From Industrialization to Urbanization: The Social Consequences of Changing Fiscal Incentives on Local Governments’ Behavior

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INTRODUCTION

China has experienced sustained economic growth of more than 9 percent per annum during 1978-2005—a record that surpassed even the miraculous growth rate of the group of four East Asian economies in the 1970s and 1980s. What is even more striking is that this sustained growth was, at least until the late 1990s, achieved in large part under predominantly public ownership, with township and village enterprises (TVEs) being the most notable organizational form under the purview of subnational governments. Regional decentralization, which drives regional competition or specifically “yardstick jurisdictional competition” and regional experiments, has been a principal force underpinning China’s unorthodox growth experience (Xu 2011). Specifically, “yardstick jurisdictional competition” refers to a process that relies on regions facing a similar external economic environment competing with one another on a (more or less) equal footing in a decentralized and nonspecialized environment (Maskin, Qian, and Xu 2000). At an earlier stage, and as part and parcel of China’s reform strategy based upon regional decentralization, the central state adopted the specific strategy of fiscal decentralization in the early 1980s. By assigning residual tax-claiming rights to various levels of local governments, this fiscal measure empowered them with positive inducements to promote local economic growth (Oi 1999). Thus, despite the notable absence of private property rights, these regional decentralization-based reforms led to sustained local economic growth.

In this chapter we investigate how the powerful incentive of fiscal stimuli has induced local governments to switch their development focus from industrializing their jurisdictions to urbanizing them, as articulated in the eventual demise of TVEs after their phenomenal rise, followed by the boom and bust of the real-estate sector in recent years. Determined to enhance “state capacity,” the central state attenuated the claims of local governments over tax revenues generated by their nonstate, nonprivate enterprises; the 1994 fiscal decentralization reduced the share of local governments’ entitlement to an important tax source, namely value-added...
or transaction tax, by a substantial 75 percent. The overall regional decentral-
ization strategy which underpinned economic growth was also weakened by
this particular fiscal decentralization measure, however. In fact, the incentives of
local governments in promoting rural industrialization had remained unchanged
up to this stage of the reform. It was only when the central state further reduced
the local governments' share in the enterprise profit tax—also by a substantial 60
percent in 2003—that the latter found it no longer profitable to continue to run
industrial enterprises that were barely profitable. It was then that many local
governments began to pursue the alternative strategy of "urbanization."

Why are local governments interested in urbanizing their localities? More
importantly, how do they benefit from such a process, and with what conse-
quence? In the context of highly decentralized rights (both de jure and de facto)
over local resources including land, fiscal revenue incentives provide an import-
ant clue to addressing these questions. Specifically, while the central government
has since 1994 reclaimed a substantial share of the tax revenues generated by
TVEs and subsequently all industrial enterprises regardless of ownership, local
governments have been assigned the exclusive right over an increasingly
important tax category, the business tax. This tax has been a driving force in
China's urbanization process, as nearly half of these revenues are generated from
the construction and real-estate sectors. In addition since urbanization helps
spur local GDP growth, it also enhances the career prospects of local officials
(Xu 2011).

Indeed, evidence does show that business tax has replaced both value-added
and enterprise profit taxes as a new source of local governments' budgetary
revenues. However, the monopoly right that the central state assigned to local
governments over the conversion of farmland to non-agricultural usages has powerfully
whetted the local governments' fiscal appetite. Blessed with escalating land prices
(specifically for commercial and real estate developments in premium locations) on
the one hand, and artificially low compensation for the value of their land
(tural land use) on the other, many local governments—especially those in the
rapidly developing coastal areas—have pocketed windfall profits from this state-
induced urbanization process. As with the wide array of fees that users of
converted farmland are made to pay to local governments and kept under the
"extra-budgetary" or unsupervised category, land conversion income or the
market price of land that developers pay for its use is similarly unsupervised.
Evidence further suggests that land conversion income constitutes the biggest
source of unregulated and unreported revenue for many local governments.

As with the effect of fiscal decentralization on the explosive growth of TVEs in
the 1980s, the strong fiscal incentives provided by the aforementioned monopoly
right over land revenue have led to two social problems. The first is that this land
revenue incentive has predisposed local governments to engage in farmland conversion at rates that not only endanger China's stock of arable land, but also subject large majorities of farmers to losing their primary sources of livelihood
with minimal compensation. And that is because, despite them being the nominal
owners, the prevailing compensation as designed by the central government
continues farmers' land rights to basically agrarian usage once land use is changed
and ownership converted (from the collective to the state), agrarian rights cease to exist. In other words, farmers would only be compensated according to the value

of crop production, which is meager in comparison to what the local governments would obtain in selling these converted rights, in particular if the latter are based
on commercial and real-estate usage. Clearly, the Chinese government needs to
address the twin problems of protecting farmers' property rights as well as halting the unabated loss of arable land.

