

# 1. Introduction

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As the political and economic reforms in China<sup>1</sup> have progressed rapidly, changes in the Chinese economy, society, and urban development have been breathtaking. Among many issues related to the transformation from a planned economy to a market-led economy, the change in the structure of property rights in land is among the most sensitive. Throughout the history of China, major political and economic reforms have been accompanied by the reassignment of property rights in land. It is notable that most land reforms took place almost immediately after the establishment of a new government, and land reform played a key role in political and economic reforms (Li, 1998). This was the case in ancient China, and land tenure changes in contemporary China also occurred when the corrupt Qing Dynasty was overthrown by Sun Yet Sen in 1911, when the People's Republic of China was established in 1949, and when an opening-up reform policy was introduced in 1979. It has long been argued that the failure of the Kuomintang regime was caused by serious income disparity, which was partly caused by land monopoly by a small percentage of the population, and the Communist Party succeeded due to its promise to the underclass and farmers that they could own their own land.

With more attention being paid to the 1980s urban land reform of China, the literature has burgeoned rapidly from different angles. Some papers focus on the significance of establishing a land market (Dowall, 1993; World Bank, 1993), some on the mechanism of land development (Yeh and Wu, 1996; Wu, 1998; Chan, 1999), some on land use and the emergence of a real estate market (Chen, 1993; Walker and Li, 1994; Li, 1998; Zhu, 2002, 2005, 2009), and some on the impact of the land use rights (hereafter LURs) system on city growth (Zhu, 1994; Wu and Yeh, 1999; Ye and Wu, 2014). This literature has focused on the analysis of experiences and problems of the emerging urban land market, but few studies, either overseas or domestic, have focused on the betterment and worsenment generated by government activities under the current institutional framework of the LURs system. This issue, however, reflects the relationship between the state and the individual in the allocation of land interests, and has important implications for the Chinese land market. This is not difficult to understand, for there has been a long tradition in

China that the state has been in the dominant position, and expectations and valuations of the individual have been given much less priority.

A critical factor in understanding urban land markets is the institutional structure of property rights in land, as well as the arrangements of organizations and agents, regulations on the market and the interplay among the actors (Han and Wang, 2003). In explaining betterment and worsenment generated by public actions, property rights can be effective tools. The structure of property rights in land has significant impacts on efficiency and equity. Betterment and worsenment are derived from externalities, and internalizing them can be a critical part of property rights arrangement. Coase (1960) suggests that the parties involved in a dispute arising from the presence of externality could settle their conflict through contracting their property rights, and the 'internalization' of externalities could be greatly affected by transaction costs. Many scholars argue that clearly defined property rights can significantly reduce transaction costs and facilitate economic growth (Demsetz, 1967; Furubotn and Pejovich, 1972; North, 1981; Cheung, 1982; Barzel, 1989; Eggertsson, 1993). On the other hand, the ambiguity in property rights increases uncertainty, encourages corruption, raises costs and reduces the incentive to invest (Putterman, 1996; Zhu, 2004a, 2004b; Desoto, 2003).

In contrast with the radical reform approach of formerly Communist East European countries, China has adopted an incremental economic reform strategy, and change in the area of property rights has been gradual and ambiguous. Cheung (1982: 21) provides interesting explanations for ambiguous property rights in China: one reason is that an idea which is not clearly stated can never be proved clearly wrong; the second reason is that in the absence of clearly drawn boundaries between the nature of one system and another, it is easy to assign all negative characteristics to one and all positive ones to the other. Furthermore, the vagueness of property rights would leave the state free to alter rules at will, spreading benefits or imposing penalties in any way it chose. The ambiguity in property rights in China, therefore, serves as a double-edged sword in economic development. In the short run, the strong state has wielded it to establish a market framework at a very low cost and within a very short time scale; on the other hand, it has incurred uncertainty and impeded long-term economic development because ambiguous property rights are not sufficient to provide order in the absence of formal institutions, and they also make the newly structured property rights being trialled insecure (World Bank, 2002).

