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Local "Land Finance" in China's Urban Expansion: Challenges and Solutions

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Abstract

This paper considers the issue of local "land finance" in the context of China's fast urban expansion. In an analysis of China's land requisition and public leasing system we argue that low-cost land acquisition is the fundamental cause of land-related distortions that have occurred during China's urbanization. Granting farmers the power to negotiate directly with land users during urban expansion, combined with coordinated land tax reforms to consolidate local tax bases is the key to China achieving both equity and land use efficiency in urban expansion.

Key words: land requisition, public leasing system, urban expansion
JEL codes: H71, O14, Q15

I. Introduction

China is now undergoing a process of urbanization that is perhaps of the largest scale in human history. Between 1995 and 2005, the official urbanization rate (the share of the urban population in the total population) rose from 29.0 to 43.0 percent (NBS, 2006).

Rapid urbanization has been accompanied by enormous urban expansion. In the past decade, each year approximately 150 000 ha of arable land was transformed for urban development purposes. From 1998 to 2005, the constructed area of Chinese cities grew from 214 000 to 325 000 km^2, an astonishing growth of over 50 percent. Urban expansion accelerated in many regions. For example, in the land-scarce coastal province of Zhejiang, the newly constructed urban area was as high as 126.4 km^2 per year between 2000 and 2004,

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which was 3.4 times as high as the annual average between 1995 and 1999.

Rapid urban expansion has resulted in a lot of arable land being used for non-agricultural purposes and millions of farmers being dispossessed. By the end of 2003, there were already 3837 industrial parks set up by various levels of local government across the country, and the figure further jumped to an astonishing 6015 by the end of 2006 (Zhai and Xiang, 2007). Each year, approximately 2.5 to 3 million farmers are dispossessed as a result of urban expansion. However, under China's current land requisition system, farmers who lose their land typically receive little compensation and they can easily end up landless and unemployed. Social conflicts arising from state land expropriations have significantly intensified in the past decade.

Why are local governments in China so enthusiastic about expanding urban space? How can we rationalize such local land development activities under China's existing institutional background in China? What actions have been taken by the Central Government to curb local frenzy in development zones and industrial parks? Are these actions sufficient to address the issues, and if not, what further steps can to be taken? These are the questions this paper aims to address.

The rest of this paper is organized as the follows. After a brief introduction of China's land requisition system in Section II, Section III describes the public land leasing strategies adopted by local governments in China. Section IV rationalizes local "land finance" in the wider context of China's economic and political institutions. Section V examines the Central Government's response to abusive land requisition and argues that the current policy framework is limited in that it addresses the symptoms rather than the causes of land issues. The final section concludes, and discusses some implications for coordinated policy reforms.

II. Land Requisition System in China

The current legal framework for land requisition in China is defined by the *Land Administration Law* (LAL) promulgated in 1998. Under the LAL, the state, if acting in the "public's interest", may lawfully acquire land owned by collectives. However, there is no clear definition with regard to what public interests represent. This inevitably expands the legal scope of land acquisition. In practice, not only the land used in urban infrastructural development is acquired from farmers' collectives, but also almost all the land used for non-pubic urban usage (such as for industrial, commercial and residential projects) has to go through the public land requisition procedure. That is, almost all the land used for urban purposes has to be acquired by the local government and converted to state-owned land first. Only after such ownership change can land users, be it the commercial land developers or the local government itself, develop the land for industrial, commercial and infrastructural purposes. Therefore, under the

current law, neither the owners of rural land (farmers or the rural collectives) have much power to negotiate with the urban land users directly about the land prices, nor can they make a private transfer of their land rights for urban use. The compensation terms for land acquisitions are more or less unilaterally decided by the local state that acquires the land.

