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Title: Urban-Rural Wage Gaps, Inefficient Labor Allocations, and GDP per Capita

Rural-urban wage gaps exist even in countries where labor mobility is presumed to be unconstrained. These wage gaps reflect differences in productivity associated with the benefits of agglomeration and higher living costs in urban markets. However, the wage gaps are often much larger than would be explained by differences in agglomeration and prices alone. If barriers to labor mobility exist, efficiency gains from removing these barriers and reallocating labor between rural and urban regions can generate higher per capita GDP.

Using a newly compiled data set from household surveys from 101 developed and developing countries, we decompose observed urban-rural log wage gaps for each country into the portion explained by skill differences and the unexplained portion. Larger unexplained wage gaps are evidence of labor market distortions that lead to inefficient allocation of labor across sectors and lower country production relative to its potential. We find that on average, eliminating unexplained urban-rural wage gaps raises per capita GDP by 13.9%.

We also show that the unexplained urban-rural wage gaps are tied more closely to economic and political institutions in the country rather than measures of resource endowments or levels of development. Unexplained urban-rural wage gaps are larger in countries with less democratic political systems, higher marginal tax rates, and higher average urban education levels, but are lower in countries with larger government shares of GDP. The implication is that both developed and developing countries can add to per capita incomes significantly by relaxing constraints on rural to urban migration.

Our study differs from the more commonly explored macroeconomic relationships between inequality and economic growth that have not distinguished between wage gaps attributable to skill and wage gaps that reflect inefficient labor market allocations. Our results imply that countries have policies determined by political and economic institutions that raise inequality and presumably lower labor mobility. In consideration that freely mobile labor equalizes wages between urban and rural areas and this minimizes lost potential output due to misallocation of labor across regions in the country, it is advisable to follow policies that reduce wage inequality between urban and rural areas.