With the acceleration of the urban development process, the issues of betterment and worsenment in the land market have become increasingly important in China. Whilst government investment has substantially increased land values in many areas, it is inevitable that government

activities may lead to the decrease of land values in other areas because of pollution, noise, and visual disfigurement. How to internalize these externalities is a key constituent part of property rights in land, and the failure to address them can lead to uncertainty and unfairness in the land market. In China, the issues of betterment and worsenment appear to arouse no great concern. For example, no adequate measures have been taken to capture surplus land value or to compensate for the loss of value generated by government investment.

The inability of the government to address betterment and compensation, however, often leads to several problems that are worthy of attention. The first problem is that it worsens an already uneven distribution of income. Among the theoretical and practical studies of betterment and compensation, Henry George ([1879] 1886) is one of the earliest scholars to pay attention to this issue. He attributes the industrial depression to the problem of land monopoly, and argues that the fundamental reason for poverty and inequality was that the benefit of land value increment, which should have accrued to the community, was ultimately monopolized by the possessors of land. Payne (2001) asserts that the concentration of land wealth in the hands of a small percentage of the population is attributed to the government's failure to capture surplus value, whereas the underclass can fall victim to the insufficiency or lack of compensation more easily. The second problem is that the inability to recover surplus land value may weaken the fiscal capability of governments to provide public goods. High urban land cost is often a serious constraint on public goods. If users are not charged for services provided, large benefits may accrue to adjoining landholders, and thus cause the government to lose the opportunity to gain the revenue that should have gone into public coffers. Especially for Chinese cities where the government is faced with limited funding, the failure to capture subsequent land value increments arising from public activities has made the financing of expensive public facilities construction more difficult. The last, but not least, problem is that the inability to recover surplus land value may lead to uncertainty in the land market, therefore impinging on long-term land market development. With the large scale of construction, failure to adequately address windfall gains and hardship, and subsequent uncertainty, have been increasingly distorting the land market price mechanism. Whilst some land developers have enjoyed enormous unearned wealth, other groups have to accept inadequate compensation, or hardship without any compensation payable,<sup>2</sup> even though a loss of value is generated by public works. As a result of uncertainties in the land market, some groups have hesitated to enter the Chinese real estate market, particularly overseas developers. Compared with their counterparts in other fields such as manufacturing

and commerce, the participation of overseas developers in the real estate market is much less significant.

Based on the above analysis, how the government can recover surplus land value and mitigate the worsenment generated by its own actions, without seriously affecting private incentives, is very meaningful for urban development in China. In other words, the government has to strike a balance between taking away the gains of development value from benefited owners on the one hand, and keeping the market working on the other hand. The philosophy of Cmnd. 5124 (1972; *Development and Compensation – Putting People First*) is concerned with public and private interests but significantly:

sees the problem not so much as one of conflict between public and private with its implications of right and wrong but as one of balancing ‘a conflict of right with right – the public’s undoubted right to have a new road or school or waterworks and the private person’s right to enjoy his home and garden undisturbed’. The government believes that all concerned with development must aim to achieve a better balance between provision for the community as a whole and the mitigation of harmful effects on the individual citizen.

## 1.1 RESEARCH QUESTIONS

Therefore, in order to promote justice, equity, and long-term land market development, it is necessary to draw attention to the issues of betterment and compensation in China. This research is an attempt to examine these issues under the LURs system and focuses on the following three key questions:

1. How and to what extent has the government captured the surplus value and compensated the hardship generated by public activities under the LURs system?
2. What are the impacts on land markets of the current measures for addressing the betterment and compensation issues?
3. What are the obstacles to implementing effective schemes of land value capture and compensation?

## 1.2 TERMINOLOGY

### 1.2.1 ‘Betterment’, ‘Worsenment’ and ‘Compensation’

Palgrave’s *Dictionary of Political Economy* defines ‘betterment’ as follows:

persons benefited by public expenditure should contribute to such expenditure to the extent of the increased value of their property, not only if the

improvement effected by the public authority was carried out for the purpose of conferring a benefit on such property, but also if the resulting benefit was purely accidental, the expenditure having been undertaken for a totally different purpose.