Under China's *Land Administration Law*, the compensation for arable land under requisition constitutes three components: (i) compensation for land (6–10 times the derived land productivity, which is the monetary value of the annual average agricultural output value over the past 3 years); (ii) compensation for resettlement (4–6 times the derived land productivity); and (iii) compensation for accessory assets in land (Ding, 2005). A policy document issued by the Ministry of Land Resources (NBS, 2004) further stipulates that the maximum compensation for land acquisition cannot exceed 30 times the derived land productivity and the maximum compensation can only be reached under special circumstances with the approval from the provincial authorities. For example, if the annual net output value per hectare is RMB15 000, the highest compensation can only be as high as RMB450 000. In practice, land compensation for highway and railroad construction-purposes is mostly set at between RMB75 000 and RMB120 000 per hectare, whereas that for industrial and commercial purposes usually ranges from RMB300 000 to RMB450 000 per hectare. Given that the average dispossessed farmer in China has a land holding of 0.07 ha, dispossessed farmers, on average, receive RMB5000–RMB9000 for land requisition due to transportation network development and RMB20 000–RMB30 000 for land requisition for commercial and industrial development purposes. However, when the land is leased out in markets for commercial usage, the prices are usually much higher. For example, in the Yangtze River Delta, the price of the land leased out per hectare ranges from RMB2 100 000 to RMB5 250 000, which is 7–10 times the compensation offered to the dispossessed farmers (UIE, 2007).

Rather than providing cash compensation to dispossessed farmers, many cities have recently promised farmers a monthly pension payment if they reach retirement age. For example, in Chengdu, the capital city of the inland province of Sichuan, local government has committed to provide a monthly pension of RMB300 to male dispossessed farmers after 60 years of age and female dispossessed farmers after 50 years of age. However, the conditions imply that these farmers cannot obtain any current period monetary compensation and have to make an extra monthly or lump-sum payment to the pension fund to be eligible for the pension. Generally speaking, under the current land compensation formula, the fair market value of the land and the negative impacts of land acquisitions on farmers' livelihood have not been sufficiently considered by the government. The dispossessed farmers are largely excluded from sharing the land value appreciation resulting from land development projects and urban growth in general (Zhu and Roy, 2007).

Unfair compensation for land requisition during urban expansion has become the most

visible and contentious rural issue over the past decade in China. A 17 province, 1962 farmer survey conducted in China in 2005 shows that actual cases of land acquisitions have increased more than 15 times over the past 10 years and appear to be accelerating. Under-compensated farmers who have lost their land easily become unemployed. Across China the hardships and grievances of these ill-treated farmers has contributed to local social unrest and political instability. In the first 9 months of 2006, China reported a total of 17 900 cases of "massive rural incidents", in which a total of 385 000 farmers protested against the government. Approximately 80 percent of these incidents were related to illegal acquisitions. According to a recent research report (UIE, 2007), there are currently over 40 million dispossessed farmers due to urban expansion and transportation networking and 70 percent of complaints lodged from farmers in the past 5 years are related to rural land requisition in urbanization.

III. Local Public Land Leasing Strategies

China's public land leasing (or the transfer of "land use right") was initially introduced in Shenzhen city of Guangdong Province in the late 1980s. A national adoption of public land leasing started in 1992, although at that time it was applied only to land used by foreign and private enterprises. Now almost all of the land used for industrial, residential and commercial purposes has to go through the public land leasing process. The maximum lease term is 70 years for residential usage, 50 years for industrial usage and 40 years for commercial and recreational usage.

The public land leasing system works in the following way: after the land requisition, local governments can lease land either through negotiation (xieyi), by tender (zhaobiao) or by auction (paimai). Leasing by negotiation refers to a one-to-one negotiation between the land users and the government about leasing terms. Both tender and auction take place through public invitation, although during the process of tendering the highest bidder might not necessarily be selected because factors other than price might be taken into account, including the land developers' reputation and the purpose the land is to be used for. Of these three types of public land leasing, land leasing through negotiation is the least transparent approach, whereas with land leasing by tender or by auction, at least two competing land users must be introduced.

