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## The Local States in China's Urban Growth: A Survey of the Institutional Characteristics

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## Surveys

# The Local States in China's Urban Growth: A Survey of the Institutional Characteristics

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**Abstract** *Conventional wisdom attributed China's rapid urbanization to targeted measures taken by the central state. This paper looks at the role of Chinese local states in China's urban and industrial growth, not as an advocate of urbanization and industrialization per se, but as an entrepreneurial manager that aims to maximize its revenues from urban physical and economic growth. It demonstrates how local states in China are motivated by the imperatives associated with fiscal and political institutions and enabled by housing and land use policies to promote the growth of real estate and manufacturing sectors. Specifically, the political appointment system links the political prospects of Chinese officials to the office achievements accomplished during their few year terms, while the fiscal system related the local financial strength to their efforts to mobilize revenue collection. It is under such circumstance that urban growth becomes the imperative mission of Chinese local states.*

*The housing and urban land use reform from the late 1990s facilitated the rise of real estate and manufacturing as the dual engines of urban physical and economic growth. Housing reform generates huge demand for residential units and land use reform enables municipalities to control the supply of urban land for both real estate development and manufacturing production. Statistics compiled from Chinese official data show the municipal strategy to expedite urban economic and physical growth is to bid up the price of land for real estate development by limiting the land supply and improving the floor area ratio on one hand, and offer land to manufacturing investors at excessively low rates in exchange for their investment commitments on the other. Furthermore, a majority of the tremendous "land granting premium" collected from real estate developers is used for urban construction projects, which may not only drive the land price up further but also can produce a shaper city image and attract more inward investments. This study concludes with implications of this urban growth logic for sustainable urban development.*

**Keywords:** Local state, urban growth, industrial growth, land use.

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## 1. INTRODUCTION

As one of the greatest transformations humankind achieved in the past century, China's remarkable urbanization and industrialization attracts the attention from communities of academia, government and business across the world. The indicator of urbanization as measured by the proportion of population living in urban areas increased from 10.6 percent in 1950 to 45.7 percent in 2008 at an average annual rate of 0.6 percent. Further investigation finds that urbanization in China demonstrated an accelerating growth rate after 1979 and became even faster since 2000 with an annual rise of 1.19% (National Bureau of Statistics of China, various years). Along with the booming urban population is the rapidly expanding urban space. Urban developed areas across China, for instance, increased from 9,386 square kilometers in 1985 to 36,295.3 square kilometers in 2008, at an annual rate of 6 percent over the 23-year period (National Bureau of Statistics of China, various years).

A vast volume of literature attributes China's astonishing urban physical and economic growth to the fiscal and administrative decentralizations that gave rise to greater autonomy and stronger quest for development at the local level (Qian, 2006). That argument, however, is increasingly inconsistent with the centralizing fiscal and political structures as will be demonstrated in this article. Others taking the metaphorical perspective of corporate firms to understand this dynamics (Oi, 1992 and 1996; Walder, 1995; Duckett, 1998) may not be an accurate portrait of today's Chinese local states because of the irrational government expenditures on public projects such as city halls, public squares, exhibition centers as well as state-of-the-art stadiums regardless of social benefits and capital costs (Jin and Zou, 2003). Besides, those focusing on the local fiscal starvation and Chinese political features (Wu, Xu *et al.* 2007), however, did not address the specific mechanism through which such conditions make local states entrepreneurial maximizers of economic and physical performances within their jurisdictions, or how that objective is achieved by Chinese local states under the transitional institutions.

Deviating from conventional wisdoms on Chinese urban growth, this article aims to illustrate its identification, causes, processes and effects by demystifying Chinese local states as an entrepreneurial manager that aims to maximize tangible urban physical and economic growth. Note that the term "local" in China studies refers to provincial, municipal, county or intra-urban district scales that are all under the central state in a hierarchical system (Chung, 1999; White, 1991). Although the overarching institutional structure as will be illustrated in this article mobilizes local states actions at all levels, municipal governments have the most substantial space and substantive power to spur such growth and will be the focus of analysis of local states through this paper. In contrast, provincial governments are subject to immediate supervision of the center and are largely devoid of direct control over tangible

assets such as urban land that can be used to build the entrepreneurial project (Fitzgerald, 2002; Hendrichske and Feng, 1999). The jurisdiction duties of county-level or district-level governments are stipulated by the municipal government and they do not have great administrative or financial latitudes as a result (Zhang and Wu, 2006).

Methodologically, the main body of this paper is divided into three sections to deal with the role of local states in China's urban spatial and economic growth. It starts from local revenue and expenditure structures to identify the general action pattern of local states and then explores how they were shaped by China's evolving fiscal and political structures in a largely unintentional fashion. On the basis of qualitative evidence collected from extensive interviews and quantitative official data, the third section uncovers the particular approaches taken by the local states during the course of China's urban housing and land use reforms to promote growth in real estate and manufacturing sectors, which is the immediate driver of urban spatial and economic growth in China. This article finally concludes with the impacts of this growth logic system and some policy implications.

