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ARTICLE

Groping for Stones to Cross the River versus Coordinated Policy Reforms: The Case of Two Reforms in China

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ABSTRACT China's economic transition has reached a stage where the past experimental approach is no longer sufficient. Future policy reforms need to be carried out in a holistic rather than a piecemeal manner. This paper analyzes the reforms of two related institutions in China: the household registration system and the rural land system. We argue that further institutional changes warrant national initiatives and coordinated reforms rather than merely drawing on local pilot experiences. A holistic policy package that can simultaneously promote the reforms of the household registration and the rural land system is proposed. We use fiscal simulations to illustrate the feasibility of the proposed holistic policy package.

KEY WORDS: Coordinated reforms, economic transition, urbanization, rural land system

JEL CODES: H23, H53, O18, O53, P41

1. Introduction

The market-oriented reforms launched in 1978 have dramatically changed the economic landscape of China. In the past 25 years, China has transformed itself from being a centrally planned economy to an emerging market economy whilst achieving an average growth rate of more than 9% (Lin, Cai and Li, 2003).

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China's growth has been realized through continuous reform and structural changes. These reforms and changes have included shifts from central planning to an emphasis on market processes, shifts from agriculture to manufacturing and services; and increasing efforts to open up to international trade and promote knowledge transfer (OECD, 2002). However, China's success has been puzzling to many economists in the west because it seems to defy much of the conventional wisdom. Although China has adopted many of the policies advocated by economists, such as being open to trade, foreign investment and macroeconomic stability, China's reform has proceeded for most of the past two and a half decades, without complete market liberalization, without privatization and secure private property rights, and without democratization (Qian, 2000). China's transition has often been portrayed as a gradual and experimental process, or in Deng Xiaoping's widely quoted phrase: 'Groping for Stones to Cross the River' (Lin *et al.*, 2003).

China's transition experiences are also closely linked to the debate of 'shock therapy versus gradualist' approaches in economic transition literature. While advocates of a 'shock therapy' to transition have argued for a fast and comprehensive implementation of all major reforms (Lipton and Sachs, 1990; Boycko, Shleifer and Vishny, 1995), those who are in favor of a gradualist strategy have emphasized the need for a appropriate sequencing of reforms (Dewatripont and Roland, 1992; McMillan and Naughton, 1992; Litwack and Qian, 1999). It is argued that an appropriate sequencing of reforms would provide demonstrated successes to build upon, thus creating constituencies for further reforms (Roland, 2002).

Given China's successful performance in transition relative to that of Russia, it now seems that more economists are in favor of the 'gradualist' approach. However, serious concerns have been raised about the sustainability of China's growth and of whether China can achieve a full transition if it continues to adopt an experimental reform strategy. Some would argue that China's strategy so far has been essentially one of delaying key reforms and avoiding conflicts. This may lead to an accumulation of problems that could result in financial and political crisis in the end and render a full transition impossible. Although China's growth so far has been impressive, the country is now facing serious challenges in its yet-to-be-finished economic reform. These include a highly inefficient banking system, a widening urban-rural and interregional disparity, and the lack of social security for a majority of the population. These challenges have created a host of uncertainties for China's further transition.

If transition to a market economy can be compared as crossing a river and China is still in the middle, can China ever navigate to the other side, and if so, how? Our main argument in this paper is that though some of the existing problems for China can be viewed as inevitable consequences of transition itself, many others can be attributed to the experimental and piecemeal approach adopted in the past. Therefore, for China to reach the other side of the river, further reforms must be carried out in a holistic rather than in a piecemeal way. At the same time, the government still needs to take into account the political economy in transition in further policy reforms to

minimize resistance in transition. Therefore, radical policy changes should be avoided and compensating mechanisms for the potential losers in reform need to be in place. This paper focuses on two key and inter-related institutions that need to be further rationalized in China's transition. One is the household registration system (or in Chinese term, *Hukou*) that hinders permanent migration from rural to urban areas.¹ The second is the rural collective land system that fails to secure farmers' property rights due to frequent rural land reallocation within villages and abusive land requisition in urbanization. It is argued that these policy challenges are closely related to each other, thus need to be addressed through coordinated reforms.

The rest of the paper proceeds as follows. Part 2 briefly summarizes China's reform experiences so far, argues that the experimental approach in the past, though helpful, has also generated many problems, and is now inadequate for China to achieve a full transition. Part 3 argues for an integrated reform approach by focusing on China's two reforms of the household registration system and the rural land system. After an analysis of the major policy options, we propose an integrated policy package that would simultaneously accelerate the reform of China's *Hukou* system and rural land system while at the same limiting resistance. Part 5 presents fiscal simulations under different scenarios to demonstrate the feasibility of our policy framework. Part 6 concludes.

2. Past Experiences: Groping for Stones to Cross the River

Compared to the experiences of many other transitional economies, China's transition has been described as adopting an unconventional gradualist approach (Lau, Qian and Roland, 2000; Lin *et al.*, 2003). As reform and opening up policies were introduced since the late 1970s, economic growth in both rural and urban sectors accelerated in the 1980s and early 1990s. However, no privatization was conducted until the mid 1990s and a market-oriented transition was carried out in a gradualist way. To take the 'dual-track price reform' in the 1980s as, for example, at that time China implemented gradual price liberalization. By maintaining plan contracts between enterprises at a pre-existing level, price liberalization was implemented 'at the margin' for any production beyond the planned contract. The political economy argument for such dual-track liberalization is that it is a way to liberalize prices without eliminating the preexisting rents of economic agents. Generally speaking, underlying China's reform is a series of institutional changes concerning the market, firms, and the government in the novel form of 'transitional institutions'. These institutions succeed when they

1. The *Hukou* system in China is similar to an internal passport system. A person's local 'citizenship' and residence is initially defined for a child as a birthright, traditionally by the mother's place of legal residence. Until the early 1990s, it also entitled urban people to 'grain rations'—rations of essentials such as grain and kerosene. Legal residence in a village entitles residents to land for farming and residential land for housing, and access to local health and schooling facilities in rural. To migrate permanently and be eligible for local benefits, one needs to change citizenship (Chan, 1994).

achieve two objectives at the same time: improving economic efficiency by unleashing the forces of incentives and competition on the one hand, and making the reform a win-win game and thus creating incentive attractive to those in power on the other (Qian, 2000).

