

Land Taxation in China: Assessment of Prospects for Politically and Economically Sustainable Reform

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The emerging land-related unrest in China poses a pressing challenge on the legitimacy of the government. Through the perspective of good governance, the paper examines the role of land in government financing and its economic and political cost, as well as the erosion of government's credibility and its negative impact on private and collective property rights. The paper emphasizes the recent upward trend in land-related unrest as a consequence of abuses by local governments on land-source revenues. Our special concern rests on the institution of collective property which is slowly emerging from the shadow of the former state property in the course of economic transition. Collective property right could be a useful legal and economic institution but must receive political support to exist alongside with private property.

Key Words: Land tax; Property tax; Land-related revenue; Land administration.

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1. INTRODUCTION

In January 2011, China launched a property tax trial in two cities, Chongqing and Shanghai, in the hope of controlling skyrocketing housing prices and stabilizing local governments' fiscal revenue. However, there is little existing public finance analysis on land-related fiscal policies to guide either the development or implementation of these types of policies. This paper examines fiscal land policy in China through the lens of theories and practices on good governance.

What constitutes good governance or government? In an Aristotelian spirit we may say that a good government is one which excels in fulfilling its proper functions. Views of government functions may vary but most of us would agree that the government has at the very least two functions: facilitation of economic life and maintenance of peace and order; to be able to fulfill these functions the government must be able to sustain itself. Land administration is implicated in the exercise of all these functions: land is one of the key factors of production along with labor and capital; failure to manage land properly has historically led to popular uprisings and erosion of legitimacy of governments; and land provides with revenue directly through land taxation or serves as the basis (via the notion of residence) for claims to other revenue sources (e.g. personal income tax).

The art of good governance consists in balancing the exercise of these functions, yet tensions and conflicts may appear as one function interferes with another. It is in this context that we consider governance over land. For the Chinese economy which has been expanding at roughly 10 percent annually over the last quarter century, growth no longer seizes the central stage of policy agenda. The focus has been shifted towards sustainability and quality of growth in the medium to long run. Therefore, government's control over land must enable socially sustainable forms of growth. In China, government — especially the sub-national tiers — plays a crucial role in ensuring socially sustainable development and provision of public services (health care, education, and social protection), infrastructure and agricultural development. However, the revenue bases of local governments are very limited, and they depend heavily on land-related revenues. Thus, inadequate land administration can be potentially economically costly; it can undermine the fiscal capacity of the state. At the same time governments fiscal policies which have promoted enclosures and land expropriations incur substantial political costs as well.

The paper proceeds as follows. Section two considers government's use of land as a source of revenue. We identify a number of aspects of the current land revenue system which carry high economic and/or political costs. Section three emphasizes the recent upward trend in land-related unrest as a result of abuses by local governments which originate — at least in part —

from certain uses of land as a source of government revenue. Land-related unrest signals erosion of legitimacy of the government. Further, we point out that government's fiscal policies related to land hinder the development of property rights by undermining government's credibility and paralyzing the political will of the people. Our special concern is with the institution of collective property which is slowly emerging from the shadow of the former state property in the course of transition. Collective property right can be a useful legal and economic institution but must receive political support to exist alongside with private property. Section four concludes.

2. LAND AS A SOURCE OF GOVERNMENT REVENUE

Since 1956, the rural land has been property of the collective, while the urban land has belonged to the state.¹ The state maintains monopoly of the primary land market in the urban areas; the state transfers use rights to a plot of land via two tracks-allocation (reserved for state-owned or non-profit) and conveyance (reserved for commercial enterprises). The land-use rights obtained through conveyance can be further transferred which has permitted the secondary land market to emerge. Needless to say, the fees on conveyance are much higher than fees on allocation.

In the rural areas, while the collectives formally have property rights and certain degree of autonomy in decisions with regard to land, the state imposes controls on certain transfer of rural land use rights, especially if they involve conversion to non-agricultural use.² Weak collectives' and individual farmers' rights have made it relatively easy for the local governments to exercise discretion over the use of land, its conversion to non-agricultural use or expropriation.

Local governments' monopoly on land decision-making makes it an especially attractive revenue source for the local governments to meet their extensive expenditure assignments. The 1994 tax reform recentralized the revenue assignments, leaving expenditure assignments largely untouched, creating a substantial fiscal gap at local levels. In 2008, sub-national governments accounted for more than 78.68 percent of total public expenditure, while receiving 46.71 percent of total government revenue (China Statistical Yearbook, 2009). Spending on social services is even more decentralized all the way down to the county level, with the sub-provincial tier financing 70 percent of public investment in social services, provincial and central tiers contributing another 20 and 10 percent respectively

¹This distinction between state-owned urban and collective-owned rural is simplified. In reality, according to the 1996 land survey report, the state owned six percent of cultivated land and orchards (yuandi) and 55 percent of forest and pasture land. Pastures and forests account for 97 percent of the state-owned agricultural land.

²See appendix A for detailed discussion on rural land tenure system and its legal basis.

in 2005 (Shen forthcoming; Shen and Zou forthcoming). Central government transfers are sizable; they financed 67 percent of provincial, 57 percent of prefecture and 66 percent country and lower level expenditures in 2003 (Shah and Shen 2008)³, yet inadequate to fill the vertical fiscal gap. Over-reliance on transfers carries the risk of soft budgetary constraints and creates perverse incentives to collect taxes, further deepening reliance on transfers and extra-budgetary revenue. In China, local governments do not have the right to set the tax rate except some minor local taxes. Especially, the “tax sharing reform” in 1994 was designed to base the fiscal relations between governments on the tax code, which recentralized the Chinese fiscal system because the central government takes a considerable amount of revenue (Wang, Shen and Zou, 2009, P208).