It should be pointed out that the fact that this article draws upon aggregate statistics published by Chinese statistical authorities for quantitative analysis does not undermine the reliability of the data itself or the conclusions about local state actions based upon it. The reasons are two-fold. One is that many statistics cited in this paper are compiled as ratio-based ones and others are used to observe the pattern on a time-series basis. Even to the extent that some numbers get tampered with by the government departments that reported them, it is very unlikely that the manipulation could happen on such a large scale or in such a sophisticated way that the ratios between them or the temporal pattern would be systematically distorted as well. Secondly, the aggregate data excludes those on the central level and is for the local level only. To the extent that the particular circumstance at each locale varies from place to place, the overall pattern as shaped by the uniform institutional scheme changes little across space, which is supported by the qualitative evidence collected at different cities.

## 2. LOCAL PUBLIC FINANCIAL STRUCTURE

One concrete representation of the actions taken by Chinese local states is the flow of their financial resources that demonstrates their entrepreneurial orientation to achieve tangible urban economic and physical growth at the expense of social concerns. Originally a term associated with the motivation driving technological and organizational innovation as well as capitalist development at large, entrepreneurialism is increasingly used in recent decades to represent the transformation of urban governance from traditional housekeeping type to a more proactive market-building one (Harvey, 1989; Hall and Hubbard, 1996; Yong and Kaczmarek, 1999; Jessop and Sum, 2000). The case of China, however,



deserves particular attention as it involves basic features distinguishing the Chinese local state, in many aspects a market actor that aims to maximize short-term achievements, from those in many other countries that orchestrate various market players into a project of structural competitiveness building. By analyzing the major sources of local revenue and principal items of expenditure, this section will present a systematic picture of the financial dynamics of Chinese local governments and their underlying orientations.

Business tax, value-added tax (VAT) and enterprise income tax (EIT) are the three largest sources of Chinese local tax revenues. Largely collected from manufacturing and real estate sectors, these three types of tax jointly registered 70 percent of total local tax revenues between 2000 and 2005. For business tax revenues, the share of real estate and its associated construction sectors had been increasing constantly since 2000 and reached nearly 50 percent in 2005. Meanwhile, the share of the financial sector, whose strength is deemed as the core of competitiveness in the modern economy, continuously declined during the same period (State Administration of Taxation, various years). Manufacturing dominated the sectoral distribution for both VAT and EIT with more than half of the former and a quarter of the latter coming from that broad sector (see Figure 1). Given the overwhelming shares of business tax, VAT and EIT in local budgetary revenues, it suggests many local governments are heavily dependent on investments in manufacturing and real estate for local budgetary revenues.

In addition to their dependence on manufacturing and real estate for revenues, Chinese local states are also characterized by the deviation of their expenditures from fields related to civic life such as education, medical care and social security. Figure 2 lists the growth rates of local final expenditures for the largest five items from 2000 through to 2005. Most items demonstrated generally accelerating growth rates over the six years, except 2002 and 2003 when a national austerity program was implemented. Noteworthy is their inconsistent growth rates in the post-austerity years of 2004 and 2005. The expenditures on both capital construction (item A) and urban maintenance (item C) quickly bounced up at rates higher than the average, while the spending on science and technology (item B), that on culture, education, science and health care (item D) and that on social security (item E) regained some momentum too, but at paces substantially slower than those of construction-related items. This indicates the motivation of local governments to launch constructions at the expense of public service provisions.

### 3. INSTITUTIONAL FOUNDATIONS

The rise of Chinese local state entrepreneurialism as represented above is an outcome of broad and profound changes in the socio-economic system on multiple scales. In spite of the administrative decentralization resulting from the globalization of capital markets, the exercise of that localized power is

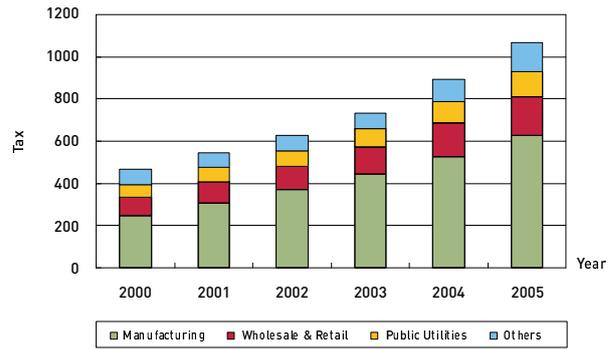


Figure 1: Sectoral Sources of VAT, 2000-2005 (in billion yuan)  
 Note: Due to limited data availability, only national total revenues are presented here. The lack of statistics on local budgetary revenues, however, does not affect the basic assertion that localities largely depend on manufacturing as their main source of VAT. The reason is that the total tax revenues will be shared between the central and local governments according to fixed rates. Thus the sectoral distribution of local tax revenues simply follows the same pattern as the presented national figures.  
 Source: Compiled from Tax Yearbook of China [zhongguo shuiwu nianjian], various years