The remainder of this chapter is organized as follows. In the next section we
provide a descriptive analysis of "regional decentralization authoritarianism" as a
general context for understanding China's reform strategy, followed by a brief
discussion of the fiscal contracting system and the powerful incentive effects it has
had on local officials in developing the nonstate local economy (in particular the
TVEs). In the following section we show the connection between fiscal recen-
tralization and the demise of TVEs, and subsequently also the waning interest of
local governments in promoting enterprise growth. We next examine the new set
of incentives that powerfully set the local states to keenly engage in hastening
urbanization or specifically land conversion. The problems of this urbanization
strategy both from a resource erosion (of farmland) standpoint and from the
perspective concerning the violation of farmers' property rights are then looked
into. The final section provides a brief conclusion.

REGIONAL DECENTRALIZATION AUTHORITARIANISM

In sharp contrast to all other formerly centralized economies where specialization
and monopoly is an outstanding feature, China had never organized its economy in
a highly centralized manner—even in its heyday as a command economy
(Naughton 2007). This may explain why, when reforms commenced in China,
the number of products produced directly under the central plan was a mere
791—compared with over twelve million in the former Soviet Union, and the
number of ministries directly under the central government's control less than
thirty—compared with sixty-two in the Soviet Union in the late 1970s (Xu 2011).
By further devolving the responsibilities of developing the local economies to
regional governments, Chinese-style economic reforms only deepened this long-
embedded decentralizing proclivity (Shirk 1995). Consisting of a region-based
multilevel hierarchy, in 2007 the central government directly controlled less than
4 percent of all industrial employees nationwide—already the largest economic
sector in which it has had direct involvement.

An overriding goal of economic reforms is to improve economic efficiency, and
the key to achieving that is to invigorate competition. The Chinese state achieved
that important goal vis regional decentralization, which essentially consists of two
core elements. The first is, given its initial conditions (of being already highly
decentralized) the state devolved property rights to various levels of regional
governments to directly set up and manage enterprises of varying ownership
types appropriate to their levels, and have them compete with each other on a
regional basis. Secondly, the state has effectively put into place a "nested" system of
personnel control by which to reward officials who have proven track records of
moving their economies forward with promotion (and "rotation" in some in-
stitutions). More specifically, this decentralized incentive was further reinforced by the adoption of a fiscal contracting system whereby local governments were entitled to retain that portion of the revenue in excess of the remitted amount that it negotiated with the central government—a system with incentive properties analogous to that of a "fixed rental" system and which, therefore, had the effect of encouraging the "tenant"—the local government—to seek more revenues (more below).

But decentralization does not always create strong incentives to regional officials for regional economic growth. Hence the intriguing question is what makes China special in providing strong incentives to regional officials for economic development, and is there empirical evidence to bear upon the effectiveness of a basically decentralized regional economic operation rooted within a hierarchy of centralized personnel control? Below we provide some clues to these related questions.

For regional decentralization and competition to work, the center must be able to observe the true effort of regional officials—a dauntingly formidable task given that typically information is "impacted" within regions (Williamson 1985). While the principal is unable to observe effort, fortunately outcome can be observed. Specifically, competition between regional officials can be evaluated among regions of comparable levels of development through a ranking system that resembles a tournament competition in which, as economic theory shows, is an effective mechanism for differentiating effort and accordingly performance. But two conditions must be met in order for a regional tournament competition to be feasible. First, the central government must be able to eradicate collusion between local or regional governments, because collusion among regional officials could destroy competition. Fortunately, this condition is made possible by the fact that Chinese regions—especially those at the county levels—are relatively self-sufficient and nonspecialized. To the extent that each region contains multiple economic sectors, it weakens interdependence between regions, as it enables local governments to carry out and coordinate most economic activities within their own jurisdictions.