Though the gradualist approach has helped China to achieve spectacular growth, it has also generated different sets of related challenges in later periods. Two examples stand out. The first, relatively well-studied set of issues is uncoordinated reforms in state owned enterprises (SOEs), social security and the financial system that have created huge non-performing loans in banks and large number of laid-off workers from SOEs. As Bai, Li, Tao and Wang (2000) have argued, because independent institutions for social safety are lacking and profit-seeking firms have little incentive to provide employment and social stability, SOEs are needed to continue their role in providing social welfare to the detriment of profitability. When SOEs are given low profit incentives, their financial performance continues to be poor. This, in turn, delays financial reforms since the state-owned banking system and the heavily regulated stock market need to be utilized to provide cheap funds for SOEs (Lardy, 1998). This is precisely what happened in China. Stronger market competition since the mid 1990s rendered many SOEs insolvent and large-scale restructuring had to begin. Since then, the state has been under huge pressure to pay for the transition costs due to these delayed reforms, including the disposal of huge non-performing loans in state banks and the social security expenditure for laid-off SOE workers. However, the sequencing of China's reforms seems to be inconsistent with what would be considered optimal from a purely economic perspective. Rather than establishing a social safety net first, China waited until the situation in state owned enterprises and state banks had deteriorated to the point of being no longer sustainable. Comprehensive social security reform started even later as a passive response to the emergence of large number of laid-off workers in SOEs.

The second, less well-studied issue is related to piecemeal reforms in China's *Hukou* system and rural land system. Under a *Hukou* system that still hinders permanent migration of labor from rural to urban and other urban biased policies, the disparity between urban-rural living standards has significantly enlarged in the past one and a half decades (Knight and Song, 1999). At the same time, rural growth and development have been undermined by a lack of secure land property rights. Owing to demographic changes within villages, frequent agricultural land reallocation has to be carried out and land tenure security has been weakened (Rozelle *et al.*, 2002). Furthermore, under a problematic legal framework of land administration, rural land tenure insecurity is undermined by state-led land requisitions in urbanization. These requisitions are leaving tens of millions of farmers under-compensated and jobless (Zhou, 2004; Han, 2005). Though these problems have attracted the interest of both academic and policy communities and have been studied independently, their linkages have not been explored and no coordinated reform approach has been proposed. The rest of the paper will analyze such linkages and propose an integrated policy framework.

3. Are Piecemeal Responses Enough? The Case of Two Reforms

3.1. Household Registration System and Rural Land System

Unfinished Hukou reform: floating population in urbanization

China's *Hukou* system has been inherited from the period of the planned economy when the country's heavy industry development strategy was not able to generate sufficient jobs in urban sectors and restrictions on rural-to-urban migration had to be imposed to reduce urban unemployment (Lin *et al.*, 2003). Though economic reforms in the past two and a half decades have witnessed a gradual loosening of labor mobility restrictions and more rural laborers have sought temporary employment in the cities, the old institutional arrangements that were part of the *Hukou* system have not been fundamentally reformed and they have remained as obstacles to permanent rural-urban migration and to movement across administrative regions.

Owing to a fast-growing urban economy from the mid 1990s, the pattern of labor mobility began to take the form of a massive floating population primarily engaged in temporary urban jobs. The 2000 Population Census shows that in 1999 there were already 121 million migrants (defined as individuals who had migrated for at least six months in the past year) in China, of which 90 million were found in urban areas and 88.4 million originated from rural areas. However, only 7% of the rural-urban migration was family migration in 2000, and an overwhelming majority of rural migrants have not obtained an urban *Hukou* (NBS, 2002).

Rural land rights: administrative reallocation and problematic requisition

In China, rural land has been collectively owned at the village level since the 1950s. With the introduction of the Household Responsibility System (HRS) in the late 1970s, agriculture shifted from a collective-based farming system to a family-based one. Under the HRS, all village members have approximately equal access to farming and residential land. All villagers, both present and future, are entitled *ex ante* to equal access to this common property resource (Putterman, 1992). For example, local cadres can take land from a household when a daughter marries away and reallocate it to a household with a newborn child. In this process, households are not typically compensated for their investments in the land. Such demographic pressures require village officials to redistribute use rights to maintain adequate consumption for all the households within a village after several years (Rozelle *et al.*, 2002).

A more serious issue in the rural land system over the past decade has been state-led land requisition in urbanization. With rapid urban expansion and rapid developments in urban land markets since the middle 1990s, rural land requisition has significantly increased in suburban areas and in places passed through by main transportation projects (roads, highways and railroads). Under China's current legal framework, land use change from a rural to an urban designation can only be carried out through government requisitions at prices unilaterally decided by local governments. According to China's Land Administration Law, the compensation for arable land

under requisition constitutes compensation for land (six to ten times of average annual land output in the past three years) plus compensation for resettlement (four to six times the average annual land output in the past three years). In practice, an expropriated farmer on average has 0.15 hectares of land before requisition and it this compensated at an amount of only CNY 5000–8000 (US\$ 620–1000) from land requisition for transportation purpose and CNY 15,000–25,000 (US\$ 20,000–30,000) from land requisition for commercial and industrial development purposes. However, when such land is leased for urban commercial use, the market values are usually three to four times or even 10 times higher (Zhou, 2004). Such expropriating practices have led to bitter complaints from dispossessed farmers and social unrest across the country (Yu, 2004).²

3.2. *Piecemeal Policy Responses so Far*

Both central and local governments in China have responded to the challenges in urbanization and in the rural land system. Starting from the mid 1990s, local reforms of the *Hukou* system have been carried out on a pilot basis (Wang, 2004). In some small towns and cities, rural migrants who own a small business began to obtain an urban *Hukou* if they satisfy certain conditions. Examples include direct cash payment for permanent urban residence permits, urban house ownership through purchase, or a specified amount of investment in the urban locality. In a few large cities, local governments have begun to lower entry barriers for permanent migration.