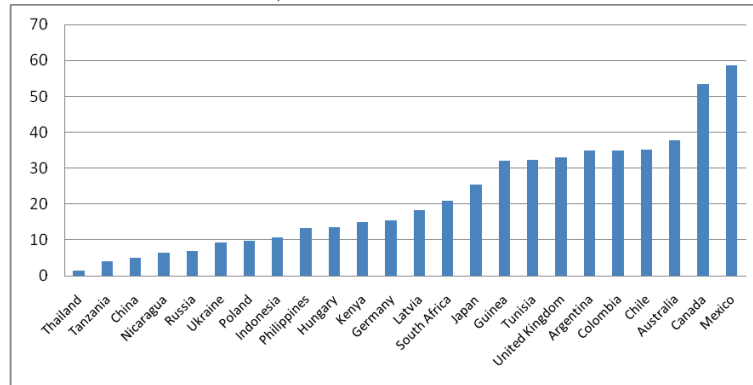
Lack of revenue seriously compromises local governments’ ability to carry out infrastructure investment and weakens social service provision. Both are highly visible public services and the failure to invest in either may lead to political repercussion. Thus local governments are faced with strong incentives and in reality provided with the opportunity to exploit land as a source of revenue. The revenues from land recorded in the formal budget are small partly due to loopholes in the tax code. For instance, there is virtually no property tax in China. And most of the budgetary income from land comes in the form of one-off charges on transactions or are based on statutorily fixed, cost-based assessments which fail to take into account the current market value of the land. Thus, budget fails to provide sound value-based tax revenue as practiced in most other countries.

During the 1990s the share of land and property taxes in all sub-national taxes averaged for 40 percent for developing countries, 35 percent for developed countries and only 12 percent for transition countries (Bird and Slack, 2004). As a share of sub-national revenue, property and land taxes amount to 18 percent in developed countries and 19 percent in developing ones; in transition countries land and property taxation contributes less than 9 percent of sub-national revenue (Bahl, 2001). As figure 1 illustrates, the contribution of property taxes to sub-national revenue in China is small even by comparison with transition countries, only 4.9 percent. The land and property taxation in sub-national expenditure is about 10 percent in developed and developing countries and slightly over 5 percent in transition countries (Deininger, 2003).

Unfavorable revenue-sharing arrangements and weakness of budgetary revenue base have led local governments to expand collection of extra-budgetary revenue. Extra-budgetary revenue from land is substantially greater in magnitude; by some estimates, land transfer fees amount to at

³Shah and Shen (2008) consider central-provincial shared taxes as central transfers according to the international standards.

FIG. 1. Reliance on Property Taxes by Local Governments (Property Tax as a Percent of Total Local Revenues)



Source: Authors, based on data from Bird and Slack (2004)

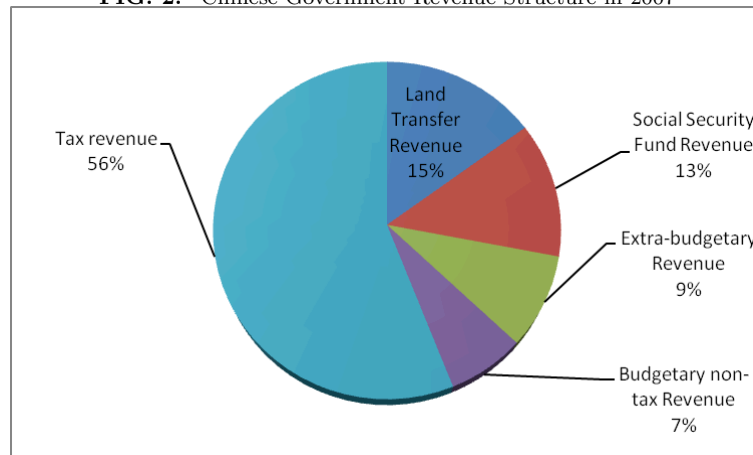
least 20 to 30 percent of total sub-national government revenue (World Bank, 2006). Unfortunately extra-budgetary funds lack stability and have uncertain legal status. Additionally, the collection and administration of extra-budgetary funds is more opaque and contributes to corruption and makes it more difficult to detect unsound fiscal practices.

Local governments generate revenue from land transfers in a variety of ways: (a) directly through land auctions⁴; (b) through the administrative transfer of land for urban use, in which case the benefits of transfer are indirect: land transfers for urban construction seek to attract industrial enterprises whose presence in turn gives local budget a boost; (c) through land banks and mortgage loans.

In 2007, land transfer revenue accounts for 15% of the total central and sub-national government revenue. The tax revenue accounted for only 56% of total Chinese government revenue, followed by the social security income (13%), extra-budgetary revenue (9%) and budgetary non-tax revenue (7%). For local governments, land transfer revenue has had an even higher share of the total revenue. Figure 3 show the trend of the land transfers revenue and land transfer price in China from 1999 and 2007. The figure depicts that land transfer has been increasing dramatically since 1999. The land transfer total sale price increased from 241.68 billion RMB in 2002 to 1221.67 billion RMB in 2007, and the land transfer local government revenue has also experienced significant raise to 454.14 billion RMB in 2007. In addition, figure 4 depicts that land related revenue take an increasing proportion of local governments' total revenue, for example, land related revenue accounted for less than 10% of central and local government rev-

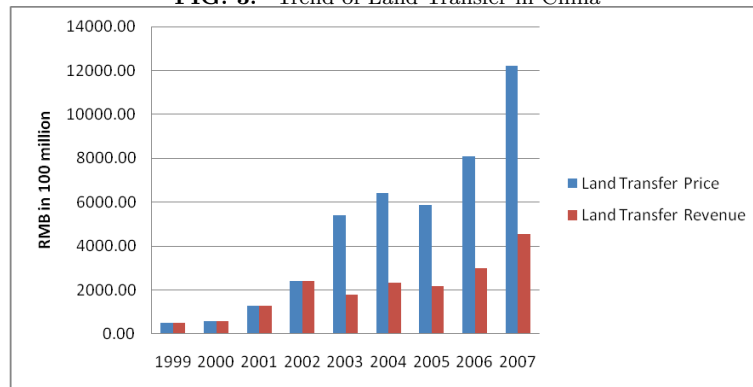
⁴Auctions account for 20 to 30 percent of all land transfers.

FIG. 2. Chinese Government Revenue Structure in 2007



Source: China Statistical Yearbook 2008, China Labor Statistical Yearbook 2008, Yearbook of Land and Resources of China 2008, and Peking University-Lincoln Institute Center for Urban Development and Land Policy.