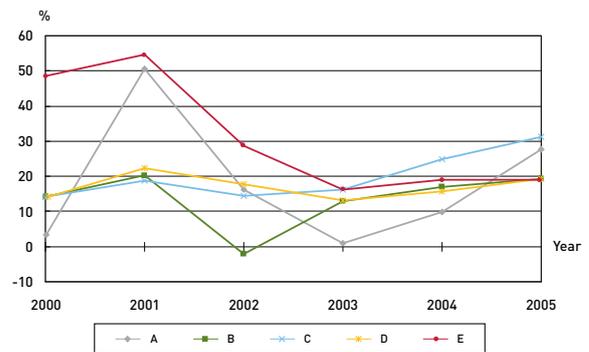


Figure 2: The growth rates of budgetary expenditures for major local account items, 2000-2005  
 Note: The expenditure categories of A through G are (A) = capital construction; (B) = Innovation Funds & Science and Technology Funds; (C) = Urban Maintenance and Construction Expenditure; (D) = Operating Expenses for Culture, Education, Science & Health Care; (E) = Social Security Subsidiary Expenses.  
 Source: Compiled from Finance Yearbook of China [zhongguo caizheng nianjian], various years

still largely conditioned by the changing economic institutions as well as the national legacy of the political system. Thus it would be a simplistic understanding of localities as a complete retreat of state power from economic and social life. Rather, they are emerging as entities using a combination of state power and market instruments to achieve specific objectives. This section will discuss the institutional foundation for Chinese entrepreneurial local states in terms of fiscal and political structures.

#### 3.1 SHIFT OF FISCAL INSTITUTIONS

In the absence of a uniform fiscal system where the central and local states have clearly defined tax revenues and expenditure

responsibilities, volatility was characteristic of all pre-1994 fiscal systems in which a locality with better financial conditions would have to deliver a higher share of its revenues to the supervising government in the next few years. This discouraged most localities from reporting its full revenues by transferring part of the budgetary revenues into the extra-budgetary accounts, the consequence of which was the quickly declining ratios of fiscal revenues to GDP and central revenues to the total.

A fundamental reform package called “tax assignment system” (*fen shui zhi*) was introduced in 1994 to deal with the problems associated with previous fiscal systems. The package included new tax items and division of revenues between the central and local governments. Additionally, a set of independent tax collection agencies, namely the State Administration of Taxation (SAT), was established in all provinces and cities to ensure the collection of central revenues. More importantly, institutionalized measures were taken against the extra-budgetary account. In September 1996, the State Council promulgated the Decision on Reinforcing the Management of Extra-budgetary Funds (*guowuyuan guanyu jiaqiang yusuanwai zijin guanli de jueding*) requiring the shift of 13 major governmental funds from the extra-budgetary to the infra-budgetary account. As a result of these initiatives, the absolute size of local extra-budgetary funds shrank abruptly in 1997 (see the last column of Table 1). With a further campaign of “transformation of administrative fees into taxes”, the relative ratio of local extra-budgetary funds to budgetary revenues started to demonstrate a continuously declining trend.

These efforts led to the reversal of the asymmetric financial strength between the central and local governments with an increasing share of revenues flowing to the center while less was left to the localities. Both the absolute magnitude and the relative share of central revenues demonstrated sharp rises in 1994. In contrast to the clear division of tax revenues between the central and local governments, however, the scope of expenditures was not explicitly specified in the tax assignment system of 1994. Many duties of public services were simply delegated to local governments via political imperatives without corresponding sources of revenues. That was further aggravated in 1995 when many small and medium state-owned enterprises (SOEs) were released from the ownership of local governments via merger, leasing, contracting, offering for sale, or bankruptcy. In order to maintain good social order, local governments had to assume the responsibilities of continuing the services that SOEs used to provide to their employees such as education, health care, and pensions, which resulted in a widening gap between local budgetary revenues and expenditures.

The tax assignment system adopted various central-to-local fiscal transfer programs to help local governments finance their expenditures. They can be divided into three broad categories (see Figure 3). The first is the regular “tax refund”. As the “tax assignment system” would cut local revenues, it was

	Budgetary Revenue/GDP (%)	Central Revenue/National (%)	Local Extra-Budgetary Funds (100 million yuan)	Local Extra-Budgetary Funds/Local Budgetary Revenue (%)
1993	12.6	22.0	1186.64	35.0
1994	10.8	55.7	1579.21	68.3
1995	10.3	52.2	2088.93	70.0
1996	10.4	49.4	2945.68	78.6
1997	11.0	48.9	2680.92	60.6
1998	11.7	49.5	2918.14	58.6
1999	12.8	51.1	3154.72	56.4
2000	13.5	52.2	3578.79	55.9
2001	14.9	52.4	3953.00	50.7
2002	15.7	55.0	4039.00	47.4
2003	16.0	54.6	4187.43	42.5
2004	16.5	54.9	4348.49	36.6
2005	17.3	52.3	5141.58	34.0
2006	18.4	52.8	—	—

Table 1: National, Central Budgetary Revenues and Local Extra-Budgetary Funds, Since 1993  
Source: Compiled from Finance Yearbook of China 2006 [*zhongguo caizheng nianjian* 2006]

initially met with resistance from many localities, especially those wealthier ones that benefited most from previous fiscal schemes. The center then recognized the vested interests of local governments by guaranteeing that each locality retained no less than what it had in 1993. In addition, 30 percent of the incremental central revenue collected from VAT and consumption tax would be returned to the local governments as incentives for them to mobilize revenue collection. In 2002, a similar scheme was instituted that localities would receive income tax and EIT no less than what they had in 2001 and a proportion of the incremental revenues would be refunded by the center.