Realizing that frequent land reallocation and abusive land requisition can threaten economic sustainability as well as social stability, the government has taken various measures to promote land tenure security and to protect farmers' interests in urbanization. The 'Rural Land Contract Law' promulgated in 2002 stipulates that farmer's land tenure security must be maintained for at least 30 years during which period no land reallocation are to be carried out. Starting from 2003, many policy documents have been sent out to local governments requiring them to constrain their behavior and raise compensation for dispossessed farmers. Many industrial development zones and industrial parks set up by local governments have been rescinded and the land expropriated from farmers returned (Yu, 2004). The centre also plans to centralize the land requisition power to provincial and central levels by establishing a vertically controlled land administration system with tighter non-agricultural land use quotas and stronger central supervision (Zhou, 2004)

However, government responses to these challenges up to now have been piecemeal and relatively passive in nature. The *Hukou* reforms in small

2. The issue of land requisition has been exacerbated by a fiscal reform that centralized revenue without providing sufficient transfers in 1994 (World Bank, 2002). Revenue-hungry city governments have every incentive to expropriate more agricultural land and make a profit since such land revenues fall into the locally controlled extra-budgets (Zhou, 2004).

cities have met with little enthusiasm from migrants because these cities are not attractive in terms of employment opportunities and public services. At the same time, obtaining an urban *Hukou* in larger cities and across provinces is still very difficult for most rural migrants. In most large and medium sized cities, migrants need to buy a commercial house in the city and pay a large lump-sum charge for using the urban infrastructure and facilities in order to be eligible for a permanent residence card. Without this card, rural migrants and local dispossessed farmers are still mostly excluded from the urban *Hukou*-linked services provided by city governments to urban permanent residents. At present, the privileges mainly include social assistance and certain forms of housing security benefits through locally funded public housing schemes. In addition, urban residents' children also have access to subsidized public schools while migrants usually have to pay extra fees for their children's schooling in urban public schools. According to a recent survey carried out by the Ministry of Education (MOE, 2006), in most cities migrant workers need to pay an extra annual fee of CNY 1200–1600 (US\$ 150–200) for their children to attend urban primary schools; the fee to attend a junior middle school is as high as CNY 2000 (US\$ 250) per year.

Within rural villages, administrative land reallocations are still being made even though the 'Rural Land Contract Law' stipulates that farmer's land tenure security be maintained for at least 30 years. Based on our field investigations in different parts of China in recent years, this is mainly because local officials claim that the reallocations are necessary to accommodate demographic changes within village. In some rural areas where the 'Rural Land Contract Law' is more closely followed, conflicts among farmers arise because no extra land can be allocated to accommodate demographic changes within the village.

With regard to land requisition in urban expansion, the central government's reaction to further centralization in land administration has typically been one of taking remedial action wherever problems arise. Even if the current policies that tighten local land requisition quotas and raise compensation to dispossessed farmers could limit abusive land requisition in the short term, it is still unclear how such policies will last in the longer term because of the high monitoring costs. Furthermore, if compensation for land requisition is still decided by the state rather than a functioning land use change market, there will be no institutional guarantee that farmers' interests will be effectively protected. Fair compensation for dispossessed farmers will not be possible if there are no fundamental changes in the rural land system to grant farmers full ownership rights over their land and if there is no functioning land use change market in the process of urbanization.

3.3. Policy Linkages

The policy challenges discussed above, i.e., temporary migration, rural land reallocation and abusive land requisitioning, are all top priorities in Chinese government's current policy agenda. Moreover, these issues are closely related

to each other. Their linkages need to be taken into account in designing further reforms and policy responses in a coordinated manner.

- (a) Temporary migration becomes a dominant form of migration in China because there is no social assistance, accessible housing and schooling arrangements for migrants to enable them settle in cities on a permanent basis.
- (b) The lack of these urban public services makes rural migrants unwilling or unable to give up their rural land. This, in turn, makes it difficult for those left behind in rural areas to expand their scale of agricultural production and secure their land tenure since little extra land can be released to accommodate rural demographic changes.
- (c) Therefore, the key to address these issues is to establish an effective financing mechanism to enable city governments in migrant-receiving regions to provide social assistance, accessible housing as well as school services to migrants so that they would be willing to relinquish their land in rural areas. Some extra land would then be released in migrant-sending regions to enlarge farm size and to accommodate demographic changes. This would make it less necessary for rural villages to reallocate the land that is already allocated to farmers who choose to stay in agriculture.
- (d) Given that the value of agricultural land tends to increase significantly when it is converted into urban use, and that at least part of the appreciation can be attributed to urban growth and infrastructure development, mobilizing some revenue from such land value appreciation is justified. Such revenue could potentially form the financial basis for social assistance, public housing as well as school services for migrants (as well as local dispossessed farmers).
- (e) Precisely because migrant workers also contribute significantly to economic growth in the cities and thus also to the land value appreciation in urban expansion, city governments should take some responsibilities for providing basic public services to them. A faster growing city tends to have faster urban expansion and higher land value appreciation, and thus it would be able to collect higher revenue from the land value added tax. At the same time, faster economic growth tends to create more jobs and attract more migrants, thus the value added tax revenue and the expenditure of providing migrants with basic urban public services would tend to match each other.