Secondly, for regional tournament competition to work, it is also important that each region and the industrial sectors contained therein face broadly similar exogenous conditions. That permits the center to compare the relative performance of regions—a more accurate and meaningful yardstick for evaluating actual performance. Based on data that contains industry classification codes and location codes for each firm, Maskin, Qian, and Xu (2000) find that the Chinese regions are indeed alike; their empirical results suggest that regional tournaments do work better than the alternative ministerial tournaments—resembling the highly specialized and monopolistic features of the formerly centrally planned economy—in providing incentives to local officials. Similarly, using data covering 344 top provincial officials for the 1979–2002 period, Chen, Li, and Zhou (2005) find that each official's performance relative to her immediate predecessor does have a significant impact on her promotion. Using a panel dataset that covers 254 provincial leaders who had served in twenty-eight Chinese provinces from 1979 to 1995, Li and Zhou (2005) similarly show that regional officials were indeed strongly motivated to promote regional economic growth. Specifically, a higher GDP growth rate in a province significantly improved the likelihood of promotion of provincial leaders—a result that underscores the underlying assumption that the central government makes promotion or turnover decisions based on a performance score of these leaders.

That there exists an intimate relationship between the performance of regional officials and their career prospects is indeed well documented in a number of studies. Tsui and Wang (2004), for instance, show that 60 percent of the targets required of leading provincial officials are related to "economic construction." Moreover, the lower the level of regional governments, the more concrete the stipulated targets become (Edin 2003). At the lowest administrative levels—the township and village levels—party secretaries and township heads are required to fulfill three categories of performance targets, with the fulfillment of the "hard" targets (consisting specifically of economic development plans most notably per capita GDP growth and tax revenue quotas) tied intimately to the award of bonuses and promotions (or political rewards) (Whiting 2000). At the county level, for instance, Edin (2003) has observed that top-ranking township officials have been promoted to positions at the county level, whereas well-performing municipal officials have even transferred to other provinces as governors (Xu et al. 2007). In this context, an important question is whether the incentive embedded in this kind of yardstick competition serves the intended purpose of spurring regional economic growth. Before answering this question it is important that we include in our discussion the unique importance of fiscal decentralization—a core element of regional decentralization—in China’s reform process.

**FISCAL REVENUE INCENTIVE AND THE RISE OF TVEs**

The career incentive embedded in the kind of regional decentralization authoritarianism outlined above explains the powerful incentives bestowed upon regional governments in developing the economies under their jurisdictions. Growth of per capita GDP, employment, and tax revenues, among other performance indicators, are the important metrics upon which their careers within the Party and the government crucially depend. Another important part and parcel of the regional decentralization strategy was fiscal decentralization. The fiscal reforms implemented in the 1980s dramatically changed the incentives for local governments. By ceasing to guarantee upper-level budget allocations to meet local expenditures, local governments had to rely primarily on revenues created within their own jurisdictions. They were granted control rights over both revenues and profits generated by these endeavors. An important part of the revenue came from the development of non-farm enterprises (Qian and Xu 1993; Qi 1999). This shared arrangement of fiscal revenues between two immediate levels of government has had the essential incentive property of a "fixed rental" contract, whereby the "tenant" gets to keep more the more revenues it manages to generate. As part of regional decentralization, fiscal decentralization played an important role in the massive and rapid development of a nonstate sector in the Chinese
economy from around the mid-1980s, of which township and village enterprises (TVEs) were a key component (Qian and Xu 1993; Jin, Qian, and Wei 2005). Indeed, with no more than a modicum of nonagricultural enterprises before the early 1980s, TVEs already counted for roughly 80 percent of output of the nonstate sector in less than a decade. Between 1981 and 1990, total industrial output of TVEs grew at an average rate of 28 percent and as such had been the main engine of growth of the Chinese economy. It is also well known that the productivity of TVEs was distinctly higher than that of the SOEs (Weitzman and Xu 1994).

County governments benefited enormously from the development of TVEs, primarily because they were able to share tax revenues that these enterprises generated under the fiscal contracting arrangement, and because the lion’s share of the increases in tax revenues (the industrial-commercial taxes) had come primarily from township and village enterprises. Starting at a modest base of a little over 2 billion yuan in 1978, taxes grew to 205.8 billion yuan by 1995—an increase of more than tenfold (Cs 1999: 36). As long as the variety of taxes that county-level governments were able to capture was based on production (product tax), income (value-added or transaction tax), and turnover (business tax) rather than profits per se, it had powerful incentives to expand TVEs without paying much regard to their profitability.

