11 – Labor Market Challenges in the Post-Financial Crisis Period, pp. 236-247.

¹⁶Chan, Kam Wing, 2007. “Misconceptions and Complexities in the Study of China’s Cities: Definitions, Statistics, and Implications,” *Eurasian Geography and Economics*, 48(4), pp.383-412.

¹⁷Wang Xiaolu, 2010. “Developing Large Cities is Imperative” (in Chinese), *China Reform*, No. 10, <http://www.caing.com/2011-01-07/100214829.html>.

¹⁸For example: Henderson, Vernon, 2009. “Urbanization in China: Policy Issues and Options,” Report for the China Economic Research and Advisory Program. Chan, Kam Wing, 2010. “Fundamentals of China’s Urbanization and Policy,” *The China Review*, Vol. 10, No.1, pp.63-94.

¹⁹For example, a ride on Beijing’s subway only costs 2 yuan regardless of distance, which is tantamount to a free ride.

²⁰“Tokyo” refers to the Tokyo Metropolitan Area;“Beijing” refers to the entire administrative area of Beijing. See: Zhao Hong, “Taking the Pulse of Beijing’s Urban Disease” (in Chinese), *China Reform*, 2014, No. 5, <http://magazine.caixin.com/2014-04-28/100671369.html?p0>. For an analysis of the populations of large cities worldwide, refer to: Forstall, Richard L., Richard P. Greene, and James B. Pick. 2009. “Which Are the Largest? Why Lists of Major Urban Areas Vary So Greatly,” *Tijdschrift voor Economische en Sociale Geografie*, Vol.100, No.3, pp. 277-297.

²¹ US Bureau of Census, 2014. Estimates of Resident Population, Metropolitan Statistical Areas, <http://www.census.gov/population/metro/data/>.

²² Wong, Christine, 2012. “Improving China’s Municipal Finance,” Paulson Policy Memorandum, The Paulson Institute.

²³ See Wen’s speech at <http://www.chinanews.com/gn/2013/03-05/4615650.shtml>.

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Paulson Policy Memorandum

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