However, most of the urban land leased out has been disposed of by negotiation, which is particularly true for land leased for manufacturing purposes. According to Ho and Lin (2004), of the land use rights distributed by conveyance in the 5 years (1993–1998) for which data was available to them, in China 89 percent were "negotiated" and only 11 percent transacted through "open bidding" by public tender or auction. Therefore, in the 1990s the vast majority of land conveyancing was done in the least open or transparent way. Although since the early 2000s, under Central Government pressure, an increasing share of land used for residential and commercial purposes

has been leased via tender or auction, most of industrial land is still leased out through negotiation, and constitutes the majority of all the land leased out. Table 1 presents the national total area of leased land and the provincial average area of leased land from 1998 to 2005. It also shows the national total number of leased land sites and the provincial average number in leased land sites for the same period. As shown in the table, overall there was an extraordinary growth of leased land in the period. In 1998, the national total area of leased land was only 20 285 ha., but by 2005 this has risen more than 7 times, to 165 586 ha. As for the average area of hand per site leased out, there was also a significant rise from 0.19 ha. per site to 1.02 ha per site from 1998 to 2005. These figures show that land development activities have been rapidly growing since the late 1990s as local governments have become increasingly involved in industrial development and urban expansion.

Table 1 presents the structure of land sites leased out by negotiation and by auction/ tender. As shown in the table, the national total number of land sites leased out by negotiation grew steadily between 1998 and 2005, and it dominated the number of land sites leased out by auction and by tender during the 8 years. Although since 2003 the share of land sites leased out by auction or by tender rose significantly due to the promulgation of "Regulations on Urban Land Leasing by Auction and Tender", the share of land sites leased out by negotiation is still well over 70 percent.

In practice, a majority of the land used for manufacturing purposes is leased out by negotiation and usually at very low prices. Take the coastal province of Zhejiang as an example: in the early 2000s the provincial average costs of land requisition and land preparation was RMB1.5m per hectare, whereas the average leasing price was less than RMB1.3m per hectare. For approximately one-quarter of the industrial development zones, the land-leasing price is less than half the land requisition and preparation costs (Huang, 2007). Because local governments need to finance land requisitions and infrastructure preparation costs *ex ante*, leasing out industrial land at low prices inevitably implies that local governments are incurring net losses in the process of land requisition, land preparation and land leasing.

Table 1. Local Land Leasing: 1998–2005

Year	National total area of leased land (ha)	National total number of land sites leased out				Average area of per land site leased (ha)
		Total number	By negotiation	By tender or auction	Share of land leased by negotiation (percentage)	
1998	20 285	105 339	91 885	13 454	87.2	0.22
1999	45 596	99 017	83 692	15 325	84.5	0.54
2000	48 630	118 846	99 632	19 214	83.8	0.49
2001	90 394	180 257	128 695	51 562	71.4	0.70
2002	124 294	242 673	196 619	46 054	81.0	0.63
2003	193 604	207 387	157 381	50 006	75.9	1.23
2004	178 331	184 850	138 111	46 739	74.7	1.29
2005	165 586	163 112	117 642	45 470	72.1	1.41

Source: NBS (1999–2006).

Although in the 1990s and early 2000s a lot of land used for commercial and residential purposes was also leased out by negotiation, since 2003 this has largely changed. Land leasing by tender or by auction for commercial and residential purposes is now a common practice at the local level. Because under the current system rural collectives cannot make a private transfer of their land rights for nonagricultural use, city governments inevitably have an almost monopolistic power in the local supply of land for commercial and residential uses. What naturally follows is that they utilize their monopolistic power to extract as much land revenue as possible from public land leasing. Many local governments at the city or the county level have set up "Municipal Land Management and Reserve Centers". A common practice of city governments is to limit land supply for commercial and residential purposes and to lease the land lots by auction or tender at much higher prices. Although, as shown in Table 1, the share of land sites leased out by tender or auction is less than 30 percent, the revenue obtained constitutes a majority of local extra-budgetary revenue from land development. For example, in the province of Jiangsu, the 2005 average leasing price of industrial land was only one-third of that for residential land leasing and one-fifth of that for commercial land leasing. Between 2000 and 2005, the average leasing price of industrial land grew only by 7 percent, whereas the prices for commercial and residential land rose by 42 and 68 percent, respectively (Gan, 2006).