A similar incentive existed for the township governments. Not only were they entitled to the bulk of tax revenues (e.g., 70 percent), they were also the keepers of enterprise income or simply profit tax, which formed an additional source of “horizontal” income essential for, among other purposes, financing the provision of local public goods. Depending on the level of tax revenues, local governments did not need to exert the same amount of effort in collecting taxes. By taxing at the minimum rather than maximum levels, which was viable in a context where the economy was still growing, some local governments could decide to provide greater incentives for enterprises under their jurisdiction to become more efficient.

In addition to reaping the direct benefits of increased fiscal revenues, the development of TVEs also had the anticipated effect of accelerating GDP growth, which in turn served to enhance local officials’ career prospects (Xu 2011). Thus, local officials were keen to develop the TVEs, such as by procuring loans from financial institutions under their jurisdiction to finance their expansion. In 1995, for example, bank loans accounted for as much as 64 percent of all credit incurred by TVEs; more startlingly, overall debt-equity ratio of TVEs even outweighed that of the SOEs (Kung and Lin 2007; 573). In fact, even up until 1999, when some provinces had already undertaken large-scale privatizations of TVEs, TVEs continued to achieve steady growth in tax revenue, only the “efficiency” of tax revenues—that is, tax revenues measured in terms of per unit of sales and profits—declined (more below on this).

1994 FISCAL REFORM AND THE DECLINE OF TVEs

By the 1990s concerns had mounted that the reform strategy of allowing localities to benefit disproportionately from local economic growth by assigning the regional governments residual income rights over tax revenues and enterprise profits was being achieved at considerable costs: to the extent that the “central state capacity” had been severely weakened. For instance, the central government’s share of overall budgetary revenue declined precipitously from 40.5 percent in 1984 to 22 percent in 1993. Some scholars even contended that the state had, as a result of fiscal decentralization, lost its capacity to macromanage the economy, which may in turn have led to political instability (e.g., Wang and Hu 1993, 2001). Responding to this concern, the state tightened fiscal control over revenues in 1994 by redefining tax rights between the national and regional governments and taking more in taxes from the localities. In particular, the central government wrestled from local governments the exclusive rights over a newly established consumption tax over such inelastic consumption products as beer, hard liquor, and cigarettes, as well as reassigned a hefty 75 percent of the transaction or value-added tax to itself. As Figure 17.1 clearly shows, this measure drastically altered the proportion of revenues shared between the national and subnational governments. For the latter, the ratio plummeted from an apex of 80 percent before 1994 to roughly 45 percent afterwards and became stabilized at that level thereafter.

While the central government has since the 1994 fiscal reform reclaimed a substantial share of the tax revenues generated from TVEs and other industrial enterprises, local governments were compensated by gaining other rights in the process. Specifically, they were assigned the exclusive right over what is to become an increasingly important tax category, i.e., the business tax. Moreover, at the 15th National Congress of the Communist Party of China, 1997, local governments were given official recognition for being the de jure owner of not merely the enterprises established under their jurisdiction but more importantly also of land.

![Figure 17.1. Central and local governments' budgetary revenues, 1978–2006](image-url)
This is especially the case before the 1978 economic reforms, when industrial growth was spatially concentrated in urban areas, on the one hand, and rural-urban migration held tightly in check—via the household registration system or *hukou*—on the other. The physical movement of people has been greatly relaxed in the last quarter century, and urbanization has since proceeded at a much faster clip, as hundreds of millions of villagers have migrated to urban areas to take advantage of non-farm employment opportunities. Yet the *hukou* system—essentially an "apartheid" system that separates the urban populace from its rural counterpart via the rights to a wide range of "entitlements" (such as the right of children to education)—remains restrictive in many respects. Moreover, a case can also be made that urbanization has been slowed by the fact that a good part of China's post-reform industrial growth has been spatially concentrated in towns and villages. While the realignment of rights over transaction or value-added taxes undoubtedly led the local governments to shed a large collection of nonprivate enterprises, many of which were likely unprofitable, the 1994 fiscal reforms did not stifle rural industrialization. Local authorities were still left with exclusive claims over enterprise income or profit tax, which caused them to focus parsimoniously on enterprise efficiency. It is thus no coincidence that the privatization of TVEs, which began in earnest around 1995, merely led to a change in ownership rather than elimination of many of these industrial enterprises.