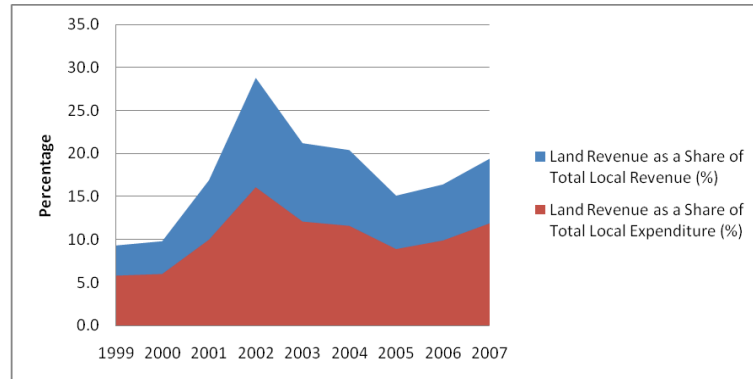
FIG. 3. Trend of Land Transfer in China



Source: China Statistical Yearbook of Land and Resources of China 2000-2008, and Peking University-Lincoln Institute Center for Urban Development and Land Policy.

enue before 2000, and dramatically increased to 20% of local government revenue and 12% of central and local government revenue in 2007. Additionally, table 1 break the land transfer revenue by province. Sichuan province ranked the highest in terms of the land transfer revenue as a ratio

FIG. 4. Land Revenue as a Share of Total Fiscal Revenue and Expenditure 1999-2007



Source: China Statistical Yearbook 1999-2008, and Peking University-Lincoln Institute Center for Urban Development and Land Policy.

of GDP (5.4%), land transfer revenue as a share of total revenue (66.66%), and land transfer revenue as a share of total expenditure (32.24%).

Land banking has evolved into a vehicle of capitalization on requisitioned land—an undertaking driven entirely by profit-making. Originally land banking was intended as a planning tool for productive development of surplus land. Today land banking facilitates land transfers which have nothing to do with planning but allocated land for suboptimal uses. Land banks hold the land for the local governments, mortgage it with loan institutions and invest recovered funds in urban infrastructure development. Land banking in China is characterized by high volume of transactions, which is virtually unprecedented in the world.

Using of requisitioned land as collateral on mortgage loans has significant implications for local government finance. On one hand, mortgage loans alleviate the deficit of funds for infrastructure investment; however the benefits from such investments are unevenly distributed. Because mortgage loans carry the risk of expropriation of the mortgaged land in case of local governments' default, local governments have to invest the funds in profit-maximizing ways, which in most cases results in investment in urban infrastructure where the returns on investment are greater. Rural areas in dire need of infrastructure investment are unlikely to benefit from such loans. The same problem confounded the subsidized loan program which failed to induce the desired poverty-reducing effect because budget-constrained local governments tended to allocate subsidized loan funds to capital-intensive industries in search for faster and higher returns.

On the other hand, access to credit softens budgetary constraints and potentially undermines fiscal discipline, especially in the environment lack

TABLE 1.

Land Revenue Statistics by Province in China in 2007

Rank	Province	Land Transfer Revenue as a ratio of GDP (%)	Province	Land Transfer Revenue as a Share of Total Revenue (%)	Province	Land Transfer Revenue as a Share of Total Expenditure (%)
1	Sichuan	5.40	Sichuan	66.66	Sichuan	32.24
2	Chongqing	4.31	Chongqing	40.18	Tianjin	29.67
3	Tianjin	3.96	Anhui	38.40	Fujian	28.15
4	Hainan	3.24	Tianjin	37.02	Chongqing	23.15
5	Liaoning	3.00	Fujian	36.65	Shandong	21.57
6	Anhui	2.84	Hainan	36.61	Zhejiang	18.88
7	Fujian	2.77	Liaoning	30.58	Liaoning	18.76
8	Shandong	1.88	Shandong	29.12	Anhui	16.79
9	Zhejiang	1.82	Hubei	26.85	Hainan	16.17
10	Hubei	1.72	Hebei	25.29	Hebei	13.25
11	Ningxia	1.60	Jilin	22.19	Hubei	12.41
12	Xinjiang	1.52	Zhejiang	20.68	Jiangsu	10.81
13	Hebei	1.46	Guangxi	19.22	Henan	8.18
14	Guangxi	1.35	Xinjiang	18.67	Guangxi	8.16
15	Jilin	1.35	Ningxia	17.77	Jilin	8.05
16	Guizhou	1.32	Henan	17.75	Guangdong	7.21
17	Jiangsu	1.07	Heilongjiang	16.63	Hunan	6.86
18	Inner Mongolia	1.04	Hunan	15.36	Xinjiang	6.71
19	Heilongjiang	1.04	Inner Mongolia	12.85	Heilongjiang	6.17
20	Henan	1.02	Guizhou	12.72	Ningxia	5.88
21	Hunan	1.01	Jiangsu	12.33	Inner Mongolia	5.84
22	Shaanxi	1.01	Shaanxi	11.62	Shaanxi	5.24
23	Shanghai	0.94	Shanxi	8.34	Shanghai	5.23
24	Shanxi	0.87	Guangdong	8.17	Shanxi	4.75
25	Guangdong	0.73	Jiangxi	7.51	Guizhou	4.56
26	Jiangxi	0.53	Tibet	6.43	Jiangxi	3.24
27	Yunnan	0.45	Shanghai	5.50	Yunnan	1.9
28	Tibet	0.38	Yunnan	4.43	Gansu	1.24
29	Gansu	0.31	Gansu	4.40	Beijing	1.1
30	Beijing	0.19	Qinghai	2.39	Qinghai	0.48
31	Qinghai	0.17	Beijing	1.21	Tibet	0.47

Source: Yearbook of Land and Resources of China 2008, China Statistical Yearbook 2008 and Peking University-Lincoln Institute Center for Urban Development and Land Policy.

of supervision over mortgage loans. Mortgage loans also lack firm legal status in China and in fact contradict the prohibition on direct sub-national

borrowing, which introduces additional risk in mortgage loans. In practice, there is no evidence of risky financial behavior by the local governments (such as defaults on the loans) mainly due to government's access to considerable supply of land at relatively low price and China's phenomenal economic performance. Potential sources of risk do exist, including (i) inability of the local governments to determine the final demand for land and (ii) local governments' exposure to interest rate fluctuations which can potentially cause volatility of local government's income; (iii) shrinkage of the supply of convertible land, which means that these practices are unsustainable even in the medium term (rapid pace of conversion of arable land has threatened food security and some provinces have exhausted their quotas of convertible land⁵).

