

# **The strategic shift toward domestic market, service enhancement, and urban competitiveness in China**

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## **1. Accelerated urbanization: the new challenges ahead**

Market reforms and increased globalisation have accelerated urbanisation in China. The process started in the rural areas where market reforms first took place in 1978, giving rise to a rapid industrialization and urbanization of the countryside throughout the 1980s. Since the 1990s, a new wave of urbanization has emerged in which large cities, after lagging behind their rural counterparts for a long while, have re-asserted their leading positions in the national and regional economy.

Between 1995 and 2005, large and extra-large cities increased dramatically from 75 to 118, whereas small and medium-sized cities dropped from 565 to 543. Total urban built-up area expanded by nearly 60 percent, from 20,465 to 32,520 square kilometres, during the same period of time. Interestingly, this dramatic expansion of cities, especially large cities, has taken place at a time when the central government instituted in 1994 a tax-sharing system to claim a larger share of local revenue while reducing its financial input in local developmental affairs.

Urbanisation has been a major strand of the accelerated pace of economic development set off by the sequence of policies to open up and reform the Chinese economy that began at the end of 1978. Since then, two developments stand out: with the relaxing of the stringent control of population movements, Chinese peasants began to move to towns and cities in increasing numbers. Moreover, the explosive growth of rural industry that in many rural counties reduced farming to a minor income source.

With the population density already high because of a traditionally low land to population ratio, many such counties became urban except in name. Subject to administrative control, the relabelling of urbanised counties has lagged behind the actual process of urbanisation. The result is a substantial number of localities that are urban in terms of socio-economic characteristics but rural in appellation.

According to various forecasts by international organisations (United Nations, World Bank, OECD), China's urban population is likely to expand from 572 million in 2005 to 926 million in 2025. The increase in the urban population comes to 350 million, which exceeds the current population of the United States. The estimated increase in the urban population implies a new city the size of Shanghai being built each year. The principal issue is no longer slowing down the pace of urbanisation but facilitating and influencing the process so as to reduce its adverse consequences and enhance its positive impact.

The growth pattern China has experienced in the last 30 years, since the beginning of the opening up and reform policy has focused on the export of labour intensive manufactured goods. This pattern seems difficult to sustain any longer. The preference given to extensive growth although bringing in an impressive development, and a remarkable improvement of standard of living in the country has also its negative side: massive pollution and growing social disparities, especially between urban and rural residents. It seems paradoxical to sustain a pattern of development depending on cheap, labour-intensive exports, while the domestic market remains, to some extent, underdeveloped.

## **2. China's administrative definition of cities and urban residents**

The main criteria for the definition of a city in China have varied over time. In the fifties, they included the size of the permanent population; the share of the non-agricultural population. In 1955, according to the State Council: The criteria was to have a permanent population of more than 100 000 or to be the seat of a district authority with a population above 20, 000 inhabitants. However, these criteria have changed in the early '80's: new economic criteria (like the size of GDP) become part of the definition. New changes of criteria occurred again in the mid 90's. In 1993, the threshold of the non-agricultural population varied from 80,000 to 120,000 persons according to the population density. The density of the urban population is set at different levels according to three different regions: East, Centre, and West. Moreover, new indicators are set up: the size of the GDP of the urban agglomeration, per capita GDP, and the structure of industry, and the level and quality of urban infrastructure (size of paved roads, areas with running water...etc)

Therefore, a simplified typology of Chinese cities could read as follow: Central places concentrating administrative power and political influence); Networking cities prone to economic influence; and a dense web of villages, small towns, big cities, and megalopolises. However, City development and ranking in the urban hierarchy is in China strongly influenced by the administrative structure. This makes the identification of city territorial borders not easy to define. Since its inception, the city in China has been a stronghold for an administration aiming at the control over the territory of a sheer country. The ranking of cities is strongly determined by their position in the

administrative hierarchy and not by their population size or their economic relevance (Skinner, 1977; Elvin, 1973; Li Xiacong, 2005). G. William Skinner (1977) shows there are two hierarchies, the centred hierarchy of administrative cities, and the regional hierarchies of economic central places.