What made local governments shift their development strategy from fostering enterprise growth to that of urban growth was the realignment of rights over enterprise profit tax in 2002. The 1994 fiscal reforms left both local enterprise income tax and individual income tax (alongside a number of other tax categories) to the local governments as sole residual claimants (Oi 1999: 55). Similar in spirit to the 1994 reforms, the central government has proposed to appropriate, from 2002 onwards, 50 percent of the enterprise profit tax (increased to 60 percent in 2003)—a change which has the effect of robbing local governments of the incentive to improve enterprise efficiency regardless of ownership. To make up for the lost revenues resulting from these fiscal reforms, local governments must look elsewhere. Fortunately for the local governments the central state has not proposed to share with them what is to become an important source of tax revenue, namely the business tax, which consists primarily of taxes levied upon the construction and real-estate industry and to a lesser extent the service sector. The Chinese economy continues to grow, and so the country is concomitantly going through a secular process of urbanization. Construction and real-estate development has become the cornerstone of this development process to the extent that it profitably provides a new source of tax revenue to local authorities, who, needless to say, are all too happy to ride on this emerging wave.14

The changing relative importance of these two taxes in overall budgetary revenues of local (county-level) governments is reflected in the growing share of business tax from 20 percent in 1994 to 25 percent in 2003 and the decline of transaction tax from 22 percent to 18 percent during the same period (Zhou 2006: 112). As shown in Figure 17.2, the construction and real-estate (CRE) sectors have been a major contributing source of business tax revenue. Moreover, its relative importance had increased over time—from 33 percent in 2001 to almost one half, 45.5 percent, in 2004. It is not surprising, therefore, that one of us found, in an in-depth study of local finance in a rapidly developing county in Zhejiang—a
province located on the eastern coastal seaboard—that business taxes collected from the CRE sector accounted for 17 percent of land-and-construction-related budgetary revenues, which in turn accounted for nearly 40 percent of total budgetary revenues (38.4 percent of roughly 12 million yuan, Figure 17.3, Zhou 2007). Against this background, it becomes apparent that as much as 17.6 percent of the farmland loss (due to conversion) between 2000 and 2005 was occupied by construction for a variety of purposes, with the magnitude rising over time (more than half, 58.7 percent, of the farmland converted in 2005 was earmarked for construction; Ministry of Land and Resources 2006). The centralization of fiscal rights since 1994 notwithstanding, the reforms in question have unwittingly left a “tail” for local governments to engage in a gamut of construction and infrastructure projects in China’s accelerating urbanization process. But it is land development or specifically the conversion of farmland to non-arable usage that provides local governments with even more powerful incentives to “urbanize” China.

The benefit of pursuing an “urbanization” strategy is by no means confined to being the sole residual claimant of the business tax. By converting farmland for a variety of development projects, local governments are able to both collect fees (fei) associated with land conversion and, even more lucratively, be entitled to land conversion income (nali chang jin)—an income stream over which it has been assigned exclusive rights by the central government (more below). As fees are classified as “extra-budgetary” revenues, local governments are allowed to lay exclusive claims over this income source, which as we can see from Figure 17.3 amounted to over half (51.5 percent) of the surveyed county’s overall “extra-budgetary” revenues in 2003. For rapidly developing counties that command a price premium on their locations, these “extra-budgetary” land revenues can indeed be substantial, and must have been a useful substitute for the lost revenues which have been channelled to the central government as a result of the 1994 and (perhaps to a lesser extent) the 2002 fiscal reforms.

But the biggest gain of all from converting collective farmland into non-arable usages comes distinctly from land conversion income, also commencing in 1994.11 Although conversion of cultivated land for urban and rural construction can be dated to the late 1980s, thanks initially to the rural housing construction boom and subsequently to industrial, transport, and urban developments, the magnitude of revenues was miniscule back then. For instance, the amount of fees collected from land-leasing totaled only 242 billion yuan nationwide between 1987 and 1994 (State Land Management Bureau 1998, cited in Lin and Ho 2005), which pales greatly in comparison with the 901 billion yuan or 90 percent of the entire revenue received during the three years between 2001 and 2003.

