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# The potential of land rental markets in the process of economic development: Evidence from China

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## Abstract

We develop a model of land leasing with agents characterized by unobserved heterogeneity in ability and presence of an off-farm labor market. In this case, decentralized land rental may contribute to equity and efficiency goals and may have several advantages over administrative reallocation. The extent to which this is true empirically is explored using data from three of China's poorest provinces. Land rental markets and administrative reallocation reallocate land to those with lower endowments but the former are more effective in doing so and have a bigger productivity-enhancing effect. Information on hypothetical market participation suggests that reducing transaction costs in land rental markets could help to realize significant additional productivity gains.

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## 1. Introduction

One of the stylized facts of development economics is that in the process of economic development, labor will leave the agricultural sector in favor of non-agricultural

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employment, often in the urban sector. This process has been particularly dramatic in China where agriculture's share in employment is estimated to have dropped from more than 70% in 1978 to less than 50% by 2000 (Johnson, 2002). Not surprisingly, a large literature has emerged to assess the factors that motivate households to move out of agriculture (de Brauw et al., 2002), the social and economic implications of such a move (Zhao, 2002), and the implications for labor market policy in view of recent challenges (Zhai and Wang, 2002). Such large-scale movements of labor have had profound consequences for household welfare (Yao, 2000). Continuing high levels of rural–urban migration, which may be further enhanced in the context of China's WTO accession (Ravallion and Chen, 2003), may contribute to higher levels of inequality between provinces (Liang et al., 2002) and between individuals (Fang et al., 2002).

The importance of land markets in this context derives from the fact that, whether a large-scale transfer of labor out of the agricultural sector will lead to greater inequality or the opposite will partly depend on the flexibility and effectiveness of operation by rural factor markets, especially those for land. Well-functioning land markets could allow those with higher agricultural ability who do not join the off-farm labor force to gain access to additional land, increase their operational farm size and thus their income, thus possibly lowering overall inequality. Traditionally, reallocations of land have been accomplished through administrative channels rather than rental transactions based on individual initiative (Kung and Liu, 1997); more recent data suggest however that, with the emergence of off-farm labor markets, land rental has become more active (Kung, 2002b). At the same time, there is evidence that better functioning of land rental markets could help the economy to realize considerable gains in productivity (Benjamin and Brandt, 2002). Despite the importance of the subject, only few studies have provided in-depth empirical evidence on the issue: Our study aims to contribute to the discussion by providing empirical evidence in three areas.

First, by describing the level and dynamics of rental market development in some of China's most backward regions and its relation to administrative processes of land reallocation, we aim to assess the extent to which non-market and market mechanisms substitute for or complement each other. We are particularly interested to assess the equity impact of land markets and to explore whether specific preconditions such as stronger individual land rights would be required for such markets to emerge or to reach their full potential.

Second, we use a measure of households' productive ability to assess the extent to which these markets transfer land to more productive producers and thus offer an opportunity to improve overall efficiency of resource use in rural areas.

Finally, by comparing households' desired level of land rental market participation to actually observed outcomes, we are able to identify the extent to which markets allow realization of the potential, the constraints that may prevent them from doing so, and the potential impact of removing some of the constraints on improved functioning of rental markets.

With rapid rural–urban migration, identifying mechanisms that would help to improve the functioning of factor markets and thus increase agricultural productivity will be of importance to ensure that the benefits from non-agricultural development reach the poorest parts of the population. This is particularly relevant because, contrary to some of its more

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