Moreover, a city in China is including not only urban centres, constructed areas, but also large expanses of rural areas. The rural/urban continuum is a very ancient feature of China's urbanisation. Cities in China have both a rural and an urban population. Chongqing city administrative perimeter for instance included in 2008 numerous rural districts, with a rural population representing half of the total. It covers a superficies of 82 500 km<sup>2</sup> (the equivalent of Austria) and is more populated than Romania.

There are currently three levels in the hierarchy of cities in China: 1. Provincial cities (zhixia shi) and quasi provincial cities (15 cities since 1994: Shenyang, Dalian, Changchun, Harbin, Nanjing, Hangzhou, Ningbo, Xiamen, Jinan, Qingdao, Zhuhai, Guangzhou, Shenzhen, Chengdu). 2. Prefectural cities (di jishi). 3. District cities (xian ji shi). Since territorial administration is split into four levels—Province (sheng), prefecture (diqu), county (xian) and township (xiang)— cities are linked to the jurisdiction of every administrative layers. A city under the central government authority (zhixiashi) like Shanghai or Chongqing for example, is on the same footing as a province. A prefecture level city is on the same level as a prefecture, and so on.

Under these conditions, urbanisation process in China is strongly influenced by local/central government relationships. Local governments at the sub-provincial level

have become the main providers of public services. Following the division of fiscal responsibilities between the Centre and the local levels of the administration established in China in 1994 and formalised in the Budget law (1995), the infrastructure and social welfare has been in great part transferred to the lower levels of the administration. Expenditures related to unemployment insurance, social security, welfare, are supposed to be covered by the lower levels of the administration. How to improve the performance of local governments in education, health and social welfare, while resources are constrained by fiscal decentralisation?

A major cause of the fiscal problems that lower government face is that they are allowed to run a deficit but not allowed to finance the deficit by issuing bonds. As a result, lower government tiers have to resort to off-budgetary revenues and self-raised funds generated by real estate programmes, leading to peasant expulsion from their land without adequate compensation, and in numerous case, to social unrest. Another way is the multiplication of industrial projects in the manufacturing sector. The latter option offers two immediate benefits: it boosts the GDP performance, which is an important element in cadres' career evolution, and provides significant fiscal revenues. Not to mention a wide array of fees and levies, often arbitrarily raised. At a lower level of the urban administration it also induces street offices to set up commercial or industrial ventures, whose economic efficiency can reasonably be questioned.

How to define urban residents in China is not an easy task. The United Nation World Urbanization Prospects criteria are far too simple and does not seem well adapted to the case of China. It takes into account the total number of city dwellers,

and the proportion of the population involved in non-agricultural activities and roughly assess the availability of infrastructure and public amenities.

As we have seen above, the definition of what is a city has greatly varied over time (Chan, 1994). Second, the size of urban population is expanding or shrinking according to criteria used to define it. According to Chinese statistics Bureau, urban population in China is made of 3 categories: shi zhen zong renkou (cities and townships total urban population); diqu fei nongye renkou (non agricultural population of urban areas); shiqu feinongye renkou (non agricultural population of city proper). Third, to those 3 categories of urban residents one has to add up a significant number of migrants (liudong renkou) or floating population who stay more than 6 months in a city. Their total number is difficult to measure precisely, but it was estimated in 2008 to 200 million, or 15% of China's total population.

More generally, urbanisation is a complex process which cannot be boiled down to farmer's migration to urban centres, and the continuing development of cities. Hidden drawbacks, such as blind expansion of cities, pressures on employment and social services, as well as bubbles in the real estate industry have become conspicuous in China's case. In particular, massive urbanisation will reshape the framework of central/local authorities relationship. The denomination local government which is the translation of the chinese term difang zhengfu is somehow misleading. The head of a local administrative unit (at the provincial or township level) is not elected by citizens but appointed by central authorities. As delegation of power gained momentum, the power enjoyed by local authorities is not negligible. They gradually accumulated

bargaining power in their negotiation with the centre.