Thus current uses of land to generate revenue are inefficient from a number of perspectives. The revenues generated from land mostly do not go through the formal channel of budget. Once we count the direct and indirect revenue generated through administrative transfer, auctions, and other fees that are land-based (in a broad sense), revenue base may be substantial. However, such revenue sourcing is unstable, non-transparent, and risky. It tends to undervalue land in effort to realize a quick profit, encourages a fast rate of conversion of arable land, and rewards corrupt officials and gives them incentives to appropriate communal lands.

LAND TAX ADMINISTRATION

A comprehensive tax reform may help to address many of these challenges, through replacing non-transparent, unreliable and unsustainable fee-based revenue with a transparent and coherent tax.

Effective administration of land taxation requires a cadastre with size, value and ownership status of each parcel of land and its productive capacity, as well as information on the costs of inputs and outputs. China does not have a cadastre which leads to problems of identification and assessment of properties; these difficulties can be compounded by poor enforcement of tax payments⁶.

Land taxes can be based on area occupied, appraised value of property or self-assessed property value. The value may refer to the land alone or to land, improvements to land and buildings. Tax on land value (excluding

⁵Exhaustion of convertible land may not be a problem in principle; instead fixed supply of convertible land can be an incentive to more intensive use of available land and its further development. The danger, however, is that weak institutions and legal code and poor enforcement ability, would allow further extensive urban development and conversion of land to urban use instead of promoting intensive growth. It is important to structure incentives in ways which are conducive to intensive growth in the industrial centers. Similarly intensive agricultural production should be stimulated as well.

⁶Property tax administration is weakened by incomplete property registers in Guinea and Kenya.

improvements) would be less distortionary and approximate a benefit tax. Taxation of land value — excluding buildings and improvements — has the merit, at least in theory, of stimulating more productive use of the land. Additionally, in the case of China where the real-estate market has been growing extremely fast, value-based taxes would significantly improve revenue recovery.

Area based taxation can be distortionary since it makes no adjustment for land quality and effectively imposes higher rates on low-quality land. Land value taxation is preferable but is costly to implement and requires adequate capacity for regular appraisals. Self-assessment is a low-cost alternative to formal value assessment and may be particularly attractive to low-income countries with weak administrative capacity. However its success hinges on being able to adequately structure incentives to promote adequate reporting of land value; and perception that self-evaluations are fair is also crucial to the success of self-assessments. For these reasons self-evaluations are not commonly used.

It is widely accepted that advantages of land taxation come at high administrative cost. The cost increases tremendously if proper value-based taxation is to be implemented due to the requirement of up-to-date information about properties. However the experience of Russia's land taxation indicates that in China's circumstances a tax reform is feasible and desirable. Russia embarked on the land taxation reform in the midst of serious economic downturn, lacking a cadastre of lands and having no experience in ad valorem tax assessment (Nitikin and Zou, 2006). China is much better positioned economically to undertake the reform.

In case of China, as in Russia, a gradual approach could be used when first cadastral assessment of land is performed. The second stage involves registration and valuation of buildings. In the absence of land markets, actual market value-based assessment can be reasonably well substituted by statistical mass-assessment techniques.

Implementation of land value taxation almost immediately increased local revenues (since 2005, in Russia 100 percent of land tax is assigned to municipal budgets), despite the fact that property taxes are criticized for their lack of elasticity and inability to increase revenue from taxes on property quickly or by a substantial margin (Bird 2000). In Ontario, reformed property taxation did not bring a windfall of revenue, but has been able to increase revenue substantially to make up for the shortage of intergovernmental transfers (Nitikin and Zou, 2006).

There is a substantial degree of subjectivity in property assessments. Valuations are likely to reflect political pressures or capture of administration by private interests. In countries where taxpayers have little confidence in the impartiality of assessments, valuation will likely generate conflict around the issue of appraisals. Therefore, in addition to having the

human and organizational capacity to conduct assessments, local governments should have appropriate organizational structures to deal with appeals. Russia's tax reform has been associated with significant increase in the total number of disputes; in 2000-2005 the number of disputes quadrupled (Nitikin and Zou, 2006).

Currently China's courts are overwhelmed with appeals for redress of grievances against government officials and definitely will be unable to arbitrate disputes related to appraisals. Local governments in India in fact have moved away from value-based taxation for the concern of social cohesion and the burden on local arbitration institutions. Assessments of land based on physical characteristics of the plot — on the other hand — anchor land taxation to more objective and easily observable and measurable attributes and allow to make adjustment — albeit very imperfect — for the quality of land. In Canada, improved valuation of properties has led to a drop in the number of disputed tax charges. Slack (2002) attributes it to taxpayers' confidence in the fairness of assessments.

Land value taxation may be opposed by the asset rich but income-poor or credit-constrained taxpayers since they cannot increase the productivity of their land due to credit constraints. By the same token, the rich, whom the tax most affects (in absolute terms) are also likely to object or to evade the tax. A similar tax once introduced in Cracow was quickly rebuffed by the legislators who faced serious political pressure from the elites affected by the tax and who incidentally were affected by the land value taxation themselves (Brzeski, 2005). Given the widespread frustration with local corruption among the peasants, it would be dangerous to risk further increasing the collusion of local elites and officials.

Even in more affluent settings — such as Canada — political pressures to adjust the level of property taxes down or not to initiate the reform altogether are substantial. In Ontario, preparation of the tax reform spanned several terms of administrations, before it could actually be implemented. This requires substantial political will. Once the reform has been initiated the same political pressure is likely to introduce new distortions.

Bird (2000) argues that decentralization can improve collection. This may work in China as well but enforcement of collection must be preceded by reforms of taxation in such ways that local governments have an incentive to collect taxes. Currently, in the absence either of solid local tax bases or the autonomy to set tax rates, the costs of enforcing collection are high relative to the benefits from it as a result of inadequate composition of local governments' tax bases. Land/property taxation rates should be set above the cost-recovery threshold—the same problem faced Russia's local government with respect to individual property tax collection before 1999, when individual property was taxed at the low 0.1 percent rate.