4. Toward Coordination in *Hukou* and Rural Land Reform

4.1. Major Policy Options

Government responsibilities for migrants and expropriated farmers

In current policy debates, it is generally agreed that city governments need to expand social security and school services to migrants and local expropriated farmers. However, it is still unclear that what specifically local

government obligations ought to be and where the financial resources should come from. Some argue that long-distance migrants and local expropriated farmers, in addition to social assistance, accessible housing, and school services, should be entitled to a basic coverage of pension, unemployment insurance, and medical insurance that is already available to most urban workers (Lu, 2004). However, a key distinction needs to be drawn between social insurance and social assistance. In social insurance programs such as unemployment, medical insurance and pension, beneficiaries (and/or their employers) need to pay a designated amount to be eligible to receive corresponding program benefits, while social assistance programs are often funded by governments at local levels and program benefits are needs-based and delivered on the grounds of eligibility. A clear understanding this difference is essential for us to define government responsibility in social security provisioning. In addition, given the advantage of resource pooling at higher levels, coordinating the social insurance programs should be the responsibility of the provincial or even national government instead of the city governments. Therefore, the responsibility of city governments should concentrate on social assistance, housing security arrangements, and urban public school services for migrant workers and the local expropriated farmers.

In China, the main program in urban social assistance is the so-called 'Minimum Livelihood Guarantee Scheme' (MLGS hereafter with its coverage extended very rapidly in recent years (Ministry of Civil Affairs, 2004). Government subsidized housing programs in which low-income urban households either purchase housing at subsidized prices or receive housing with subsidized rent have already been set up in many cities. However, the MLGS and subsidized housing programs are at present limited only to urban residents who have permanent residential permits. Though the central government in 2004 mandated that local governments in migrant-receiving cities provide such access for migrants' children (State Council, 2004), no additional financial resources have been allocated for such purposes. In practice, local governments still limit school access to children from other regions.

Expanding such services to long-distance migrants and locally expropriated farmers would not pose great administrative challenges. What the government needs to do is to find the financing for such service extension.

Land privatization

In current policy debates, rural land privatization has been proposed by many scholars as the best approach to address the problems of frequent administrative land reallocation and abusive land requisitions. It is argued that weak or incomplete land rights arising from frequent land reallocation, restrictions on land rental rights, and regulations covering other land rights, weaken farmers' incentives to invest in the land (Carter and Yao, 1998). Wen (2004) further argues that land privatization would make it possible for migrating farmers to sell their land before they leave for the cities, and that the income from land sales would facilitate a smoother transition to urban

communities. It would also help those who stay in agriculture to expand their operations in farming and to realize economies of scale, which is especially important for farmers to increase their income. Furthermore, privatized lands would serve as collateral in obtaining loans from local banks and credit cooperatives.

However, the distributional impacts and political feasibility of land privatization need to be considered in further policy moves. For most migrant-sending regions, the people who migrate out to cities and coastal regions on average earn a much higher income than those who stay. Land privatization implies that these migrants would enjoy the monetary benefits from their privatized land ownership, and that with the relatively low-income left over, farmers would have to buy or rent land from the migrant workers. More importantly, in further reforms of the rural land system, a realistic question to ask is the political feasibility of land privatization. At least in the short run, land privatization is politically unacceptable to the ruling Communist Party because not only is it inconsistent with the official ideology of the Party, but also it has the potential to destroy the Party's power base in rural areas. Therefore, it would be best if an alternative policy package could be proposed with no negative efficiency consequences, while at the same time in favor of income distribution.

4.2. Elements of an Integrated Policy Package

From the discussions above, an integrated policy package is needed to achieve coordination in China's *Hukou* system and rural land system reform. Such a policy reform package would incorporate several key elements that recognize the complex interrelationships between migration, the land system, and livelihoods in China's economic transition and urbanization.

First, the government would need to set up land offices in rural areas and issue permanent (or long-term) land certificates (by land slots) to farmers to consolidate farmers' legal rights in land use, transfer, and disposal. Farmers would also have the right to collateralize land certificates. These certificates could be used for bank borrowing and could be transacted freely on markets provided there was no change in land use designation from agricultural to non-agricultural purposes.

Second, city governments would define reasonable entry criteria that may vary by locality and migrant workers who reached the criteria would eligible to apply for an urban *Hukou*. For example, to apply for an urban *Hukou*, the migrant would need to have stable employment in the city for two to three years and would be able to verify that his or her monthly income in the one-year or so was at or above a certain level (CNY Y 1000, or US\$ 125). At the same time, city governments would provide the eligible migrant workers with an urban welfare package that would include basic social assistance (MLGS), a public housing subsidy, and equal treatment in their children's education. If a migrant reaches the criteria and is willing to give up his or her agricultural land on a voluntary basis, he or she would be granted an urban

Hukou, and would thus be eligible for the welfare package automatically;³ Farmers could also opt not to give up their rural land but still seek off-farm employment and live in cities. For example, some richer migrants may not need the welfare package associated with urban *Hukou*. Some farmers may also sell their land use certificates but continue to stay in the countryside, for example, in their old age.

Third, the government would reform the current land requisition system so that the rural collectives or farmers could enter land requisition markets directly and negotiate prices with land users under the condition that such land use changes would have to be carried out in accordance with local urban planning and land use regulations. Such a reform would enable the rural collectives and dispossessed farmers to reap most of the benefits from land transactions. Once the land was sold for non-agricultural uses, expropriated farmers would be granted an urban *Hukou* automatically and thus be eligible for the urban welfare package.

Finally, city governments would levy a value added tax on land transactions from agricultural use to non-agricultural commercial use. The value added would be defined as the difference between land sale/lease prices and the imputed land value for agricultural uses, and it would be allocated to the revenue pool to finance the urban welfare package for the eligible migrant farmers as well as the local expropriated farmers. The tax rate would have to be less than 100%, otherwise it would be confiscatory. We use 40% later.