Local governments at the sub-provincial level have become the main providers of public services. Following the division of fiscal responsibilities between the Centre and the local levels of the administration established in China in 1994 and formalised in the Budget law (1995), the burden of expenditures in the field of infrastructure and social welfare has been in great part transferred to the lower levels of the administration. Expenditures related to unemployment insurance, social security, welfare, are supposed to be covered by the lower levels of the administration.

The main problem derives from the fact that although local powers are allowed to run a deficit, they cannot offset it through bond issuing. Therefore, local authorities are increasingly relying on off-budgetary revenues and self-raised funds generated by real estate programmes, leading to peasant expulsion from their land without adequate compensation, and in numerous cases, to social unrest. Another way is the multiplication of industrial projects in the manufacturing sector. The latter option offers two immediate benefits: it boosts the GDP performance, which is an important element in cadres' career evolution, and provides significant fiscal revenues.

### **3. The institutional process of city creation**

#### **a. Anti-urbanism and urban growth stagnation**

It has been considered that China has exhibited in the 1950's a kind of anti-urbanism, through a policy restricting great cities and promoting the development of small towns instead of great cities as proposed by the Ministry of Construction to the State Council in 1955. In 1956, a resolution adopted by the State Council

recommended that the size of the city should not be too big for two reasons: not to overload urban infrastructures, to widen the urban/rural divide.

For decades, urban policies have in China hindered the growth of great cities, while specific institutions like hukou registration system have impeded the entrance of migrants in cities. Labour mobility restrictions for migrants in several cities under the form of specific professional interdictions, and the allocation of jobs and residences was made through bureaucratic arrangements. All these measures have resulted in a stagnation of urban growth during the period 1958-1978.

The restrictive policy kept unabated in a large part after the launching of the reforms: in 1978, 3rd national conference on cities stated that “the size of great cities has to be absolutely controlled, in order not to become mega-cities”. In 1980, the regulations regarding urban planning: restrict great cities growth, actively encourage the growth of small and medium size cities. In 1990: the motto was to strictly restrict the size of great cities, rationally develop small and medium size cities. Finally, the 10th 5YP (2001-2005) was aiming at developing townships, and promote the growth of small & medium-size cities; improve cities as regional centres.

#### b. Migration and urbanisation

While many studies (cf. WDR 2009) have found a positive correlation between internal labour mobility and economic growth, hukou registration system still hampers migration flows in China and a long lasting integration of mingong into cities. More specifically, the restrictions of rural urban migration negative in the long run: it limits density and its positive spillovers, reduces innovation and subsequently,



productivity.

A decisive driver in China's urbanisation has been the movement of hundred of millions of people from the countryside to the urban areas. This trend imposes new responsibilities to local powers, in terms of job creations, public safety, city planning, physical infrastructure. It will also bring new pressures to local governments in providing a more integrated scheme for social welfare provision and education. The last challenge will be in expanding the scope of service industry, which lags behind the secondary sector and is underdeveloped in Chinese cities, in order to accommodate million of migrants looking for jobs in urban areas.

The first step toward a bottom-up scheme of urbanisation in China accelerated with the relation of townships and villages enterprises (litu bu lixiang: to leave the land, not the countryside). However, this large population of migrant labour (estimated today to 200 million) concentrated in the constellation of cities on the eastern seaboard: the Pearl river delta; the Yangzi River delta and the Bohai bay area. However, the lack of comprehensive security system of social security induces migrants to remained linked to their rural hukou. As formal land markets do not exist, the right to use the land in their home province provides them a form of economic security, as it has been evident during 2008-2009 economic downturn.

The rural-to-urban migration flows are massive and the migrant population is huge, even relative to China's population. During the year 2007, 132 million rural workers left home for a month or more to work; this comes to just 25% of the rural labor force. This figure includes workers leaving permanently and those leaving

temporarily. A vast majority, around 80%, are lone migrants, leaving their household in the countryside. Most migrate repeatedly for short periods of work.