High visibility of property taxes increases the political costs of property taxation.⁷ These taxes are normally charged annually and require lump sum payments which make tax payers more aware of their property taxes. Since the tax base on property taxes is inelastic, to increase revenue from property, the governments must raise the tax rate, also a very visible parameter. Visibility of the property taxation could be used for the purpose of accountability and transparency of local governments. And precisely for this reason they encounter political resistance from elites and local officials. Additionally, since property tax is so closely connected with the incidence of benefits, taxpayers resent property taxes if they observe that the local governments fail to deliver public services (poor road maintenance or trash removal services, or poor access to health and education facilities). This gives another reason why land taxes should remain in municipal budgets.

3. FISCAL LAND POLICY IN CHINA: EROSION OF LEGITIMACY AND GOVERNANCE

3.1. Erosion of legitimacy

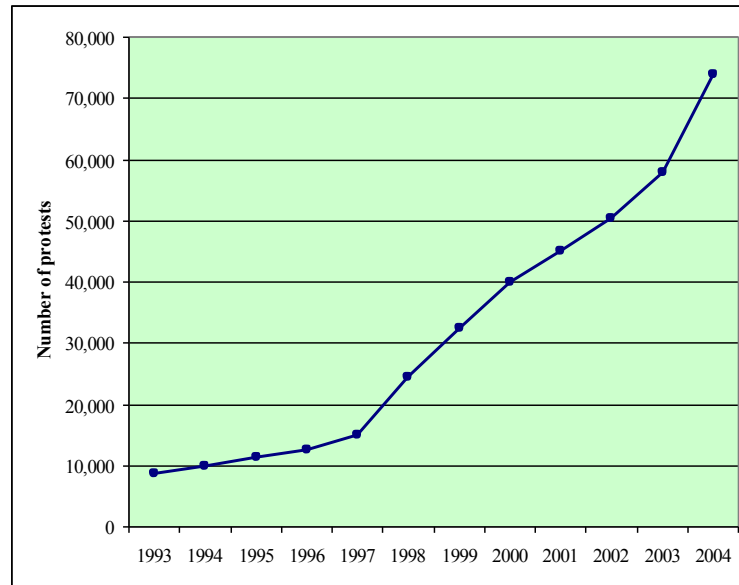
Financing a government may involve substantial political risks. Political calculus has special importance for China. Political turmoil is a frequent companion of transition. In China, social unrest has increased from 10,000 protests in 1994 involving 730,000 participants to 74000 protests involving 3.7 million. During the nineties, incidence of protests rose dramatically by 60 percent from 1997 to 1998 and by 30 percent from 1998 and 1999. After a slowdown, a new cycle of growth in unrest began in 2004 (see figure 5).

Secular upward trend in social unrest notwithstanding, changes in the level of unrest are precipitated by government policies. The 1997-1998 rise in protests occurred as a result of SOE downsizing⁸. The latest wave of unrests is to a great extent fueled by land-related issues: (1) land expropriations for public development projects, (2) enclosures of farmland without adequate compensation for the losses for urban development, and (3) corruption and unfair land reallocations by village administrations, (4) coercion of farmers to relocate through the use of violence. For example, in October of 2004, 90,000 peasants in Sichuan province confronted the police over the expropriation of their land without due compensation to enable the construction of a hydroelectric dam (Marquand, 2004 and Mooney 2004). Increase in land-related protests roughly coincides with a new wave of growth of capital investments and increased demand for land.⁹

⁷Bird (2000) observes that “academics tend to be much fonder of the property tax than the politicians who have to impose it.”

⁸Thirty million workers lost jobs in 1997-1999.

⁹Gross fixed capital formation expanded by 19.7 percent in 2003.

FIG. 5. Incidence of social unrest in China, 1993-2004

Source: Liaowang and China Ministry of Public Security, cited in Tanner (2004), State Department (2005), Chan 2004, Pei (2005). Note: Number of protests refers to “mass incidents”.

Most of the unrests have origin in grievances against mistreatment by local officials. There is an overwhelming perception of corruption and abuse of authority by local officials among peasants. The issue of enclosures has provoked steep increase in the levels of social unrest in terms of number of events and number of participants. Peasants protest against coercive means some local official employ to induce farmers to sell their land. In 2005, 30 protesters were killed by the police in Dongzhou village in Guangdong. In Dingzhou village, Hebei province, protests ensued after the local government used hundreds of thugs to force peasants from their land to make way for a power plant; confrontation with police resulted in six deaths and many more wounded (AFP, February 28, 2006).

Grievances are so numerous that the overloaded system of petitioning redress of abuse by local officials cannot process them. Only two out of 1000 petitions find some sort of resolution through intervention of the higher officials. The court system¹⁰ is also overloaded with case of abuse of au-

¹⁰The RLCL modified the procedure for resolution of dispute related to land. The 1998 Land Management Law and Administrative Review Law required that all disputes sought resolutions through the administrative reviews, and only passed to the people's

thority by local officials; courts take no more than 90,000 such cases a year and rule against the government in 1/4 of these cases (Pei, 2005a).

Social unrest is a frequent outcome of land reforms and without prompt resolution, political tensions surrounding the land issues can spill into mass violent conflicts or civil war. Tensions around land issues preceded, for instance, the outbreak of a civil war in Rwanda and underpin ethnic confrontation in Cote d'Ivoire and Ghana.

Creation of institutions which can diffuse tensions in a timely fashion before they escalate into a violent conflict is crucial. Rolfes and Mohrman (2000) document a positive effect of legal aid centers in Vladimir and Samara oblast in Russia in resolving contentious land-related issues. In Mexico the government launched a large-scale program on provision of legal aid to farmers, which involved establishment of 42 agrarian courts (Zepeda, 2000).

Provision of written land use contracts to individual farmers in China is a step in the direction of prompt resolution of disputes related to ownership right. Introduction of elections of village leaders represents an important political safe guard against corruption in village administrations. The success if this initiative has been limited however.