A puzzle arises here regarding why local governments are willing to sacrifice their extra-budgetary revenue by leasing most of the land by negotiation to manufacturing sectors? After all, all of the revenue from public land leasing goes to local governments' extra-budgets, over which local governments have complete control. Therefore, local governments should have very strong incentives to lease the land out in more competitive ways so that more extra-budgetary revenue can be generated. Attracting manufacturing investment by offering cheap land not only results in a loss of extra-budgetary revenue, but also leads to a gain in local budgetary revenue through value-added tax levied on manufacturing. However, the gain is limited because the center shares 75 percent of the value-added tax.

IV. Rationalizing Local Land Finance Strategies

Local governments have strong incentives to lease most of the land for manufacturing purposes through negotiation and at very low prices partly because of the importance of the manufacturing sector in generating local GDP and employment and partly because of the fierce regional competition for manufacturing investment across regions. Although most of the fiscal revenue generated from manufacturing sectors (i.e. 75 percent of value-added tax) goes to the central coffer, local officials are still keen to attract manufacturing

investment. This has to do with the political incentives of local officials under China's current polity. Under this system, local leadership is evaluated by the upper level of governments according to a series of economic indicators, such as the annual growth achieved in local GDP and employment, the amount of revenue collected and the revenue contributions made to higher levels of the state. Therefore, if local governments can take a lead in regional economic competition for manufacturing investment, GDP, employment and budget revenue thus generated would imply a stable stream of GDP and budget revenue in the future, and would signal stronger political performance and a better chance for political promotion. Because under the current land requisition system the costs of acquiring farmers' land are very low, local governments can afford to subsidize manufacturing investors by lowering land leasing fees, hoping that such temporary revenue losses are offset by future gains in local economic growth and by the attainment of an edge in political competition across regions.

In contrast, investment in real estate and commercial sectors is much more location-specific in the sense that in any city the land sites suitable for commercial or residential purposes are limited by the level of local development and purchasing power. Local governments can take advantage of their monopolistic positions in local urban land supply and extract extra-budgetary revenue as much as possible. The emergence of Municipal Land Management and Reserve Centers across China might be viewed as a local strategy for controlling the quantity of land for residential and commercial purposes and for maximizing the extra-budgetary revenue from auctioned or tendered land leasing. A further reason for local governments to limit land supply for residential and commercial purposes is that under China's current tax system, property taxes have not been introduced as local taxes. This implies that leasing out land for residential and commercial purposes would not yield a stable stream of local tax revenues, which we have seen in many developed countries where property tax is the single most important tax base for local government. Local governments in China have a natural tendency to maximize current-period land leasing revenue by intentionally under-supplying residential and commercial land.

The analysis above also helps to account for China's overinvestment in the manufacturing sector over the past decade, the bubbles emerging in the real estate sector, and finally for the loss of macroeconomic stability in recent years. Regional competition for industrial firms by cheap land leads to excessive investment in the manufacturing sector and over-capacity in industrial production. This easily translates into the trade surplus in the manufacturing sector, an ever-increasing reserve of foreign exchange and excess liquidity in the Chinese economy. Combined with the under-supply of land leased for residential and commercial purposes, excess liquidity inevitably pushes up the value of real estate, finally leading to asset bubbles. As a matter of fact, the property market prices in many large and

medium-sized cities have seen extraordinary growth since 2003. In large cities such as Beijing, Shanghai, Guangzhou and Shenzhen, housing prices have at least doubled in the past 5 years and a major reason for such growth is the rapid increase of land prices in public leasing partly due to the intentional under-supply of residential and commercial land to maximize local extra-budgetary revenue from land leasing and partly because of excess liquidity in the economy resulting from the over-capacity in the manufacturing sector and the huge trade surplus associated with it.