### c. The two processes of urbanisation

What are the institutional mechanisms through which cities are created in China? There is indeed a peculiar incentive for local governments to upgrade counties to cities. Economic growth rate is a key factor in this process. Central government makes upgrading a major reward to local officials for their role in promoting high growth and aligning local interests with those of the Centre in the field of employment, social stability, education, public health, environmental issues, etc.

As a matter of fact, urbanisation comprises two fundamental processes. The first is an extension of land taken up by towns and cities, which usually takes the form of the diversion of agricultural land to urban uses. The second is a redesignation of a section of rural population as urban, a process that is usually accompanied by a shift of labour out of farming into services and industry. In China, as elsewhere, these processes have taken two conjoint forms: first, the expansion of existing urban settlements combined with rural-to-urban migration, and second, the urbanization of rural localities, which takes the form of the redeployment of labour from farming to industry or services without migration. The second has been favoured by the government and far more prevalent in China than elsewhere. The driving force behind it has been the growth of rural towns and villages enterprises (TVEs).

Both forms involve a change in the land use pattern, in particular the conversion of farm land for uses associated with urban settlements, e.g. high density housing,

transport infrastructure, offices and factories. Similarly both forms involve a redesignation of the rural population as urban population. Both these processes take a particular form in China because of the property in land and various institutional impediments to the redesignation of rural into urban population.

The connection between land development by local governments and urbanisation financing is currently underestimated. Compulsory land acquisition by city governments has been the prevalent method for the acquisition of land for urban growth. The combination of land acquisition and public land leasing has generated huge financial resources for the upgrading of old and the construction of new infrastructure. Land acquisition has gone beyond acquiring land for urban construction and become a major revenue source. The process generates huge profits. How it is shared between local government, developers, various intermediaries and farmers is highly contentious and source of social tension in the countryside. Too low land acquisition compensation, with government getting land from farmers at lower prices and selling it at very high prices has set off wide dissatisfaction among rural residents. Key parameters of urban expansion and city creation should help defining urbanisation as a comprehensive set of policies dealing with economic, spatial, social and legal issues.

#### **4. Urbanisation and change in cities sectoral development**

##### **a. The underdevelopment of services**

Considered to be “non-productive” or even exploitative, services were restrained in the 50’s. Yet, urbanization in industrialized countries has shown that population

density of service is higher than in manufacturing, knowledge spillovers are stronger and service use less land per employee than manufacturing, and co-dependency is higher than in manufacturing: service firms serve one another. Jobs in the service industry are highly concentrated in Hong Kong & Singapore, much less in Shanghai. China is thus setting out a skewed economic structure characterized by an hypertrophy of manufacturing and an atrophy of services industry. It appears when one look at the GDP structure of Beijing, Shanghai, Tianjin and Guangzhou in 2008.

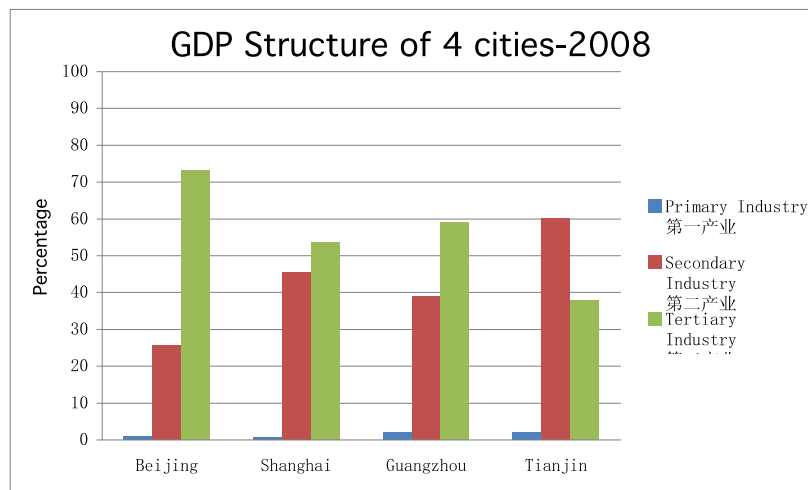


Figure 4.1 GDP structure in Beijing, Shanghai, Tianjin and Guangzhou in 2008

Except Beijing, where the government office concentration explains the high proportion of the service sector in GDP, the share of services in a city GDP hardly get over the 50% mark. The case of Shanghai is striking: while the city is often presented as the head of the dragon, the share of service sector has not dépassé 50 until the mid 2000. The picture looks better for service industries in Guangzhou, while Tianjin appears a city dominated by manufacturing activity.