But apart from corruption, the failure to resolve land disputes is also associated with poor titling, fragmentation of forest administration across several agencies, and ambiguous legal relationship between collective and state property. We see evidence of these problems in relation to forest tenure. For instance, in 1997 nearly 18 percent of state-owned forest area and 21 percent of collective forest area was unregistered nationwide.¹¹ Several offices participate in forest administration: the State Bureau of Forestry, the Ministry of Agriculture, the Ministry of Land Resources, and the Ministry of Civil Affairs (Ho, forthcoming).

Even when the methods are legal, the level of compensation is frequently unfair, which undermines credibility of local governments. Article 65 of the 1998 Land Management Law calls for "appropriate compensation" to the land users whose land was expropriated for the construction of public facilities or public welfare undertakings. Unfortunately "appropriate compensation" is a vague standard and the law provides no guidance for its interpretation. There is a tendency for most collective entities to interpret "appropriate compensation" as a very minimal amount (Prosterman, 1998).

court as a last resort. The RLCL gave farmers a choice of ways for pursuing dispute resolution, including consultation, deviation, arbitration and law suits in people's court.

¹¹There is sizable variation across provinces. For example, in Inner Mongolia which has the largest forest area in the country (over 12 percent of all forest area) and where the state owns 3/4 of forest, over 50 percent was unregistered.

3.2. Property rights and non-credible governance

Local governments' appetite for land has created political tensions in the countryside between local officials and the peasants who face frequent dispossessions in the name of "public good;" increase instances of social unrest indicate erosion of people's confidence in government. Popular confidence in the government is an integral component of tenure security. Even when one is granted formal property rights, one must be confident that these rights will be enforced equitably. In Russia for instance, one of the reasons for slow rental market is precisely such lack of confidence: property owners — despite having a written title to the property — are in many cases uncertain whether their property rights will be upheld.

While the collective may claim customary use right, in the formal legal sense the forest is state owned unless collective ownership can be legally proven. Such burden of proof may be too much for the collective for a number of reasons. The definition of the collective is ambiguous: is it the township, the administrative village or the natural village or villagers' group? Second, the collective's claim to ownership of the forest land is based on customary use since before the current state was established (prior to 1949); however China's legislature invalidates all land titles issued prior to the land reform of 1949. This effectively leads to the situation when in practice the ownership right of the collective is in fact a right to manage and administer the use of land, while the ultimate owner is the state.¹² The weak legal status of collectives' claim to ownership of land relative to the state's similar claims makes it difficult for the village to resist reclamations and enclosures: once the county or township government decides to convert the land to non-agricultural use, the collective has no legal recourse (Ho, forthcoming). From the juridical point of view, reclamation constitutes the transfer of the collective's use right to the state, thus aligning the use right with the property ownership right.

Another instance when the weakness of the current collective ownership rights becomes obvious is conversion of arable land to non-agricultural use. If collective property right existed as an institution independent from the state, would not one expect that that collective ownership of rural land would interfere with arable land conversion? Yet it does not, which points to the weakness of collective ownership right. It would be more accurate to say that in practice the collective land rights consist of a bundle of rights to use and administer the land resources on behalf of the real owner, the state. The problem of conversion then is not caused by the failure of the

¹²The state then "may in accordance with the law, expropriate land which is under collective ownership, if it is in the public interest" (Land Administration Law (1988, 1999), Article 2).

collective ownership as such but rather by the invasiveness of the state which undermines the autonomy of the collective.

If invasiveness of the state ownership is the problem, dismantling of collective ownership and institution of private ownership in its place misses the point. The state can invade and subvert private property rights as well (in Turkmenistan private property is recognized by the Constitution¹³ and all the formal attributes of private property right to land are present, e.g. well documented land titles).

When it comes to collective property rights, the importance of confidence in the government is even greater. China is at an important juncture when it has to decide whether collective property ownership should exist. In our opinion it should, but in a modified form. Yet collective property is a delicate form of property since it involves cooperation of many parties. As such it requires protection from the government. Unfortunately, current land policy contributes to the destruction of the popular support for collective property, thus undermining a powerful source of socially sustainable growth.

International evidence suggests that collective land ownership and equitable access to land it provides is conducive to growth. Equitable access to land is associated with higher growth and as well as higher returns accumulation of human capital (Deininger and Olinto, 2000). Indeed we see that distribution of land in China is among most equitable in the world. Research points to the importance of initial equality for growth and China's experience is consistent with this generalization. Elimination of collective property is likely to increase inequality in land distribution and can be potentially damaging to long-term growth. We have seen that income/consumption inequality in China has been increasing and has slowed down the pace of poverty reduction. Privatization of land in the absence of collective property will further exacerbate this trend.

Additionally Pei (2005b) argues that in China during the 1990s, collective ownership of land combined with HRS created an institutional framework which allowed more uniform labor-intensive industrialization of the countryside through TVEs, absorbed surplus labor¹⁴ and raised local welfare levels minimizing the threat of social turmoil fundamental restructuring of factor markets could bring. During the late 1990s and 2000s, the role of TVEs in growth has declined and the private sector has assumed the leadership role in development, however the contribution of collective property

¹³Article 9 of Turkmenistan's Constitution states: "Turkmenistan establishes the rights of private ownership over the means of production, land, and other material and intellectual goods."

¹⁴Approximately 110 million rural surplus workers moved from farming to rural industries in 1978-1996 (Pei, 2005b).

ownership with improved incentives structures and greater tenure security should not be discounted.

The reason why collective ownership promoted equitable land distribution is a system of frequent land readjustments — one of the unique features of China's land administration, by comparison with other countries. Approximately 3/4 of all changes in land holdings are related to village-wide reallocations¹⁵ (Rozelle et al., 2005). Reallocation consists in redistribution of responsibility land from one household to another; for instance, land can be shifted towards a household which had a newborn son, and away from a household who married their daughter. Reallocation takes place without compensation to the previous tenants for any investments they have made.

It has been argued that the possibility of reallocation and other restrictions on land use create disincentives to invest in the land. However, Kung and Liu (1997) and Carter et al. (1995) report that villagers favor land reallocation. If so, and if reallocation implies lack of tenure security, then either villagers oppose tenure security, or in fact reallocation and tenure security are not mutually exclusive notions from the point of view of the farmers.