This definition is limited since it only considers particular improvements carried out at public expense, but betterment may also occur without any public expenditure at all: for example, the change of planning parameters. The 1942 Uthwatt Report (p. 104) thus defines the term 'betterment' as 'any increase in land value (including the buildings thereon) arising from central or local government action, whether positive, e.g., by the execution of public works or improvements, or negative, e.g., by the imposition of restrictions on other land'. According to Hagman (1978), betterment is any increase in the value of land arising from central or local government action, excluding increases due to general inflation, the efforts and expenditure of the owner.

In this book, the term 'betterment' does not include the land value increment arising from general community influences such as population growth, general inflation or land user's investment in land, for it is generally difficult to prove the extent to which any increase in value can properly be attributed to any of these factors. Therefore betterment is defined as the land value increase generated by government activities such as infrastructure investment and change of planning parameters. Likewise, the term 'worsenment' means any decrease in the value of real estate generated by government actions other than one caused by land users or general deflation. In some countries, say the USA, 'betterment' and 'worsenment' are also called 'windfall' and 'wipeout' respectively.

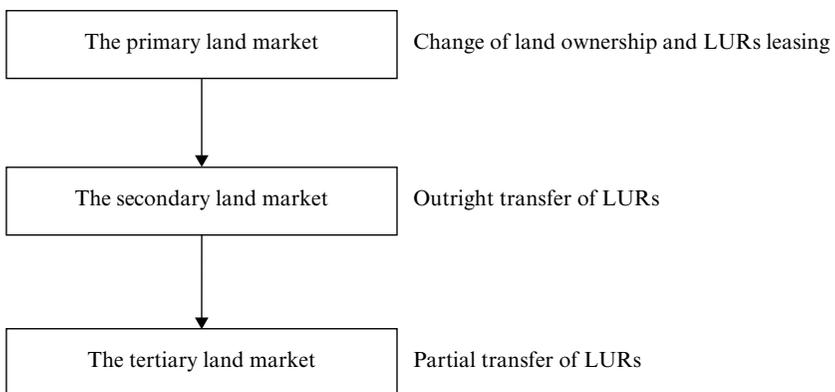
'Compensation' in this book not only means compensation for worsenment, but also includes compensation for land acquisition. In China, there is no compensation for the decrease of land value caused by government activities. Therefore, the term 'compensation' in this volume focuses on the discussion of compensation standards and compulsory purchase in land acquisition.

### **1.2.2 'Land Market' and 'Real Estate Market'**

Owing to the institutional difference between China and the Western world, the terms 'land market' and 'real estate market' have different meanings under the LURs system. In the Western world where freehold is the dominant land tenure, there are no distinct differences between real estate markets and land markets. According to *Black's Law Dictionary*, real estate includes the land and anything fixed, immovable,

or permanently attached to it such as buildings, walls, fixtures, improvements, roads, trees, shrubs, fences, roads, sewers, structures, and utility systems. However, for technical purposes, some scholars prefer to distinguish real estate, referring to the land and fixtures themselves, from real property, referring to ownership rights over real estate. Seabrooke and How (2004) differentiate the concepts of 'land' and 'real estate' in the way that real estate is not defined simply by the physical characteristics of the land or the buildings on it, but by the enforceable rights that allow the use of land and buildings thereon to be exercised, protected, and transferred. Basically, the real estate market includes markets for various property types, such as an office market, housing markets, and the commercial market.

Under the LURs system, the land ownership and the LURs are separated, that is, the state owns the land, but not structures on the land. Therefore, 'land market' and 'real estate market' are slightly different concepts under the LURs system. Usually the transfer of land property rights is divided into three levels in urban land markets (Figure 1.1). The first level is named the primary market, which means both the conversion of collective land into state land and the transfer of LURs between the state and individuals or corporations; in theory, the primary market should be monopolized by the state. The secondary market refers to the outright transfer of LURs as a bundle of rights between individuals or corporations with the permission of the government. If the government needs land for the construction of public facilities, it can acquire collective land in the primary market or purchase LURs from other land users in the secondary market. The tertiary market means the partial transfer of LURs between individuals or corporations, for instance the rental or mortgage of LURs.