That the acceleration of land conversion is a recent phenomenon can be clearly illustrated in Figure 17.4, where we plot both the incidence and magnitude of land conversion for the period 1993–2005 from figures provided by the Ministry of Land and Resources. There we can see that it is only after 1999 that both the incidence and magnitude exhibit a steeply upward trend, until 2003 when the state became worried that China would soon deplete its arable land below its lowest threshold required for food self-sufficiency and began to clamp down on the “excessiveness” of land conversion, at a time when land prices—especially those in premier locations—already commanded hefty valuations (more on this below).12

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**Figure 17.2.** Share of construction and real-estate sectors in business tax, 2001–2004

*Source: State Administration of Taxation, The Taxation Yearbook of China, 2005 (Changsha Shihao Newpaper) (Beijing Renmin Chubanshe, 2005)*

**Figure 17.3.** Profits from land revenue in S County, Zhejiang Province, 2003 (million yuan)

*Note: CRE = Construction and real estate, % of budgetary revenue, % of "extra-budgetary" revenue, % of "non-budgetary" revenue.
Source: Zhou (2007)*

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11 A clear example of this is the rapid acceleration of urbanization in many parts of the country, which in turn has led to a significant increase in land conversion and associated fiscal revenues.

12 This trend is even more pronounced in cities and towns, where the pressure to develop land for commercial and residential use has been particularly acute.
In an attempt to slow down the conversion of farmland by regional governments, the Ministry of Land and Resources set a quota on the maximum quantity of land authorized for conversion in a policy document in 2001, beyond which limit it would be considered illegal. But if Zhou’s (2007) micro-study approximates the reality, the colossal magnitude of land conversion fees received by governments in the rapidly developing counties (as large as budgetary and “extra-budgetary” revenues combined) implies that it would not be an easy task for the central government to effectively put a brake on land conversion. The fact that regional governments have been assigned monopoly rights to receive this lucrative, unregulated income source in its entirety must have powerfully whetted the fiscal appetite of regional officials in hastening the pace of land conversion.

This may help explain why, even though authorized (or “legal”) land conversion activities declined after 2003, unauthorized (or “illegal”) ones rose sharply during the same year; this is especially so with regard to land area (Figure 17.5). Escalating land prices—especially those in premier locations—and the low costs of land compensation were the likely culprits. The prices of land in premier locations appreciated by leaps and bounds; for instance, eight premier sites in the municipality of Hangzhou were expected to fetch 6 billion yuan from cash-flushed domestic developers in 2007 (South China Morning Post 2007: 3). Such lucrative revenues have to be set against the exceedingly low costs of land conversion incurred by regional governments—the subject of our next section. For instance, Zhou (2007) finds that compensation for a county government in Zhejiang Province accounted for an extremely tiny fraction, 1.59 percent, of the selling price. Even after paying various fees to the relevant government departments, total costs of land conversion only made up 4.75 percent of overall land conversion revenues. And in the less lucrative instance of residential and mixed (commercial and residential) usages, the pertinent percentages accounted for only 13.84 and 9.16, leaving colossal profits to be reaped by the municipal government.

Similarly, Zhou Qiren (2004) has also shown that in selling one mu of arable land, the township government of Maichen in Xwben County in Guangdong Province had to pay only 40,000 yuan, which, when set against the average selling price of 0.88 million yuan per mu, the township government there could easily cover the cost from selling only four mu of land; the Maichen township government sold 90 mu of land in this instance and made a windfall profit.

Small wonder regional governments increasingly turned to auctioning land usufruct rights to commercial and real-estate usages instead of either industrial (in the form of “development zones” or kafqafq) or public welfare projects (gongyi xiexue niangemu), such as road and highway construction, schools, and hospitals—the latter a trend until the mid-1990s (Liu and Ho 2005: 424). Regional governments’ waning interest in allocating land to public welfare projects can be easily explained by the fact that land is typically provided for free in such instances. Moreover, regional governments have to provide subsidies typically required in developing land for these projects. And while industrial usage is in principle also a revenue generator, fierce competition among localities could easily drive prices down (Zhou 2004), to a point where local officials would be enriched by the township government for having charged an unconscionably low price that they suspected the local officials of corruption. Some villagers were so angry that they even robbed the cadres’ houses (Ming Pao Daily News 2007a, 2007b). Once again, Zhou’s (2007) study of the three municipalities/counties in Zhejiang Province demonstrates this
LAND CONVERSION: LOW COMPENSATION
A VIOLATION OF FARMERS' PROPERTY RIGHTS?