Deininger and Jin (2002) argue precisely that: they show that increased transferability — even without transfer of ownership right — of land will significantly improve the alignment of land resources with households' farming ability. Transferability of the land would also increase the land supply by allowing households with low aptitude for farming to move to non-farming activities, in turn reducing rental prices and thus facilitating the access to land by able but poor farmers.

Yet at the same time Deininger and Jin (2002) find that current administrative reallocation practices do promote productivity as well, even though there is scope for improvement through better matching of land supply to households' demand. It is likely that reallocation and transfer contribute to productivity via different mechanisms: the former by preventing excessive concentration of land and the latter by inducing more efficient land allocation.

A wise strategy would consist in trying to pursue the advantages of private property rights as well the advantages of the collective property rights, especially since peasant seem to appreciate the equalizing effect of land reallocations.¹⁶ Such a route would entail: (a) continued separation of property rights and land use rights for some of the land; this land ; (b) preservation and strengthening of collective ownership and/or land use rights; (c) strengthening of tenure security and transferability of tenure

¹⁵Rozelle's data describe the period prior to the 2002 Rural Land Contracting Law.

¹⁶Ho (forthcoming) argues for a dual tenure system — private and communal — for the forest land.

either through private property rights or surrogates¹⁷; (d) further lifting restrictions on the kinds of productive agricultural land use, (e) devolution of decision-making power regarding land readjustment to the collective, along the line of the 2002 RLCL which calls for approval of land reallocation decisions by the supermajority introduced in the village assembly.

The principle of periodical adjustments of land distribution is the essence of collective ownership. While the practice of land readjustment should be continued it must be reformed. It must involve fair compensation which takes into account the improvements made to the land by the tenant as well as the inconvenience of changes due to land assignment. The compensation mechanism will improve tenure security and stimulate investment in the responsibility land. Land reassignments must also become more targeted and less sweeping in magnitude, applying to a smaller share of agricultural land to create room for a land rental market.

Unfortunately, the current of governance practices, especially those of local governments undermine collective property ownership. Lack of accountability of township officials and village leadership undermine peasants' trust in fairness of reallocation decisions. Current practices of unfair compensation have a similar effect.

At the same time legislation is indispensable, which would establish the collective ownership right, one that is independent of state ownership.

4. CONCLUSION

Our discussion has focused on the role of land in government financing and its economic and political cost, as well as the erosion of government's credibility and its negative impact on private and collective property rights. There are obvious deficiencies in the administration and design of the land taxation. First, budgetary revenue from the land is small, reflecting the fact that property taxation is virtually non-existent in China. Second, tax autonomy of local governments is limited and local revenue bases cannot support the assigned level of expenditures which has led to the proliferation of EBFs; the latter provide large contributions to sub-national coffers, but lack stability. Third, state monopoly on the primary market in urban land and control over rural land has made it easy for local governments to raise revenue through conversion of agricultural land to industrial to finance the vertical fiscal gap.

A number of modifications to the land taxation have been considered. Land value taxation has definite advantages on theoretical grounds since it approximates benefits tax and can induce development. However international experience indicates that land value taxation is costly in terms of

¹⁷See appendix B.

organizational capacity (to make property valuation possible and to support processing of disputes related to assessment); furthermore, it would more likely increase political tensions in the countryside. Bird (2000: 14) explicitly states that “experience around the world shows that the political costs of reliance on the property taxes are so high that no government [motivated by purely cost-benefit considerations] with access to cheaper sources of finance will willingly do so.”

However, judging from Russia’s experience, implementation of land taxation in China is feasible and can be expected to pass even more smoothly than in Russia, where the reform was conducted in adverse economic circumstances. If a gradual approach is taken, the cost of creation of property registry, assessment, etc. will be manageable.

A comprehensive land tax reform has the potential to address many of the distortions produced by the current forms of land revenue-generating. Current forms are unstable, non-transparent, and risky; they tend to undervalue the land in an effort to realize a quick profit, encourage a fast rate of conversion of arable land, and reward corrupt officials and give them incentives to appropriate communal lands.

Furthermore, land conversions and unjust expropriations undermine the institutions of private and—even more so—collective rights by causing erosion of popular trust in the government. The latter are still emerging as a separate form of ownership independent of state ownership and rely heavily on credibility of governments. Collective rights are particularly vulnerable to erosion of credibility. Meanwhile, collective land ownership promotes more equitable asset distribution and thus contributes to faster and more socially sustainable growth.

Thus, in the long run improved land taxation in properly implemented can foster credibility and promote the institutions of private and public property. Nevertheless, in the short run, land taxation reform itself carries the risk of wakening the credibility of government. Land value reform is known to arouse political tensions, even in more affluent economies. A margin of credibility has proved important even in course of Ontario’s modernization of its land taxation system. Moreover, in China there is strong evidence that haphazard land management practices have eroded public trust as seen in the increase of grievances and protests.

Considering political and social tensions surrounding land in China, it is recommended that first, implementation of the land value taxation should be gradual, introducing land value taxation first and then moving to valuating buildings; second, that it runs parallel to a profound reform of local governance to boost government credibility; and third, that additional more flexible revenue bases (e.g. PIT or EIT) are desirable for local financing.¹⁸

¹⁸See Bird (2000) and World Bank (2002) for a review of alternatives.

APPENDIX A

The rural land tenure system

Five modalities of tenure of agricultural land can be identified: responsibility land, ration land, private plots, contract land, and reclaimed land. Responsibility land tenure is — the most common type reported by 90 percent of villages and covering 80 percent of all farmland — is allocated to households by the village in exchange for a mandatory quota of agricultural output at below-market prices. Responsibility land is allocated based on the household size and the number of working age household members. It is subject to reallocation to other households by the village administration. Ration land is allocated to households on the basis of their size to ensure households' self-sufficient grain production; tenure of ration land is not subject to any fees or other obligations. Private plots are mainly parcels of land in farmers' backyards; households' tenure of these plots is practically secure in the long and short term and in some localities the private plots can be bequeathed to children; however farmers cannot transfer title to these plots to other households. Private plots are the second most common type of land tenure practiced in 54 percent of villages. Contract land is rented out to farmers by the villages for a monetary fee and may or may not be subject to a production quota. Reclaimed land is previously uncultivated land to which farmers can acquire use rights without incurring delivery quotas or fees (Rozelle et al., 2005).

