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Discussion Paper 196

Rural and Urban Dynamics and Poverty: Evidence from China and India

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A growing consensus in development literature warns against treating rural and urban areas as distinct entities and acknowledges that the livelihoods of rural and urban households are vitally interconnected. Nevertheless, over the past several decades, many developing countries, hoping to accelerate modernization, have concentrated public resources in the urban sector, reinforcing the separateness of urban and rural areas and widening the income gap between them.

The coexistence of a modern urban sector and a traditional rural sector, a common scenario in developing countries, is often the result of the pursuit of a heavy industrialization development strategy supported by explicit and implicit government interventions—such as state pricing and procurement of agricultural products, fiscal transfer and investment, and the restriction of labor migration. This division can also result from a policy perspective that sees urban as "modern" and rural as "backward," scarcely considering how agriculture can, with appropriate investment, be modern, too. These strategies have transferred significant rents and surpluses from the rural to the urban sector. Labor productivity and income per capita in the rural areas have lagged behind the urban areas in these countries, leading to an increased concentration of poverty among the rural population.

Purpose of this Paper

This paper explores the dynamic relationship between the rural and urban sectors and the consequent impact on poverty in China and India, both of which followed aggressive urban industrialization paths in the mid-twentieth century. The bulk of the population of each of these countries still resides in the rural areas where the incidence of poverty is greatest. However, the development gap—indicated by the difference in urban and rural incomes and in the poverty rate between rural and urban areas—is much greater in China than in India.

Historical Tendency towards Urban Bias

Urban bias has strong roots in China's history. In 1949, the Communist regime adopted a development strategy that promoted urban industries with capital-intensive technology and established a rationing system to ensure low-priced food and other necessities as well as guaranteed employment with benefits for most urban residents. Rural inhabitants, on the other hand, were confined to production units where they produced agricultural commodities under strict state planning. Surpluses emanating from the agricultural sector contributed to capital accumulation in industries and supported urban-based subsidies. Moreover, strict control of rural-to-urban migration reinforced the segmentation of China's rural and urban sector.

At roughly the same time (1950), a newly independent India prioritized rapid industrialization as a path to self-reliance and invested in urban industries at the expense of the agricultural sector. In order to provide cheap food and inexpensive basic inputs for industrial development, farm prices were kept artificially low and agricultural exports were curtailed through quantitative restrictions and an overvalued exchange rate.

Decades later both countries initiated agricultural reforms that, whether intended or not by the policymakers, actually began a process of correcting the bias toward urban-based industry in many respects. Agricultural prices were raised in China, the state procurement system was abolished, and most restrictions on labor movement were lifted. An important development during this reform period was the emergence of rural industry clusters known as Township and Village Enterprises (TVEs), which further strengthened the linkages between the rural and urban sectors. For example, urban industries outsourced part of their production to the TVEs to benefit from the cheaper rural labor force, existing machinery, and the more relaxed enforcement of environmental, health, and safety regulations in rural areas. Urban industries also used labor and raw materials from the rural areas, which led to an increase in agricultural labor productivity and farmers' income. These activities encouraged the growth of small rural towns that served as bridges between rural areas and urban centers.

Rural and urban livelihoods are vitally interconnected. Yet many developing countries, hoping to accelerate modernization, have concentrated public resources in the urban sector, reinforcing the separateness of rural and urban areas, increasing the gap between them, and contributing to persistent rural poverty.

In India, macroeconomic reforms led to an improvement of the terms of trade for agriculture, agricultural growth accelerated, and rural poverty declined. At this time, India also began to promote small-scale industries in the rural areas.

Analysis and Results

Information on rural-urban interdependence in China and India is still relatively sparse. Yet a better understanding of the rural-urban linkages in these countries and of how public policy and investment affects these linkages has important implications for growth and poverty reduction. This study used panel data from China and India to measure (1) the contribution of rural growth to the reduction of both rural and urban poverty, and (2) the impact of urban growth on rural and urban poverty reduction.

The analysis indicates that, in the case of China, agricultural growth has contributed to poverty reduction in both rural and urban areas, but its effect on rural poverty is larger than its effect on urban poverty. The results for India also clearly show that rural growth helps to reduce rural poverty, but, unlike China, it has no statistically significant effect on urban poverty reduction. Urban growth does not have an important effect on rural poverty reduction in either country, and in fact, in China, the results suggest urban growth correlates with an increase in rural poverty. The lack of effect of urban growth on rural poverty is likely due to several barriers, such as inadequate infrastructure, that prevent desirable spillover effects.

Policy and Program Challenges

Despite significant improvements, government fiscal and investment policies in China and India have frequently remained skewed towards urban areas. The dichotomy of modern urban versus traditional rural sectors in the economy has persisted in terms of actual investment choices and policy perspectives. For instance, government subsidies in the health sector tend to flow to urban areas when the provision of basic health services in rural areas is more pressing. Facilitating the mobility of productive factors, such as labor, is an important instrument to counter urban bias. Yet, although rural-to-urban migration has contributed to poverty reduction in rural areas, it continues to be hampered by policy barriers such as formal residency restrictions, or lack of education, access to information, and infrastructure.

Development of rural nonagricultural production and service sectors and improved access to small rural towns and urban centers are important for the growth of the rural economy. The development of small rural towns is also associated with better infrastructure, which in turn will facilitate access to markets by both urban and rural consumers and producers and lower transportation costs. Furthermore, by absorbing agricultural labor surplus, small rural town development in India and China can help to alleviate the pressure on bigger cities, while contributing to the growth of the national economy.

Empirical evidence demonstrates that public investment in the rural sector—particularly in rural infrastructure as well as in agricultural research and development, and education—will yield the largest returns in terms of both growth and poverty reduction. In the poorest areas, such as western China and eastern India, the poverty reduction effect from these investments is particularly high.

Keywords: urban-rural linkages, poverty, China, India

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