4.3. Implications of the Policy Package

Rural land certificates and enforceable rural land contract law

As discussed earlier, though the newly promulgated Rural Land Contract Law stipulates farmers' land tenure be secured for at least 30 years, administrative land reallocation still takes place in many rural areas. In addition to the demographic changes within villages, a further impetus for land reallocation is the rent-seeking motives of local cadres who, for example, seek to manipulate land allocation and collect more land rents for personal benefits. Under such a circumstance, issuing land certificates directly to farmers would effectively minimize such rent-seeking by making the protection of land tenure security legally enforceable. Experiences in other developing countries such as Vietnam have shown that issuing land certificates to farmers is a cost-effective approach in property right protection (Do and Iyer, 2003).

Qualification criteria for rural migrants to obtain an urban Hukou

Some qualification criteria for urban *Hukou* are necessary to avoid the excessive rural-urban permanent migration that exceeds the urban fiscal

3. In policy design, migrant farmers may only need to give up their arable agricultural land plots exchange for the urban *Hukou*, but their residential land could in principle be kept (or fully privatized). This is because farmers' investment in rural housing is more intensive. Privatizing residential land would also reduce the potential pressure on urban social assistance system if some farmers chose to return later in their life.

capacity to finance the *Hukou*-associated welfare package.⁴ Such qualification criteria are by no means to limit any temporary migration, but are used as a screening device for migrants who are able to earn a livelihood in cities instead of relying on the urban welfare system. Setting up certain qualification criteria would not only smooth the urbanization process, but would also promote migrants' work incentives to reach the qualification criteria and obtain the urban *Hukou*. This in turn would limit expenditures on the urban welfare package.

Setting qualification criteria based on local working experiences and income levels is obviously a step forward from the current policy practices. At present, city governments usually require a migrant either to have a college certificate, to purchase commercial housing, or to make certain amount of investment. These practices have prevented most rural migrants from migrating into cities on a permanent basis, while the local working experience and income levels are much easier to achieve. More importantly, if the criteria were set in a way that they did not increase (or grow as fast as income grows), it would imply a declining barrier for potential migrants to overcome as their incomes grow.

Marketization of land requisition with value added tax

In the proposed policy package, one important component is to liberalize land requisitioning while at the same time levying a value added tax.⁵ This policy can be justified in terms of both economic efficiency and income distribution. Theoretically, the source of land value-added in rural-urban land use change can be largely attributed to the 'positive externality' generated by urban growth and infrastructure investment. Therefore, there is an economic rationale to install the tax. Moreover, rural migrants would also need to give up their agricultural land to be eligible for an urban *Hukou*. The released land would then be used to subsidize the relatively low-income farmers left behind in the migrant-sending village. Since the *Hukou*-related welfare package is financed by the proposed value added tax collected in migrant-receiving cities, it implies that the migrants who opt for an urban *Hukou* would share some benefits from urbanization-led land value appreciation. Therefore, compared to pure rural land

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4. Between 2001 and 2003, a few large cities, such as Shijiazhuang city in Hebei province and Zhengzhou City in Henan province, have experimented with bold *Hukou* reform policies that allow most migrant workers to obtain urban *Hukou*. These cities soon found local infrastructural capacity and provisioning of public services inadequate to meet the demands of new migrants and had to lift their qualification criteria again for urban *Hukou* applicants in 2004 (Wang and Liu, 2006). Such experiences not only indicate that *Hukou* reform needs to be coordinated across localities, but also show that *Hukou* reform has to be gradual.
 5. The tax is to be levied on the difference between the converted land market value in urban use and its net agricultural value. The latter would be decided by the present value of net agricultural incomes (for at least 30 years, to be consistent with the State Land Contract Law). In practice, land use changes from agricultural use to infrastructural development such as highway would not be subject to the value added tax since there is no market for such change and compensation still needs to be set by the state.

privatization, the proposed policy package would lead to a more desirable income distribution while at the same time entailing no negative impact in terms of economic efficiency. Since the proposed welfare package would be newly created and migrating farmers would have absolute autonomy in choosing between the urban welfare package and their rural land certificates, migrant who opted for the welfare package would necessarily have improved their welfare in decision-making.

Moreover, financing the urban welfare package by means of the proposed land value added tax has the advantage that it would not impose further financial pressure on China's existing urban social security system. This would make the proposed policy more resistance-proof. With faster urban expansion that can be foreseen in the coming decade, the value added tax would make significant contributions to urban public goods provision in the short or even the medium term.

5. Fiscal Simulations

In this part, fiscal simulations under different scenarios for our proposed policy package are conducted. To drive such simulations, we have to make a significant number of assumptions about revenue and expenditure. To place these assumptions on a relatively solid footing, we have collected all the data and information available in China on land price, revenue, government expenditure on social assistance, public housing, as well as basic education. A nationally representative rural labor force data survey conducted in 2002 is utilized to examine the income distribution of migrants in China, which helps to determine how many migrants per year can be absorbed into cities on a permanent basis. Experts in related fields such as land, social assistance, and education both in China and abroad have also been consulted to ensure our estimation is reasonable.

5.1. Basic Assumptions

In Table 1, we list the basic assumptions for our fiscal simulations. We estimate three alternative scenarios that differ in both the number of migrants and the number of expropriated farmers to be transferred to the cities per year. Here we focus our analysis on the baseline scenario (scenario I in the Table 1).

We first need to decide how many migrants can be taken into cities per year. This is related to the qualification criteria to be set for migrants in the urban *Hukou* application. In setting such criteria, we need to consider the number of local expropriated farmers in urbanization as well as the income distribution of migrant farmers. Given that the local farmers who forfeit their land in urban expansion have more bargaining power with local officials than migrants from other regions in China, they are the group of farmers that are likely to receive priority in obtaining an urban *Hukou*. In baseline scenario I, we assume that every year there would be about 3 million local expropriated farmers to be accommodated in the cities (roughly consistent with current annual number of dispossessed farmers).