The second category includes various special purpose subsidies and grants. To compete for these resources, localities took measures called “*paobu qianjin*”, or “soliciting grants from central ministries officials” who are in charge of their distributions. This incurs considerable costs for local governments and largely counteracts the benefits associated with these well-intended grants. Besides, the “transitional transfers” (renamed “general purpose transfers” in 2002) was designed to narrow the regional disparities in public service provision. This program, however, depends on incremental central revenue, which is quite limited by the difficulty in redistributing the existing revenues. The share of this program in the pool of all fiscal transfers has therefore been less than 10 percent since 1994.

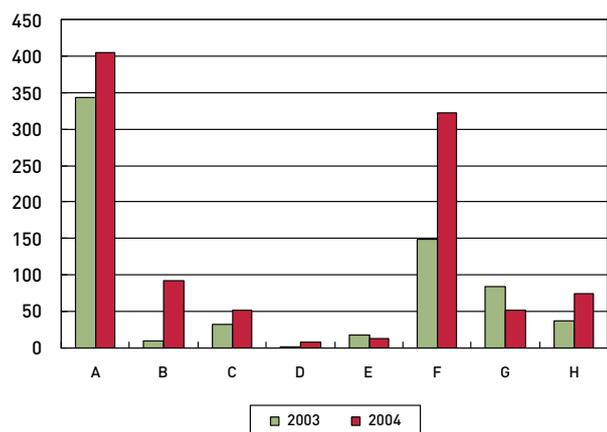


Figure 3: Central-to-local transfers in China, 2003-2004 (in billion *yuan*)

Note: The transfer categories of A through H are (A) = tax refund; (B) = Subsidies for increasing wages of public employees; (C) = subsidies for abolishing rural taxes and charges; (D) = subsidies for minority regions; (E) = subsidies for continuing implementation of pre-1994 fiscal schemes; (F) = earmarked transfers; (G) = other specific purpose transfers; (H) = general purpose transfers. Source: Shah and Shen (2006)

The immediate consequence of this overall transfer scheme is that business tax, VAT and EIT become the three most important revenue sources for Chinese local governments in the face of increasingly expanding expenditures. Firstly, business tax is not to be shared with the center and can be entirely retained by local governments. Secondly, the growth in tax refund is closely related to a locality's efforts in mobilizing collection of VAT and EIT and is a more reliable source of revenue for local governments than those specific purpose grants. Given that the amount of tax refund is determined on the basis of the incremental tax contribution, a locality can only receive the same refund in the second year if its revenues of VAT and EIT do not increase over time. It is exactly under this circumstance that local governments start their proactive search for investments and eventually embrace entrepreneurial industrial growth and urban expansion.

### 3.2 PERFORMANCE-BASED POLITICAL SYSTEM

In contrast to the progress China has made in the realm of economic reform, its political institutions are characterized by a centralized system of personnel control that has remained largely intact even to this day (World Bank, 2002; Xu, 2004 and Tao *et al.*, 2004). Under such a top-down hierarchical system, government officials who are appointed from above but not elected by their respective constituencies have tended to be more responsive to higher-level government mandates than they are to local needs. Political centralization does not mean that there has been no change at all in the political arena. China's reform of its bureaucrat appointment system coincided with the beginning of its economic reforms. With class struggle supplanted by economic development as the

dominant national ideology, a crucial turnaround in personnel management has involved the wholesale change in the evaluation criteria for government officials.

Although "economic development" consists of the quantitative and qualitative aspects of economic dynamics, the asymmetric information between different levels of governments makes it extremely costly, if not impossible, for the higher-level governments to be informed of the qualitative characteristics of local economies such as environmental sustainability, economic equality and social justice. The more easily available information on local economic performance is the quantitative magnitude of the economic base that is not only measured by the indicators of local GDP, the fiscal revenues and FDI inflows (Li and Zhou, 2005) but also can be sensed from the tangible urban physical development like modern infrastructure, mega-projects for art and sports and high-rise buildings (Wu, Xu *et al.*, 2007). Thus, a rapidly growing local economy as represented by striking economic indicators and concrete projects becomes important political incentives or career concerns on the part of Chinese local officials (Blanchard and Shleifer, 2001) who unanimously engage themselves in the competition for economic performance within their own jurisdictions as well as for the associated personal political promotion (Qian and Xu, 1993; Qian and Weingast, 1996).

As an important representation of officials' competence and performance, financing large-scale urban construction is well beyond the capacity of regular tax revenues. For instance, the total local budgetary revenues including central transfers were 2191.6 billion *yuan* in 2004 and the budgetary expenditures excluding capital construction and urban maintenance were 1753.1 billion *yuan*, which means only a portion of 438.5 billion *yuan* could be used for urban construction projects as the rest had to be spent in the rural. The total urban construction cost in that year, however, reached 525.8 billion *yuan*. That means urban construction in China is financed by other important market-based instruments. Table 2 presents the financial sources of urban construction in China between 2001 and 2004. Bank loans, local budgetary revenues and land granting premium were the three largest financial sources underpinning unprecedented urban physical renewal. Local tax revenues and bank loans provide pivotal support to urban physical construction that is publicly owned and used. What remains intriguing, however, is the nature of land granting premium. Starting with a brief review of the urban land and housing reforms, the following section will reveal the nature of this fund and show the critical role it plays in shaping urban spatial development as well as driving industrial growth.