The extraordinarily strong incentives of local governments to boost fiscal revenues have far-reaching consequences both for China's arable resources and state-peasant relationships with regard to competition over these scarce resources. Although the state has officially set quotas on land conversion, local governments have strong incentives to circumvent the law. For instance, of the 837 appeal letters received by the central government in 2003 concerning land issues, fully 55 percent were related to illegal land expropriation and occupation of collective land (Yu 2005: 23). This finding is consistent with the evidence that unauthorized land conversion increased in 2003 amidst the decline in authorized conversion (Figure 17.5). Although it receded in 2004, by 2006 the Ministry of Land and Resources was still forced to issue an urgent circular to local officials who approved new land acquisitions without authorization from the central government. The circular warned them of possible consequences of party disciplinary sanctions, and also called upon the supervisory ministry to ensure better enforcement in the crackdown. In light of the trend that an average 200,000 hectares of farmland has been converted annually into non-arable usage (Chen Xiuwen, cited in Wang Hongru 2006: 3), in 2007 China's premier Wen Jiabao warned gravely that China must rigorously protect its arable resources as it could ill afford to fall below the minimum threshold of 1.2 million square kilometers of arable land required for food self-sufficiency.

Even more seriously, as unauthorized land conversions often involved forced evictions of farmers from their land and homes, inadequate compensation, deferred payments, or downright embezzlement, they threatened social stability. Indeed, the "land issue" (nuli wenti) topped the list of the three key major agrarian issues (samnong wenti)—accounting for 68.7 percent of all responses in a CCTV telephone survey conducted in 2004. It is also not surprising that violent conflicts between villagers and local police over land disputes have repeatedly occurred since the early 2000s, with county and municipal governments being notable villains (Yu 2005).

To better understand the nature of property rights in the Chinese context it is necessary to invoke a little bit of history. In a nutshell, de jure private ownership of land with respect to bundle of use, income, and transfer rights ceased to exist in China after the Communist Party came to power in 1949 and collectivized agriculture in successive stages in the mid-to-late 1950s. Since decollectivizing its agriculture in the early 1980s, China's use and income rights have been reassigned to the farm households through land-lease contracts which farmers signed with village authorities (cun jishi). Neither the right to alter the land's usage nor to transfer it to another party was conferred to the farmers, however. This crucial right to transfer the foregoing bundles of rights has remained firmly in the hands of the state and in part the village authorities. But as an increasing number of farmers leave for long-distance off-farm employment opportunities, it becomes apparent that it is necessary for the state to relax the grip placed upon farmers that keeps them from transferring their use and income rights in land—at least temporarily.

It is in this evolving context of development that the state further extended farmers' rights by allowing them to temporarily transfer their use rights or simply rent. According to the new Rural Land Contracting Law (Nongcun nudi chengxi ban) enacted in 2002, farm households are allowed to sublease their land to other farm households. To ensure that farmers are able to enjoy this limited transfer right, the state has even gone so far as to prohibit village authorities, the nominal owners, from periodically reallocating land among farm households in response to demographic changes—a customary practice embedded in the collective ownership nature of China's arable land. Unfortunately, this protection of farmers' transfer right is confined to only arable land use; once land is converted to non-arable usage the statutory power of the Rural Land Contracting Law ceases to apply.

In fact, nationalization has been the only legal mechanism by which farmland, which is de jure collectively owned, can be converted into non-arable uses. According to Article 61 of the Land Management Law of 1999, the legal statutes governing land conversion, farmers do not possess the right to convert arable land into non-arable usage; only the (nominal) owner, meaning the local authorities, is empowered to do so. Moreover, any non-arable usage of collective farmland requires a corresponding change in ownership—specifically from collective to state ownership (Article 43). Apart from the minimal compensation stipulated by the state, which therefore is liable to legal protection, China's farmers are thus subject totally to the whims of local authorities in the process of land conversion.
As mentioned earlier, even in the best-case scenario where local governments observe the quota limits of land conversion and abide by the procedures of compensation, the massive disparity between the "windfall profits" resulting from selling the farmland for commercial and real-estate development on the one hand, and the meager compensation made to farmers on the other, has created an enormous sense of injustice from the latter’s point of view.

In the process of land conversion, local authorities have triggered serious conflicts with the farmers, who feel that they have been robbed of the bundle of rights assigned to them at the outset of the reform. From this vantage point it is thus ironic that, while the state has legislated to protect farmers’ use rights by prohibiting local authorities from periodically reallocating land, it accords the same authorities the monopoly right to grab land away from the village community with only minimal compensation. Although they are nominally “members” of the village collective, farmers are basically unable to defend their collectively held land rights against the local authorities. With this power bestowed upon them and, more specifically, with a clearly defined compensation formula stipulated by the central state, many local authorities simply find it unnecessary to negotiate with the peasants for a fair compensation; the major binding constraint in determining compensation appears to be the threshold value of avoiding social unrest. Thus, although local authorities are supposed to act in the interests of the farmers, in particular in guarding their collective land rights, more often than not they have turned out to be robbers of valuable communal resources.