Table 1. Assumptions for fiscal simulations. *Source:* NBS (2004), Ministry of Land Resources (2003), Ministry of Civil Affairs (2004)

I. Basic assumptions				
(1)	Duration of the Simulation: 9 years from 2006 to 2014			
(2)	Qualification criteria for migrants to obtain urban <i>Hukou</i> : above CNY Y 1000 for monthly salary			
(3)	Number of migrants to obtain urban <i>Hukou</i>	Scenario I (baseline) 4.0 m migrants +2.3 m children (2.2 m from 2009, 2.0 m from 2012)/per year	Scenario II 5.0 m migrants +2.75 m children (2.75 m from 2009, 2.5 m from 2012)/per year	Scenario III 6.0 m migrants+3.42 m children (3.3 m from 2009, 3.0 m from 2012)/per year
(4)	Land requisition scale	133,333 hectare/year	150,000 hectare/year	166,667 hectare/year
(5)	Number of expropriated farmers to obtain urban <i>Hukou</i>	2.0 m farmers + 1.0 m children/per year	2.25 m farmers + 1.13 m children/per year	2.5 m farmers + 1.25 m children/per year
II. Assumptions for revenue from the land value added tax				
(1)	Land price	Current 1.95 m CNY/hectare	2006 2.25 m CNY/hectare	Growth 10% every year
(2)	Net present value of farm land	0.225 mill CNY /hectare	0.285 mill CNY/hectare	5% every year
(3)	Average land rehabilitation cost	0.40 mill CNY/hectare	0.45 million CNY/hectare	8% every year
(4)	Land value added tax rate	n.a.	40%	
III. Assumptions for expenditure on MLSG, education and housing subsidy				
(1)	Expenditure on MLSG subsidy	Current	2006	Growth
	Policy target	All urban poor with <i>Hukou</i>	Poor migrants and expropriated farmers who obtain urban <i>Hukou</i>	
	Probability of receiving MLSG (%)	4	10	
	Months of receiving MLSG (month)	12	12	
	Monthly MLSG subsidy (CNY)	65	100	Annual increase by 120 CNY

Table 1. *Continued*

(2)	Expenditure on education			
	Policy target	Children with urban <i>Hukou</i>	Children of new migrants and expropriated farmers who obtain urban <i>Hukou</i>	
	Married rate(%)	57	57	Annual decrease by 1–3%
(3)	Annual urban education subsidy (CNY/child, year)	900–1000 in budget expenditure	1000	Annual increase by 100 CNY
	Expenditure on housing subsidy			
	Policy target	All urban poor with <i>Hukou</i>	All migrants and expropriated farmers with <i>Hukou</i>	
	Subsidized area (m ² /person)	6–12	10	Increase by 1 m ² every 2 years
	Subsidy per m ² (CNY/person, month)	6–10	10	Increase by 1 CNY every 2 years

Utilizing a national rural labor surveyed data set collected in 2000 by the Centre for Chinese Agricultural Policy (CCAP labor survey hereafter) at the Chinese Academy of Social Sciences, we are able to infer, by income group, the numbers of migrants who had off-farm employment outside their home counties for more than six months in the past year. This covers 1199 randomly selected households distributed across 60 villages in six provinces.⁶ As shown in Table 2, the number of migrants who had a monthly income over CNY 1000 (US\$ 125), between CNY 800–1000 (US\$ 100–125), between CNY 600–800 (US\$ 75–100) and CNY 400–600 (US\$ 50–75) is estimated to be 7.88 million, 6.36 million, 10.88 million and 17.58 million respectively in 2002. Since the incomes of migrants have been increasing since then, the number of migrants who earn over CNY 1000 (US\$ 125) per month can be relatively safely assumed to be around eight million at present. If every year cities can take four million migrants, those with monthly income above CNY 1000 would be absorbed into cities within two years. Given that there is still a huge surplus labor force in China, it is reasonable to assume that the lower income groups may not easily increase their monthly earnings to CNY 1000 (US\$ 125) within a short period (OECD, 2002). Therefore, an annual plan to absorb four million migrants may not be sustainable after two years unless the qualification criteria were lowered (for example CNY 800 or US\$ 100 per month). However, since there are already 20–25 million locally expropriated farmers (Han, 2005), setting the qualification (monthly salary) criteria at a relatively high level of CNY 1000 (US\$ 125) per month is still reasonable. This would allow city governments some time to take care of the already dispossessed farmers and would allow the lower-income migrant groups to catch up gradually in earnings to be qualified for an urban *Hukou*.

As assumed in Table 1, the policy package would be initiated in 2006 and our projection would last for nine years to 2014 (to match China's nine-year compulsory education period).⁷ Further assume that the market value for commercial land would be CNY 2.25 million (US\$ 281,250) per hectare in 2006 with an annual growth rate of 10% afterwards.⁸ Remember that as the tax is to be levied on the land value added from the conversion of land use from agricultural use to urban use, there is also a cost for basic infrastructure development before land sale. The net present value of agricultural land would be decided by the discounted present value of net agricultural incomes

6. For further information of the data set, please refer to De Brauw *et al.* (2002).

7. Presumably, after nine years the children of migrants and expropriated farmers who obtain the urban *Hukou* would graduate from junior middle school, which would mean no further increase of expenditure in government education.

8. The average urban land price per hectare for the years of 2000, 2001 and 2002 were CNY Y1.23 million, 1.44 million and 1.95 million respectively (Ministry of Land Resources, 2003). Therefore, the annual growth rates were 17% and 36% respectively. If we consider that the annual growth rate of the Chinese economy is generally expected to be around 8% for the next decade (Lin *et al.*, 2003), and take into account the relatively limited land endowment as well as the relatively tight government policy to protect arable land in China, an annual growth of 10% in land prices should be reasonable.