## 4. STRATEGIES TO PROMOTE URBAN GROWTH

The enormous land granting premium is a product of urban land use reform that commodifies land use rights (LURs) at bidding prices. Before it actually happens, however, there must be sufficient market demand for land use to support the

	2001	2002	2003	2004
Central Fund	9.0	7.6	7.7	5.3
Local Taxes	59.5	70.9	90.5	111.2
Urban Fees	20.2	30.1	37.1	42.7
Land Granting Premium	16.7	28.3	50.7	110.0
Domestic Loans	74.2	94.0	136.9	148.0
Foreign Investments	5.6	6.9	7.7	8.7
Bonds	0.7	0.3	1.6	0.06
Stock Financing	0.1	0.7	0.03	0.3
Self-Raised Funds	41.0	60.1	77.0	90.0
Others	25.6	30.5	33.0	26.1
Total	252.6	315.6	427.6	525.8

Table 2: Financing urban construction, 2001-2004 (in billion yuan)  
Source: Compiled from Urban Construction Yearbook of China [*zhong-guo chengshi jianshe nianjian*], various years

prices. Housing reform initiated at the end of the 1990s played such a role of demand generator.

#### 4.1 GENERATING HOUSING DEMAND

Comprehensive reforms of urban housing and land use started from 1998 but prior to this, most urban land uses were carried out via state allocation or under-the-table negotiation. The absence of market mechanism detached urban land use from price principle. Consequently, this system of free allocation by the state led to the inefficient land use pattern in urban areas. One example was that residential land was squeezed out in favor of industrial land in urban cores because industrial production was given the highest priority by the state.

Like the pre-reform urban land system where most urban land had been owned by the state and distributed free of charge, about 60 percent of the urban housing had been provided by the state work units as part of the socialist welfare package with the rest developed by the local governments as public housing for workers in small-sized enterprises that were ineligible for state housing investments or could not afford to build by themselves (Wu, 1995). Under the housing system featured by a single investment source of state money and negligible return from rent, it was impossible for the construction and maintenance costs to be recovered even with the allocation of free land. The provision of housing heavily burdened the socialist state and urban housing conditions had rarely been improved since 1978.

Since both the land use and urban housing problems were associated with the centrally socialist planned economy, they were expected to be resolved through a market mechanism. In

July 1998, one month after the fourth national housing reform conference, the "Circular on Further Deepening Urban Housing Reform and Expediting Housing Construction" (*Guanyu jinyibu shenhua chengzhen zhufang zhidu gaige jiakuai zhufang jianshe de tongzhi*) was released by the State Council. For the first time since 1978, this document explicitly regarded marketized housing provision as a "new economic growth engine". One of the most critical changes it introduced was to terminate the material housing distribution as welfare that had been existing for decades. Instead, individual households are expected to finance their house purchase via savings, provident fund and housing mortgage, which instantly forced a majority of people who had not received decent housing through their work units to purchase commercial houses from the market.

In the same year, the central bank promulgated the Management Measures on Individual Housing Mortgages (*geren zhufang daikuan guanli banfa*) to facilitate the provision of housing mortgage. As a result of these deregulation measures, nationwide balances of housing mortgages rocketed from 19 billion yuan (0.25 percent of all loan balances) in 1997, through 740 billion yuan (5.89 percent of all loan balances) in 2002 (Wang, 2006), to 1840 billion yuan (9.45 percent of all loan balances) at the end of 2005 (The People's Bank of China, 2006). This, along with the provident savings, greatly improved the purchasing power of individual households. In 2006, the regular residential units sold in terms of square meters increased to four times that in 2000 (see Table 3). Encouraged by the rapidly growing demand for housing, the number of real estate development firms doubled from 27303 in 2000 to 58710 in 2006 with newly constructed regular residential units rising from 179.2 to 559.7 million square meters across that six-year period.

Market-based housing provision inherently requires a marketized land use system so that both the land and the houses built on it can be properly priced. Pushed by the housing reform starting from 1998, a strict measure against illegal land transactions on the black market, widely known as "No. 11 Decree of Ministry of Land and Resources" (MLR), was promulgated in May 2002. Conventionally, developers with connections to government could usually acquire LURs at a non-public negotiated price then transferred it to other users at a higher market rate to reap a huge profit. This critical "Regulation on Granting State-Owned Land Use Rights by Tender, Auction and Quotation" (*Zhaobiao paimai guapai churang guoyou tudi shiyongquan guiding*) was expected to prevent such land speculation as it required the land for commerce, tourism, entertainment, and commodity housing uses to be granted through designated public processes. As a result, the national cases of negotiated granting increased from 99,632 in 2000, to 145,228 in 2001, and 203,866 in 2002 but abruptly dropped to 157,381 in 2003 (MLR, various years).

With all LURs for commercial/residential development to be acquired only via marketized tender, auction or quotation, the consequence of residential building boom was that

		Residence			Office	Commerce	Others
		Regular	Luxurious	Affordable			
2000	S	12170	641	3760	437	1399	231
	C	17919	1169	5313	899	3035	1248
2001	S	15040	878	4021	503	1696	274
	C	23280	1457	5796	1073	4105	1683
2002	S	18457	1241	4004	539	2219	348
	C	27162	2278	5280	1254	4926	1900
2003	S	24310	1450	4019	630	2833	475
	C	36174	2349	5331	1467	6707	2680
2004	S	28235	2323	3262	693	3100	619
	C	40716	2976	4257	1704	7791	2970
2005	S	43564	2818	3205	1096	4081	721
	C	48837	2835	3513	1671	7675	3533
2006	S	48414	3672	3337	1231	4338	865
	C	55966	4058	4379	2135	8473	4241

Table 3: The floor areas of sold and started buildings, 2000-2006 (in hectares)

Note: The first sub-rows headed by "S" represent the floor areas of actually sold buildings while the second sub-rows headed by "C" refer to the floor areas of newly constructed buildings in that same year.