CONCLUSION

China's sustained economic growth since 1978 has occurred in a highly decentralized context of "yardstick competition" among regions facing similar external conditions. While the initial decentralization-based reform led to the phenomenal success of industrial growth (in the form of TVEs) in many regions, the realignment of fiscal rights over various tax categories and revenues has subsequently induced some local governments to focus disproportionately on "urbanization." The key impetus behind this drive for "urbanization" lies in the conversion of farmland into commercial usage, and the construction and real-estate sectors associated therewith. The exclusive income and monopoly rights of local authorities over land conversion have powerfully predisposed them to maximize their fiscal coffers at the expense of farmers’ rights in agricultural land. However, the legal rights with which local officials have been assigned and the biased incentives embedded in these rights have led to ever-worsening social conflicts. To arrest these adverse tendencies, the central government has endeavored both to crack down on land conversion and development and to temper the growing rural social unrest. However, a thorough solution would require more than mere piecemeal attempts to contain these problems; just as in the case of previous reforms, further reforms down the road of transition and growth will require a reconfiguration of existing institutions and their attendant property rights structure.

NOTES

1. Comments from the IFD China Task Force Manchester Workshop, particularly Joseph Stiglitz, Christine Wong, and an anonymous referee, are gratefully acknowledged. We thank Xiulin Sun for helpful research assistance.

2. While the term is used to refer to the provincial level and below, in this paper we are mostly concerned with the economic behavior of lower-level government authorities spanning the municipal and township authorities.

3. Jean Oi (1999) describes this revenue-sharing-fiscal contracting system most succinctly: "Revenue sharing is a process in which local governments down to the level of township have the responsibility for collecting all nationally set taxes and then turning over a portion of this revenue to the next higher level. Those who have increased their tax revenues are allowed to keep the major portion of the increase. The provisions of revenue sharing are formalized in fiscal contracts between the central state and each of its provinces, between each province and its prefectures, between each prefecture and its counties, and between each county and its township." (p. 29).

4. For example, even if the tasks of agents are similar but outside random factors that agents face do not follow the same distribution, the principal would be unable to compare the performance of one agent with that of the other even if the absolute performance of both can be observed.

5. Oi (1999) notes that the terms of the contracts vary from one place to another; while some areas employ an overall ratio such as 70:30 (with the level of government from which the taxes are collected keeping 70 percent whereas the immediate supervising level keeps 30 percent), others merely pay a fixed lump-sum quota to the next higher level (p. 29). "Regardless of the system of revenue sharing in effect, increased tax collection guarantees a locality an increase in tax revenue" (Oi 1999: 30).

6. Although county-level industrial firms continued to be the bedrock of county-level income and taxes, their tax contribution decreased as a proportion of total revenues over time as TVEs grew (Wong 1991; Naughton 1992).

7. In 1985 enterprise income tax was extended to township and village enterprises in replacing the industrial-commercial income tax (see Oi 1999: 35).

8. Oi (1999), for instance, has found that rich counties tended to grant more tax breaks than did poor counties (p. 38).

9. The existing literature predicts that when the protection of private property rights has improved, when asset markets are better developed, and/or when large-scale migration has occurred, the ownership advantage of TVEs tends to become suboptimal and privatization is more likely to occur. Evidence is consistent with these predictions (Xia 2011).

10. The percentage of the Chinese population classified as "urban"—those residing in towns and above—increased from less than 18 percent in 1978 to 43 percent in 2006 (State Statistical Bureau of China 2007).

11. It was first introduced in 1989 as a shared arrangement between the central and regional governments under the provisional regulation "Temporary regulation on the transfer of use rights of state-owned land in towns and cities." When it was amended in 1994, the state allowed regional governments to appropriate in full the proceeds from transferring the use rights of state-owned land.

12. Statistics show that farmland decreased by as much as 120 million mu (1 mu = 0.0667 hectares) between 1996 and 2005 or 6.6 percent of the total arable land (Ministry of Land and Resources 2006).
13. The next major reason, which accounted for 25 percent, pertains to compensation being "too low or misappropriated."

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