Table 2. Income distribution for long-distance long-term migrants in China. Source: CCAP Rural Labor Survey data and *China Statistical Yearbooks*

	Sample		% of total sample	National population		Income per month	Working month	Age		Education		Share of male		Share of married	
	Num			Million person		CNY	Month	Year		Year		%		%	
Total sample	348		100	58.25		602	10.3	25.2		8.0		63.2		37.9	
Income group															
Below 200 CNY	32		9.2	5.36		112	10.1	23.1		8.7		56.3		21.9	
200–400 CNY	61		17.5	10.21		290	10.6	22.7		7.0		62.3		21.3	
400–600 CNY	105		30.2	17.58		479	10.5	24.7		7.6		58.1		32.4	
600–800 CNY	65		18.7	10.88		655	9.9	26.4		7.9		63.1		47.7	
800–1000 CNY	38		10.9	6.36		850	10.8	26.2		8.7		55.3		52.6	
1000–1200 CNY	21		6.0	3.52		1046	9.8	26.7		8.7		81.0		52.4	
1200–1400 CNY	13		3.7	2.18		1230	10.4	31.3		9.1		92.3		69.2	
Above 1400 CNY	13		3.7	2.18		1921	9.7	28.8		9.9		92.3		53.8	

(for 30 years, to be consistent with the State Land Contract Law). Assume that the average net income from agricultural land use is CNY 18,000 (US\$ 2,250) per hectare in 2006 and the discounted rate is 5%, the 30-year net present value of such agricultural lands would be CNY 285,000 (US\$ 35,625) per hectare. Assume that this value would grow at an annual rate of 5% and further assume that the costs for land rehabilitation would be CNY 450,000 (US\$ 56,250) per hectare with an annual growth of 8%.⁹ Further, assume that the land value added tax rate would be set at 40%.¹⁰ As shown in Table 3, land value added tax would reach CNY 80.8 billion (US\$ 10.1 billion) in 2006, and then increase to CNY 124.6 billion (US\$ 15.6 billion) in 2010 and 190.4 billion (US\$ 23.8 billion) in 2014.

On the expenditure side, the baseline scenario assumes that every year cities would need to accommodate three million local expropriated farmers and a further four million migrant laborers in 2006. As shown in Table 3, assume that there would be one million school-age children among the three million expropriated farmers and that of the four million migrant workers, 57% would be married (consistent with the share of married migrants who work outside their home county and have a monthly income over CNY 1000 or US\$ 125 according to the CCAP rural labor force survey). Taking into account the existing demographic trends that these migrant workers tend to enter cities at a younger age and marry at an older age, we assume that between 2009 and 2011 their marriage rate would decline to 55% and further decline to 50% after 2012. Assuming that one married migrant worker would bring one child into the urban public school system, there would be 2.28 million children of migrant workers requiring school places in 2006, 2.2 million between 2009 and 2011, and 2 million after 2012. Adding the 1 million children of the local expropriated farmers, there would be 3.28 million new children that would enter urban public schools in 2006. Based on consultations with education experts in China, further assume that in 2006 the government would need to pay CNY 1000 (US\$ 125) for every school age child and that such expenditure would grow by CNY 100 (US\$ 12.5) per year up to 2014.

Next, we consider the expenditure for the social assistance system. Assume that after becoming urban residents with permanent residence permits, 10% would need social assistance. Assume that in 2006 each of them would receive a monthly assistance of CNY 100 (US\$ 12.5) for 12 months and that

9. The infrastructure development cost is decided after the authors' field investigations and consultation with land development experts in China. The annual growth of agricultural land value and of infrastructure development costs are very close to the corresponding figures in the past decade.

10. A nationally flat tax rate is assumed here because we are estimating the national average values. However, tax rates varying by localities may need to be introduced to reduce the potential intra-region revenue-expenditure imbalances coming from a mismatch between the local land value added tax revenue and the local expenditure to fund the proposed welfare package. In addition, because the market value for commercial land varies significantly across locations even within one city, a progressive value tax would need to be considered to achieve relatively compensation equity for farmers within one city.

such subsidy would grow by CNY 10 US\$ 1.25) per month every year. The expenditure for social assistance would be CNY 1.1 billion (US\$ 137.5 million) in 2006, then increase to CNY 5.8 billion (US\$ 725 million) and CNY 18 billion (US\$ 2.25 billion) in 2010 and 2014 respectively.

Finally turning to the housing subsidy, we assume that the government would provide cash subsidy based on a per capita cash subsidy of CNY 10 (US\$ 1.25) per square meter and 10 m² per month. In 2006, the cash subsidy per capita would be CNY 1200 (US \$ 150). Assume that the subsidy is provided to every migrant worker, expropriated farmer and their children, the total subsidy would be CNY 11.1 billion (US\$ 1.375 billion) in 2006, and further climb to CNY 196.4 billion (US\$ 24.5 billion) in 2014.

5.2. Fiscal Balance

As shown in Table 3, the revenue in the baseline scenario would exceed the expenditure every year before 2012 and there would be an increasing accumulation of surplus. After 2012, the current year deficit would emerge and reach CNY 72.5 billion (US\$ 9.1 billion) in 2014. However, under the assumption of an annual 5% interest rate for surplus in earlier years, there would still be an accumulated surplus of CNY 166.6 billion (US\$ 20.8 billion) by 2014.

The revenue-expenditure dynamics shown in Table III have two further very favorable implications for local public finance reform in China. At present, many local governments in China are highly dependent on the extra-budgetary revenue from land requisitions to support local infrastructure development. Installing a value added tax on land use change and annexing the tax revenue into local budgets would help to increase the transparency of the local budgeting process. More importantly, as shown in Table 3, after the value added tax revenue is classified into the local budget, there would be a significant, though declining amount of surplus during the first several years of implementation before 2009. This would enable local governments to continue to use the surplus for urban infrastructure investment (and even to accommodate the local expropriated farmers accumulated in the past), thus it would reduce the local resistance to finance the proposed welfare package. In addition, local governments would also be able to gradually introduce a property tax and draw more revenues from such a stable and increasing tax base to finance the proposed welfare package and other public service in later years.