Source: Compiled from China Statistical Yearbooks [*zhongguo tongji nianjian*], various years

a dominating share of publicly granted land was used for residential development. The percentage ratio of residential land among all granted land acreage rose from 47.7 percent in 2003 to 62.4 percent in 2005 (MLR, various years), which suggests a majority of the property development in the market was residential building that was followed by the commerce/service.

## 4.2 LAND-BASED URBAN GROWTH STRATEGY

### 4.2.1 CONTROLLING LAND SUPPLY AND ACQUIRING AGRICULTURAL LAND

It is regulated that the supply of urban land via public processes of tender, auction or quotation be conducted by the *de facto* owner of municipalities on behalf of the *de jure* owner of the state and most land granting premium be retained by the municipalities. With the explosive demand for residential houses and land, property development not only became a intriguing sector for private developers to make profits, but also a critical driver for the entrepreneurial local states to expedite the growth of cities both physically and economically. To the extent that some urban land is under the immediate control of agencies other than municipalities, such as the army, larg SOEs or universities, they can be used only for their own building projects upon approval and cannot be directly transacted on the open market. Because the presence of these land

parcels does not affect the municipal manipulation of land use to promote urban physical and economic growth, the discussion hereafter on urban land use will focus on those supplied at the discretion of municipalities.

One strategy to maximize land granting premium is control of urban land supply that would not only lead to more intense competition among developers and thus higher LURs price, but also force developers to increase the floor area ratio. Inversely, the subsequent sharper image of city height and urban modernization would further boost urban land prices. The process was further complicated by developers' efforts to create a stock of land in the expectation of higher prices in the future, which curtailed the amount of land available for immediate development. In response to this situation, the central state has repeatedly issued regulations since 2005 to increase the urban land supply and prevent overly delayed development. As the attention shifted to residential land and housing prices, land for commercial development, service and office use was still under the tight control of municipal governments. The acreage of land granted for these purposes decreased from 19,466 hectares in 2003 to 16,390 in 2005 (MLR, various years) while the floor areas of those buildings kept increasing (see Table 3).

Meanwhile, land left idling or delayed development was largely tolerated by municipalities by reason of *force majeure*

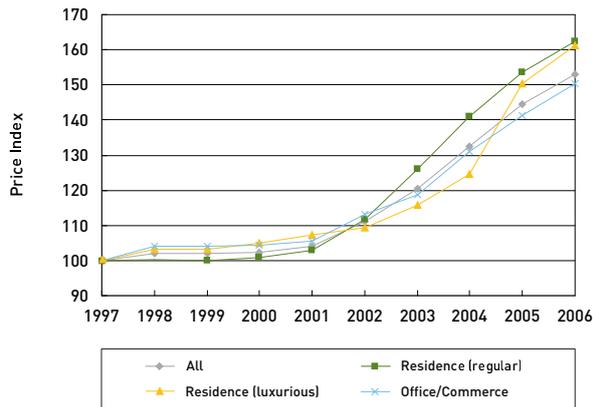


Figure 4: National land price indices, 1997-2006

Note: The land price indices in 1997 are set to 100.

Source: Compiled from China Statistical Yearbook [*zhongguo tongji nianjian*], various years

such as the difficulties associated with displacing original residents or preparing sites. As a result of the tremendous demand as well as controlled land supply, the national land price indices increased abruptly in 2002 when the No. 11 Decree was implemented (see Figure 4). According to official statistics, the average price of land purchased by developers was 576 *yuan* per square meter in 2003 and reached as much as 907 *yuan* in 2006. It should be noted that the prices of residential land (both regular and luxurious) increased more quickly than for office and commercial uses, which suggests the former was not only an outcome of rising urban land value in general but also a result of the interaction between huge demand and undersupplied residential land.

As land became a valuable commodity and its supply was monopolized by the municipal governments, relentless acquisition of arable land with unjust compensation to the farmers occurred. The total area of arable land across the nation shrank from 129.21 million hectares in 1999 to 122.08 million hectares in 2005 as reflected by a declining share of acreage in all land categories from 13.59 to 12.84 percent (MLR, various years). Nearly half of all lost arable land was used for constructions or other higher-yield agricultural activities with the remainder either damaged by natural disasters or reclaimed for ecological restoration. As the majority of the rural population relies on the land to make a living, the loss of arable land posed a threat to the economic and social stability of Chinese society. In 2003, the MLR issued the "Circular on Taking Further Measures to Strictly Implement the Arable Land Protection Scheme" (*Guanyu jinyibu caiqu cuoshi luoshi yange baohu gengdi zhidu de tongzhi*) to address the alternative uses of arable land. In 2006, the approved eleventh Five Year Plan for the Development of National Economic and Social Development (2006-2010) explicitly mandated the preservation of a total of 120 million hectares of arable land across the nation.