V. Central Policy Responses and Limitations

The problematic land requisition and public leasing system in China have become a major source of both social injustice and economic inefficiency. Not only are most of the dispossessed farmers unsatisfied with the unfair compensation, but also the regional competition for industrial investment by provisioning of low-cost land leads to serious waste of rural arable land. In practice, local governments make every effort to take land from farmers by evading central regulations on arable land protection. A survey of 16 cities by the Ministry of Land and Resources in 2005 showed that nearly 50 percent of the new land under development was acquired illegally. The figure was as high as 90 percent in some cities (Xinhua News, 2006).

In response, the Central Government has issued several policy directives since 2004, requiring local governments to raise the compensation to dispossessed farmers while at the same time constraining their unfair methods of land acquisition. The compensation for land takings must be adequate to "maintain affected farmers' living standards for the long term" (State council, 2006).

A policy document issued by the State Council has also declared that China will set up and implement the most rigorous arable land protection system in the world to protect farmers' livelihood and national food security (State Council, 2004). To slow investment growth in the manufacturing and property sectors and to ease social tensions arising from land acquisition, the government even suspended land sales for 6 months in 2004 and vowed to maintain a very restrictive policy for non-farm land supply over the medium term. In 2005, the center disqualified numerous development zones that had been set up by local governments without central authorization. To stop local governments from giving land to investors free of charge or at very low prices, the Central Government is now imposing a minimum price tag on land leasing, which will vary according to what it is used for. In the past several years many national inspection teams have been sent out each year to ensure that local practices are consistent with central policies in arable land protection and that decent compensation is paid to dispossessed farmers.

The center also takes active steps to control the lease of land from farmers directly to

non-agricultural users because it believes that local governments are permitting such direct land leasing to dodge central regulations on urban land use. As Zhou (2004) shows, in many provinces such as Jiangsu, Guangdong and Hunan, rural collectives have already moved beyond state regulation by leasing out rural land for non-agricultural purposes. This has usually been done under the implicit endorsement of local governments. However, because these transactions are illegal under the current policy framework, they have to be carried out in private, which further implies that local governments have no way to receive tax during the process of such transactions.

There are also proposals to further centralize land requisition power to the provincial and central levels because from the central perspective local governments are largely responsible for the serious problems surrounding land requisition and public leasing. The idea is that by establishing a vertically controlled land management system with tighter land quotas and stronger supervision from above and by sharing part of the land revenue with local governments, the center can dampen local incentives to abuse their authority during the process of acquiring land from farmers.

However, it seems that most of the policy actions taken by the center so far have addressed the symptoms rather than the roots of land-related issues in urban expansion. For example, when dispossessed farmers are dissatisfied with the compensation package offered for land acquisition, the state requires local governments to raise the compensation to a level that can will "maintain affected farmers' living standards for the long term". However, it is very difficult in practice to specify what level of compensation can satisfy this criteria and it is also unclear who is in a position to define the criteria. Because the Chinese economy is growing rapidly, it is reasonable to expect the value of land used for urban purposes to appreciate at a very fast rate. If the market value of the land rises much faster than the increase in compensation, the dispossessed farmers might still feel highly dissatisfied. This has already happened in many coastal cities. In the past several years, partly because of strong economic growth in these regions and partly as a result of a very restrictive policy for non-farm land supply imposed by the central state, the value of non-agricultural land has been growing much faster than the government-specified compensation.

The case is similar for public leasing. When there is too much public land leased at low costs to industrial users, the center's response is to ask local governments to raise the land use charges. The center also requires that all the land, be it for manufacturing uses or commercial and residential uses, be leased out by auction or tender. However, if local governments still have strong incentives to compete for manufacturing investment under the current system, they will always find ways to evade such regulations by, for example, carrying out nominal land auctioning or tendering but still leasing land out at low prices. It will be very difficult for the center to exert effective supervision over such practices.