In addition to the baseline scenario, we also estimate two alternative scenarios as shown in Table 1. In one scenario, there would be an annual land requisition of 150,000 hectares (and thus 3.375 million local expropriated farmers) and an annual inflow of migrants of 5 million. In another, there would be an annual land requisition of 166,667 hectare (and thus 3.75 million local expropriated farmers) and an annual inflow of migrants of six million. As shown in Figure 1, the accumulated fiscal balance patterns of surplus in earlier years and deficits in later years would be unchanged if we hold all other assumptions unchanged. Compared to the baseline scenario

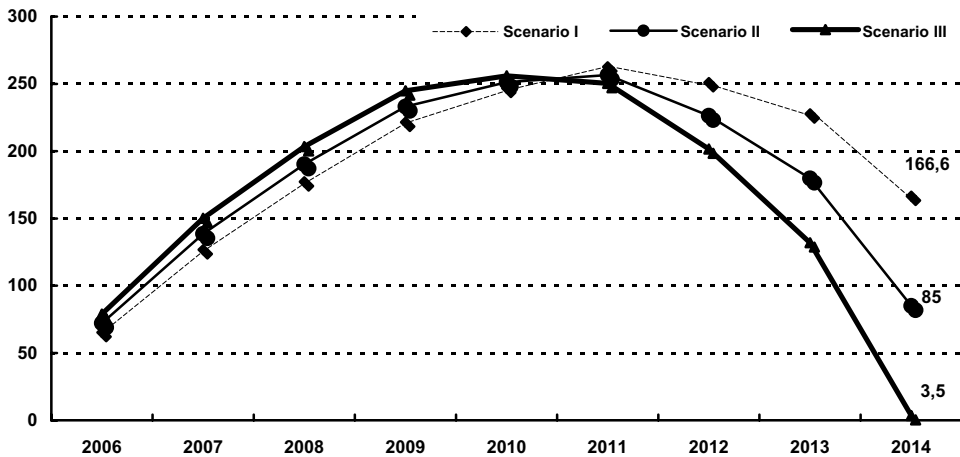


Figure 1. Accumulated fiscal balances under different scenarios.

that would generate a larger accumulated surplus of CNY 166.6 billion (US\$ 20.8 billion) by 2014, scenarios 2 and 3 would have smaller accumulated surpluses of CNY 85.0 billion (US\$ 10.6 billion) and CY 3.5 billion (US\$ 438 million) respectively. Therefore, under all scenarios and reasonable assumptions the proposed policy package would be self-financing.

5.3. Policy Impacts on Rural Land Tenure Security

In the baseline scenario, we assume that the cities would take three million local expropriated farmers, four million migrant workers, and over two million children of these migrant workers. That means that every year there would be over nine million newly urbanized farmers. With the number of migrant farmers, the impacts of such a scheme on rural land reallocation can be evaluated. In the past several years China's net annual growth in rural population has been around five million with new births of 10 million and new deaths of five million (NBS, 2004). Therefore, an annual outflow of four million migrant workers and over two million children implies that the land released by those permanent migrants and those who decease would be roughly sufficient to accommodate rural demographic change. We can still safely conclude that the proposed policy would significantly reduce the demographic pressure on administrative land reallocation.

6. Conclusion

The success of China's transition over the past two and a half decades has been praised because it has adopted an experimental approach of 'Groping for Stones to Cross the River' (Lin *et al.*, 2003). However, China's transition has reached a stage where such an approach, though still useful, is no longer

sufficient and further reforms need to be carried out in a holistic rather than a piecemeal manner.

Roland (2002) notes that there are four possible strategies for easing political constraints so that reforms can be enacted: (a) building reform packages that give compensating transfers to losers from reforms; (b) making partial reforms to reduce opposition; (c) creating institutions that make credible a commitment to compensating transfers; or (d) wait for a deterioration of the *status quo* to make the reform more attractive. In our policy package, the losers from the reforms are mainly local governments who can now expropriate farmers' land at below market prices to enhance their extra-budgetary revenue. However, if the proposed land value added tax could be installed and furthermore a property tax could be introduced to form a local tax base, it would help to 'give compensating transfers to losers from reforms' while at the same time 'creating institutions which make credible a commitment to compensating transfers.' This would be particularly helpful for promoting China's *Hukou* reform and land requisition reforms in which both central initiative and local coordination are necessary for the reforms to be pushed forward.

While an integrated approach is essential to address the serious challenges, the past reform experiences have also indicated that considerable progress is possible with sensible but imperfect institutions, and that some 'transitional institutions' could be more effective than the best practice institutions for a period of time because of the second-best principle (Qian, 2000). With regard to the rural land system and the *Hukou* system in China, successful reforms at the current stage require policy makers to utilize, rather than discard all at once, certain functions of the existing institutional arrangements. Even if the final target of such reforms is to realize free migration and full land ownership rights, the policies in the short and even medium terms ought to be oriented to lower the barriers gradually to permanent migration and to create conditions for more stable land tenure. On the one hand, such a strategy is to 'make reforms only partial to reduce opposition.' On the other hand, it would help to ease the financial constraints of the city governments in providing *Hukou*-related public services to migrants, while at the same time gradually releasing agricultural land to accommodate rural demographics. As more farmers become urbanized and rural land tenure becomes more secure, the best practice institutions would emerge more easily. China's growing urban-rural disparity and conflicts arising from the present land requisition practices, make accelerating the reform of the *Hukou* system and the rural land system necessary. Above all, China needs to avoid a situation in which it is 'waiting for a deterioration of the status quo to make the reform more attractive'.

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