Since the acquisition of agricultural land could only be legitimately conducted by municipal governments, the continuous decreasing acreage of arable land and the rapidly increasing land prices clearly demonstrate the municipal intention to convert the potential value of land into tangible cash in their coffers. Analogous to the "enterprise profits" in the business world, municipalities are left only "net premium", a portion of the gross land granting premium, with the rest to be spent on compensating the dislocated farmers (for agricultural land), residents (for residential land) or workers of bankrupt SOEs (for industrial land) as well as on consolidating the acquired land for sale in the market by "five connections and one leveling" (*wutong yiping*, or connecting roads, water, drainage, electricity, telecommunications and the leveling of sites). In the three consecutive years from 2003 to 2005, the share of "net premium" in gross land granting premium was 33.2, 36.5 and 37.1 percent respectively (MLR, various years). In other words, approximately one third of the gross land premium was retained by the local states as "municipal profits".

Recall that a significant share of capital for urban construction across Chinese cities came from land granting premium. In 2004, the land premium expenditure on urban construction was 110 billion *yuan* (see Table 2). The total land granting premium available for use in a given year could be estimated by its net proceeds in the previous year. Consequently, two thirds of the collected net premium was spent on urban construction because the net premium was 179.9 billion *yuan* in 2003. In other words, a majority of the land granting premium was used to finance urban construction in Chinese cities. It should also be pointed out that until very recently, land premium was independent of either budgetary revenue or extra-budgetary funds as to be listed as a separate category in municipal accounts. Thus, real estate development not only led to the enormous land granting premiums it created, but also became one of the key local industries with considerable tax contribution.

#### 4.2.2 NEGOTIATED LAND GRANTING FOR MANUFACTURING INVESTMENT

Despite the vast municipal revenues associated with urban property development, they alone are insufficient to meet the expenditure needs of local governments. Firstly, as shown in Table 1, the main contributor to local budgetary revenues is the manufacturing sector. Real estate is lagging behind the sector of wholesale and retail in shares until 2005 when its tax remittance was still less than 40 percent of that of manufacturing. Secondly, a large proportion of local expenditures is financed through the central-to-local transfer whose magnitude largely depends on the growth of manufacturing. In 2005, for example, the local expenditures reached 2,515 billion *yuan* while local revenues were only 1,488 billion *yuan*. As debt financing by localities is not allowed in China, the transfer of 1,123 billion *yuan* played a critical role in local public finance. As illustrated in Figure 3,



approximately 40 percent of these transfers are in the form of “tax refund” and how much a locality would receive is determined by the VAT and EIT it remits. As the primary base for these taxes, the manufacturing sector attracts local governments who are in the pursuit of greater “tax refund” to bridge the gap between revenues and expenditures.

The indispensability of manufacturing is also associated with its qualitative features as opposed to those of real estate, the growth of which is largely driven by relatively more volatile demand and is more easily susceptible to speculative capital or stringent state regulations against excessive investment and an overheated economy. Perhaps a more realistic reason for valuing manufacturing is its ability to create sustainable revenues. In contrast, because property tax is not levied in China, revenues associated with property development, whether tax or land granting premium, are one-off in nature and will have to cease once the development is complete and the property is sold. Land is a finite resource in the sense that they can be occupied legitimately for decades. The acquisition of agricultural land is also subject to the constraint of master plans that must be approved by the center. Thus, the rapidly growing property development means the land stock available for development is quickly decreasing and its aggregate value is shrinking.

It is under such circumstances that localities attached great importance to the growth of manufacturing sector. As land is an input of most manufacturing activities, its pricing is often manipulated to attract manufacturing investments with a dominating majority of industrial LURs granted via negotiation. During the three years from 2003 to 2005, 145,632 or 95 percent of all the 153,429 industry-purposed LURs granting cases were conducted through negotiation at prices substantially lower than the market level. Over the same period, the average negotiated price was 120.91 yuan per square meter, only one third of the average market rate of 347.64 yuan per square meter (MLR, various years), which clearly indicates the hospitality of Chinese local states toward prospective industrial investors.

The suppressed industrial land price can be also mirrored by its stability over time. It is certainly true that due to the much lower return rate of land investments for industry development, industrial land is usually located on the urban fringe with prices substantially lower than those of commercial/residential uses land. In the context of increasing needs for urban land, augmenting prices are expected for both industrial land and commercial/residential land. The growth rates of land price for residential housing and commercial development, however, have been markedly higher than that for industrial use. Urban land price survey at 35 major cities clearly shows the divergence between the growth rate of industrial land price and that of commercial land. From 2000 to 2007, the industrial land price increased slightly from 444 to 507 yuan per square meter while the residential and commercial land

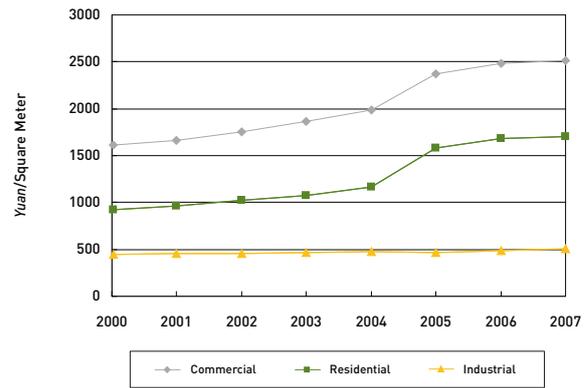


Figure 5: Average land prices in 35 major Chinese cities, 2000-2007  
Source: Compiled from data on <http://www.landvalue.com.cn>