The center's land policies so far have not been effective in reducing unfair treatment of farmers during the acquisition of land. Local governments are able to lease land out to industrial users at very low prices because they can acquire the land at low costs from farmers. The current land requisition system, by depriving farmers of power in negotiating land prices and compensation packages, is to blame for both the under-compensation in land acquisitions and the excessive expansion of urban and industrial land. Therefore, if real progress is to be achieved in China's urban land use policy, the separation of land acquisitions and land leasing under the present system has to be changed. This can be done by "marketizing land requisition" so that dispossessed farmers can negotiate directly with urban land users about the terms of compensation. This would mean that farmers, or the rural collectives who own the agricultural land, could obtain legal status in land transfers for urban usage. Although the Central Government strictly prohibits agricultural land from entering urban land markets, many localities have found ways to evade the central regulation by implicitly permitting rural land to be leased out for non-agricultural uses without firstly being acquired as state-owned land.

Granting farmers the legal status of land transfer during the process of urbanization not only implies that the rural collectives and farmers would be able to reap a much larger share of the benefits from land appreciation; but would also result in a significant rise in land acquisition costs. This is because the dispossessed farmers, unlike the local governments, would not take into account the potential political and revenue benefits derived from competing for manufacturing investment in their calculations. They would only agree to lease their land out when they believed that they could be better off from the deal. If the intention of the central state is to really "maintain affected farmers' living standards for the long term", permitting farmers to negotiate directly with land users about compensation packages is the best way to go.

Marketizing land requisition would also imply that local governments can no longer monopolize the leasing market for residential and commercial land. This would help to rectify the distorted local incentives to maximize extra-budgetary revenue by limiting land supply for residential and commercial uses. If local governments are no longer the monopolistic suppliers of residential and commercial land, the excessive growth of estate prices witnessed in the past several years in many Chinese cities would also be effectively contained.

A further implication for granting farmers legal status in land transfer is to decentralize land use regulations and land administration. In the new system, local governments would no longer be directly involved in requisition of land used for non-public purposes, but would focus on developing urban infrastructure and regulating land use through effective urban planning and land use planning. The Central Government would be responsible for

maintaining a balance between the two conflicting targets of securing national food supply and providing land for urban development. Since 2004, the Central Government, in response to local abusive land requisition practices, has been tightening the supply of land for all non-agricultural purposes. However, such policy is misleading because there is both an over-supply of industrial land and an under-supply of commercial/residential land. The lack of selectivity in central policies with regard to land used for different purposes is apparently a cost that cannot be avoided from the centralization of land administration. We believe that further centralization in land administration would only lead to disaster because it is very difficult to imagine how the Central Government or the Ministry of Land Resources can effectively monitor and regulate local land development activities in a country as large as China. It would be even harder to imagine how the Central Government can define what constitutes a reasonable compensation package for dispossessed farmers because land is a commodity that is highly location-specific.

VI. Conclusion

By arguing that the root of various land-related issues in China's urban expansion lies in the country's low-cost land requisition, we propose the marketization of China's land requisition system by allowing farmers to directly negotiate their compensation packages with potential land users. This would not only help dispossessed farmers to benefit from China's urbanization and industrialization process, but would also significantly reduce local incentives to compete for manufacturing investment by offering cheap land. It would further help to address the excessive growth of real estate prices caused by local under-supply of commercial and residential land.

A possible concern is that such reform would significantly reduce local extra-budgetary revenue, which is now the financial basis for local infrastructural development. However, marketizing land requisition would not necessarily mean that local governments would lose financially if supporting institutions were in place. For example, local governments could levy a value-added tax on land transactions between the farmers and the land users. Given that the value of agricultural land will usually appreciate when it is converted for urban use and that at least part of such value appreciation can be attributed to general urban economic growth and infrastructure development, levying a value-added tax on such land transactions can be fully justified. The value added would be defined as the difference between land sale/lease prices and the imputed land value for agricultural uses. In addition, a property tax on existing residential and commercial real estate can also be introduced to consolidate local tax bases in China. With the introduction of land value-added taxes and property

taxes, the negative impacts of marketizing land requisition on local fiscal revenue would be largely offset. Because both the land value-added tax and the property tax are formal taxes, administratively they would be much more transparent than the current land leasing revenue that enters local budgets.

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