b. The shift towards service industry

China is still strongly influenced by an industrialist view of development : its corollary is a bias (for fiscal reasons essentially) towards manufacturing, and an underdevelopment of services in Chinese cities. Producer services are now recognised as a new and key driving force behind the dramatic expansion and transformation of large city-regions in China. What kind of impact will have on cities the new productive power —complex, fragmented, mobile, internationally oriented, and increasingly difficult to manage?

**Conclusion: Patterns of China's urbanisation for the next decades: big cities and/or small and medium size cities**

What is the optimal size of a city? To identify the role of urbanisation as well as larger market size and improved infrastructure and telecommunication in enhancing industrial agglomeration. Au and Henderson have shown how a great number of cities in China suffered losses of productivity due their small scale (Au and Henderson, 2006). According to those researchers, between half and two thirds of Chinese cities

are considered too small to be efficient: lack of opportunities, as large pools of skilled labour, and suppliers of specialised intermediate inputs are brought together to large cities, enhancing employers-employees, and buyers-sellers matches, loss in net input per worker. The relationship between per capita GDP and industrial share should be assessed here. Moreover the constraints on free flows of labour and interregional market segmentation has to be examined in relation to smooth industrial agglomeration in China.

To better understand what are the principal incentives for local governments to upgrade counties to cities: economic growth or fiscal performance. Is the upgrading of a county to city status the result of a bargaining or the result of an incentive mechanism to align local interests with central ones? Does this upgrading (city-creation) lead to a higher economic efficiency and productivity and an increasing bargaining power of local governments with central government?

Massive urbanization driven by the expansion of large cities since the 1990s owed its origins to the 1994 reformulation of central-local fiscal relation; land development has been actively pursued by local government as an important means to finance urbanization and there exists significant relationship between the contribution of conveyance fee and the expansion of urban-built area.

City size is determined by the interaction between: centripetal forces (drawing on agglomeration economies) and centrifugal forces (deriving from diseconomy of scale). As long as advantages linked to the growth in cities exists, government intervention will limit growth of cities with negative effects such as a loss of productivity. The national characteristic of a large population with little land is the determinant of the

fact that China is taking the path of intensive development. Statistics show that the larger the size of the city, the more it will economize in resource utilization and the higher its productivity will be. In light of this, encouragement should be given to existing cities with a good carrying capacity in environmental resources to further agglomerate population, with a particular focus put on developing large and medium cities, giving prominence to the demonstration role of big and mega-cities and avoid the decentralization of urbanization.

On the other hand, small towns, as the hub of balanced development between the urban and rural areas, can absorb a surplus of rural population and drive rural economic and social development. They have their own advantages in absorbing the transfer of rural workforce, proximity, low transfer costs and large numbers and deployment, as well as more suited to farmers' needs in terms of their technologies, culture and living characteristics.

According to numerous surveys however, from the viewpoint of migrants, the choice is often set in favour of large cities: they offer better job opportunities, infrastructures for transport, and education. Asian experience is also relevant here: the great Tokyo area is including more than one fourth of the whole Japan's population. The same goes for Seoul. Shanghai will never reach that level. But could it be thinkable to have a dense network of cities in the Jiangsu Zhejiang area combining their populations to that of Shanghai ?

A concentrated approach to urbanization in China, modeled on super-cities, hub and spoke arrangements, or city groups, is the appropriate approach to the creation of the infrastructure, agglomeration economies, human resources and skills that are the

crucial underpinnings for harnessing the much needed and sustainable contribution of producer services to city development and competitiveness. Adoption of the most appropriate strategy will not only have ramifications for the competitiveness of cities within the Chinese urban system but also for their international competitiveness and the performance of the Chinese economy as a whole in a globalised world.

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