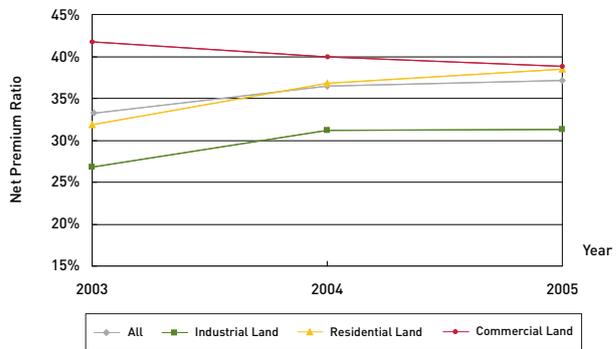


Figure 6: Net premium ratio for different land uses, 2003-2005  
Source: Compiled from China Land and Resources Almanac [zhongguo guotu ziyuan nianjian], 2004-2006

prices jumped from 923 to 1702 yuan per square meter and from 1615 to 2509 yuan per square meter respectively.

Perhaps a more convincing piece of evidence for the involvement of local states in pricing industrial land is the ratio of net land granting premium to gross land granting premium (named “net premium ratio” hereafter) as presented in Figure 6. Remember not all gross premiums can be retained by municipalities as their profits. The difference between gross and net premiums is the government expenditures on compensating the dislocated or affected people and on physically consolidating the land for future development. Thus, the net premium ratio generally reflects the intensity of government investment in converting the land from its current condition into one that is ready for immediate sale and development. Higher net premium ratio means less expenditure on unit acreage of land controlling the type of or the revenue gained from that plot, and vice versa. Results show the net premium ratios of industrial land are systematically lower than those of residential and commercial land with 26.8, 31.2 and 31.3 percent, 31.9, 36.8 and 38.5 percent and 41.7, 40 and 38.8 percent for the three categories respectively from 2003 to 2005.

Industrial land's lower net premium ratio suggests its higher consolidation costs or greater expenditures of municipal governments on "seven connections and one leveling" (*qitong yipping*, connecting gas and heat in addition to the ordinary five connections of roads, water, drainage, electricity, telecommunications and the leveling of sites) or even "nine connections and one leveling" (*jiutong yipping*, connecting cable TV and broadband internet in addition to the seven items above). Assuming most industrial plots are on the periphery and most residential and commercial plots are closer to the urban core, we can expect higher relocation costs associated with the latter for the sake of a higher population density and larger amount of compensation an urban resident may demand. Only when the consolidation work of industrial land costs much more than the residential/commercial land does, can the net premium ratios of industrial land be lower.

## 5. CONCLUDING REMARKS

Urbanization involves the switch from rural to urban life in which housing and employment are critical elements. In the sense that spatial and industrial growth led by Chinese local states generates a vast housing supply and demand for labor, it works as the catalyst for urbanization across Chinese cities. This article shows that such growth or urbanization is largely driven by land use manipulated by localities. The booming property market not only provides tax revenues associated with real estate development, but also creates a daunting amount of land granting premium that is used to support urban physical construction. On the other hand, land zoned for industrial use is priced at artificially low rates so that inward manufacturing investment can be contracted. The improved urban physical conditions and strengthened manufacturing economy are then expected to reinforce each other so that the whole entrepreneurial plan can be materialized. The result of this intertwining market force and state power is the continuing growth of urban space and industrial output in China.

The benefits associated with urban growth, however, are not evenly distributed across space or groups, a consequence that is largely unintended by the central housing and land use policy markers in Beijing. Governments, banks, industrial investors and property developers are the main beneficiaries. Farmers living on the urban fringes are usually hurt by the relentless municipal acquisition of their land without just compensation. A majority of urban residents that have not purchased houses from the market are disadvantaged by the rocketing housing price. The housing price indices experienced a dynamic resembling that of land prices. Since 2003, as seen in Figure 4, the prices of almost all kinds of urban properties have surged. With all land granting premium belonging to the local governments, the high market value and low acquisition cost of land means huge municipal profits and strongly discourages Chinese local states to build affordable housing on land allocated for free. As presented in Table 3, the construction and sale of affordable housing demonstrated

a generally shrinking pattern since 2001, which is a clear indication of the disinterest of local governments in providing affordable housing.

As the hunger for industrial investment largely originates from the pecuniary motivation of local states, they are much less concerned with the qualitative nature of prospective projects. More often than not, projects with greater intensity of investment and larger volume of output are preferred by localities to small but flexible firms that are deemed as the carrier of creative potentials. This exclusive interest with big industrial projects greatly disadvantages private economy that has remained weak even after thirty years of economic liberation. More often than not, environmental impacts are also ignored as a result of this investment hunger, which contributes to the increasing tension between urbanization on one hand and ecological deterioration on the other. China's trade imbalance is also aggravated by its unparalleled volume of industrial production. All these factors call for a new mode of urbanization and industrialization on the future path of China's rise.

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