In addition to land readjustments, crop selection and land use are strictly regimented — quotas are demanded to be paid in grain and cannot be substituted with cash and farmers are not allowed to grow cash crops despite the fact that they are more lucrative. All these measures serve to promote food security and self-sufficiency in agricultural production.

Decisions about land reallocation are made in most cases by the village heads, but 14.4 percent report that reallocation is decided at the township level. Reallocation decisions are made in a decentralized way by villages and townships, and despite a single nationwide policy about land allocation (30 year term on land tenure prior to reallocation), there is substantial variation across provinces, townships and villages. Slightly over 10 percent of villages reallocate land and reallocations involve approximately 1/2 of the village's land, affecting 2/3 of village households (Rozelle et al., 2005).

Legal Basis for the rural land tenure system

Collectivization¹ in the mid 1950s and de-collectivization since the late 1970s and 1980s which precipitated the introduction of the Household Re-

¹Despite initial institution of egalitarian individual ownership after the expropriation of land from the landlords and rich peasants in 1949, during the 1950s, China collectivized its agriculture following the example of the USSR.

sponsibility System (HRS) are central events which shaped China's current land tenure system. The 1982 Constitution established State ownership over the urban land, while the rural land was recognized as the property of the rural collective; thus dual system of land ownership was instituted.

The trend toward gradual de-collectivization continued during the eighties and nineties. The 1988 constitutional amendments asserted transferability of the land use rights and the 1998 amendments to the Land Administration Law extended the length of contracts for farmers to 30 years and provided for written registration of the land use contracts, thus giving farmers and important instruments of land dispute resolution.

The Rural Land Contracting Law (RLCL) adopted in August of 2002 further deepened the rights of individual farmers, stating that land rights include "rights to use, profit from, and transfer land contracting and operation rights, and the right of autonomy over production operations and disposition of products and the right to receive the corresponding compensation" for the land readjustments and expropriations.² Specifically RLCL permits the following transactions: transfer to other village households, lease to non-village households, exchange, assignment and other transactions involving land which do not contradict the law. The RLCL does not provide guidance with regard to the right of inheritance of arable land, while it explicitly permits inheritance of forest land. Omission of the right to inherit arable land seeks to avoid disrupting the property structure of household land holdings (Gu, 2002)

The RLCL secured the right of farmers to 30-year contracts and prohibited land readjustments during this term and most importantly limited the right of the collective to reallocate the land to the instances when natural disasters severely damage the contracted land and some other special circumstances.³ The authority to define the range of "special circumstances" rests with the local governments; however, RLCL specifies that such decisions should win approval of the super-majority (two-thirds) of the village assembly or village representatives and receive clearance from the township government and the county agricultural administration. The Law also stipulates that farmers must be party to any transaction involving contracted land and explicitly prohibits attempts to "intercept or reduce" the proceeds from land transaction by local officials.⁴ Furthermore, RLCL validates contracts which contain prohibition of readjustment, except in those cases when readjustment is mandated by the law.⁵

The RLCL modified the procedure for resolution of dispute related to land. The 1998 Land Management Law and Administrative Review Law

²Article 16.

³Article 27.

⁴Articles 34 and 35.

⁵Articles 27 and 55.

required that all disputes sought resolutions through the administrative reviews, and only passed to the people's court as a last resort. The RLCL gave farmers a choice of ways for pursuing dispute resolution, including consultation, deviation, arbitration and law suits in people's court⁶.

APPENDIX B

Land use rights, their marketability and contribution to tenure security

International experience suggests that private property rights to land are not necessary to create a market in land. Land use and land lease rights are divorced from ownership rights in Botswana, yet land leases are readily used in the real estate market and as collateral by financial institutions¹. The leasehold rights are fully marketable and their value has appreciated over time, making them increasingly attractive to the banks.

Collective ownership of land by land boards does not significantly interfere with transactions in land. Land boards certify leasehold rights of the loan applicants but their permission is not required to take out a mortgage. To be sure, land use rights in Botswana have evolved since 1968 — when the land boards were established — the functionality of the leasehold rights has been subjects to upgrades which allow land leases for residential lands and extended the leasehold right to individuals outside of the community.

In Vietnam, similarly, land ownership rights are not coextensive with land use rights; nevertheless, long-term land use rights provide adequate security of tenure. There is a moderately active market in land use rights with just over 15 percent of land leased out. Land sale and rental transfers tend to be informal to avoid official land administration fees. Vietnam's experience with land transfers also supports the claim that market rental transfer tend to lead to more efficient allocation of land: overall land-leasing households tend to be more efficient at farming.²

Three Central Asian countries — Uzbekistan, Turkmenistan, and Kyrgyzstan — also provide valuable insight into the relation between land use and land ownership rights. Bromley (2005) draws on the experience of these ex-social countries to argue that private property rights are not necessary for successful economic development or for operation of land markets. In Uzbekistan — by far the most successful in terms of per capita growth among the three — agriculture is dominated by collective farms which are able to pursue economies of scale in cotton production (mainly in irrigation) and remain effective agricultural producers. Private ownership of

⁶Articles 51 and 52.

¹Information on land policy in Botswana comes from Department of Lands of the Ministry of Lands, Housing and Environment (2002).

²Information on land tenure in Vietnam comes from EASRD (2004).

land is in fact prohibited to avoid speculation and concentration, but individual land use rights are recognized. In Turkmenistan, on the contrary, property rights well defined and land titles well documented, but land use and transfer are restricted. Kyrgyzstan also directly prohibits private land ownership, yet land market is developing, albeit slowly.

The bottom line is that it is possible to develop effective use rights without committing to private land ownership. Appropriately defined land use rights can promote tenure security and support market transactions such as rental transfer and land mortgage. Privatization of land in an ex-social country can prove too ambitious an undertaking involving substantial social costs which can threaten social cohesion if there is not enough political will in the government or among the popular masses as it has turned out to be the case in Russia.

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