

Modeling Chinese Labor Market: A Deep Investigation of the Current *Hukou* System

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This paper attempts to formulate a theoretical model to incorporate the most central features of the current Chinese labor market and to demonstrate how this model might be utilized to analyze the labor allocation as well as the wages in different economic sectors.

As is known, the current Chinese labor market has some unique features, such as the hukou system, labor market segmentation, co-existence of urban labor shortage and rural labor surplus, etc. Good policy work requires sound theoretical foundations. In China's context, hitherto, very few studies have attempted to establish theoretical models for Chinese labor market. Based on some central features of the current Chinese labor market, the present paper constructs a three-sector labor market model with wage dualism, unique hukou system, and labor market discrimination, which is the hitherto most detailed and rigorous theoretical model particularly for Chinese labor market.

The model makes large contributions to the current literature and provides several valuable insights on the current Chinese labor market at least in the following aspects.

First, this model elaborates how the hukou system indeed affects the functioning of the current Chinese labor market. Almost all of the previous literature on modeling Chinese labor market only claimed that hukou system was a major institutional restriction on labor mobility, but did not explain how it actually works. The hukou system was similar to a black box which previous researchers had never explored for the purpose of modeling Chinese labor market.

Second, this model explains the puzzle of the co-existence of urban labor shortage and rural labor surplus. Why do a considerable number of rural hukou holders still choose to stay in the poor rural area and earn very little, instead of migrating to the coastal city for higher wages and guaranteed employment? There are two suggested reasons from this paper. One is that the labor market discrimination in the SOE sector limits the opportunities for rural hukou holders and thus reduces their expected payoffs associated with migrating to the city. Another reason is that due to hukou constraints, rural hukou holders have to bear a large amount of cost in the city, but cannot enjoy much social benefit as urban hukou holders does.

Third, the model offers a profound insight on explaining the simultaneous surplus labor in rural areas and rising real wages in the urban area. The original Lewis model implies that as long as there exists a surplus of labor to the modern sector, economic growth would generate inter-sectoral shifts of employment but little or no increase in real

wages in the urban area. However, the current Chinese labor market witnesses the two phenomena at the same time. The reason is also related to the unique institutional system in China, that is, hukou system, which reduces the expected payoffs associated with migrating to the urban area for rural hukou holders.