*Figure 1.1 Stratification of land markets under the LURs system*

Generally speaking, land leasing means the transfer of LURs between the government and individuals or corporations in the primary market.

## 1.3 THE STRUCTURE OF THE BOOK

### *Chapter 1 Introduction*

This chapter outlines the background, the scope, and the objectives of this research. It also identifies research questions and indicates the structure of this book. Several terms are also defined in this chapter.

### *Chapter 2 The nature of land rent and land value capture*

This chapter examines the classic theories of land rent and land value, and focuses on the fundamental questions: What is the nature of land value and real property? Who are entitled to capture the land value increments?

### *Chapter 3 Studying betterment and compensation from the perspective of property rights*

This chapter adopts an analytical framework derived from the New Institutional Economics to examine the following betterment and compensation issues:

1. Externalities, transaction costs, betterment and worsenment.
2. Property rights as a tool of economic development and public policy.
3. The theory of the state.

These theories are employed to develop an analytical framework for how the land market is affected by property rights arrangements, and what role the government has been playing in land markets.

### *Chapter 4 Assessing and addressing betterment and compensation: international experiences*

This chapter firstly presents the methods that are frequently applied to assess the land value change generated by certain events. Then it describes various international practical approaches to addressing betterment and compensation, and analyses their strength and weakness. The complexity and costliness of these approaches are analyzed to explain why it is difficult to enforce betterment and compensation policies in practice.

*Chapter 5 Urban land reform and the evolution of the land market in China*

This chapter provides an introduction to the institutional context and process of urban land reform in 1988. Firstly, the historical evolution of Chinese land tenure, particularly the land tenure of contemporary China – the Republic of China after 1911 – is reviewed. Then the traditional land use system from 1949 to 1987 is explained and its consequences are analysed. The chapter then introduces the legal and administrative frameworks of the LURs system. Finally, the urban land market since the 1988 land reform is described to illustrate its problems and prospects.

*Chapter 6 Betterment and compensation schemes under the LURs system*

Under the LURs system, current mechanisms for dealing with betterment and compensation, such as LURs fees, land taxation, land requisition approaches, and compensation standards, are described in this chapter, and their deficiency and influences on land markets are analysed. Then the role of the state in addressing betterment and compensation is examined. The chapter concludes with an analysis of the obstacles to addressing betterment and compensation.

*Chapter 7 Assessing and addressing betterment and compensation in Guangzhou: empirical evidence*

This chapter adopts a case study approach at two levels. At the municipal level, Guangzhou is selected as a case. In evaluating its betterment approach, the main attributes, including land revenue and real estate taxes, the proportion of land revenue in local revenue, and infrastructure investment are used as evaluation indicators. It is very difficult to evaluate compensation quantitatively at the municipal level. Therefore the evaluation is mainly a descriptive analysis.

At the project level, the Inner Ring Road and the Metro Line 2 are selected as case studies. A repeat-sales model and hedonic regression model are applied to evaluate to what extent the government action has affected the land and property value.

*Chapter 8 Institutional evolution in the land market of Guangzhou*

This chapter provides a wider institutional context in which to understand the current schemes of betterment and compensation. It examines the evolutionary path of the institutional arrangements and property rights in

the land market of Guangzhou, such as changes in the land administrative framework, and the coexistence of formal and informal property rights. The chapter ends with reflections on institutional arrangements in the transitional land market.

### *Chapter 9 Conclusion*

This chapter summarizes the analyses and findings above, and explores policy implications germane to betterment and compensation in China, including the role of the state, the establishment of information structures, and further reform of property rights in land. It concludes with a recommendation for further research.

## NOTES

1. In this research China refers to Mainland of China, excluding Hong Kong, Macao, and Taiwan. Hong Kong and Macao were returned to China in 1997 and 1999, respectively, and they are highly autonomous economically as well as politically. Taiwan is still independent of the control of Beijing. All of these areas are implementing different policies and management frameworks from Mainland China.
2. Under the situation where their occupied land is compulsorily acquired, they can be paid compensation based on the existing market value of their property at the time of land acquisition.