

## INCENTIVES AND THE BOTTOM-UP APPROACH TO LAND USE REGULATION IN CHINA

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### *Introduction*

In attempting to regulate rural land use in China, the central government has two major goals. First, it wishes to halt or at least retard the conversion of arable land to non-agricultural uses, either voluntarily or through requisition (*zhengyong*).<sup>1</sup> Second, it wishes to increase the security of farmers' land tenure under their production contracts (*chengbao hetong*) in order to stimulate agricultural investment and production. As is well known, the achievement of both of these goals is subject to serious challenge by the development activities of local governments.<sup>2</sup> What is perhaps less well understood, however, is that both these problems stem at least in part from a common source: a top-down, centralized, and bureaucratically-oriented approach to land use regulation instead of a bottom-up, decentralized, and market-driven approach.

The key to solving any problem lies first, of course, in diagnosing its cause. As is constantly pointed out in the Chinese legal press, the central government has regularly promulgated edict after edict forbidding local authorities from violating *chengbao* contracts and converting arable land to non-agricultural use without proper authority, and local governments have just as regularly ignored these edicts.<sup>3</sup> Unfortunately, the cause of this problem is all too often attributed simply to a lack of understanding of the central government's policy on the part of rural cadres, or at times to a lack of clarity in the applicable legal concepts. More education and more

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<sup>1</sup>The question of whether such conversion is always a bad thing is beyond the scope of this paper.

<sup>2</sup>On the problem of uncontrolled development, see Carolyn Cartier (Department of Geography, University of Oregon), "Development Zones and the Evolving Land Use Regime in China: The Inherent Contradictions" (unpublished paper, 1999). On the problem of lack of security of tenure for farmers, see Kari Madrene Larson, "A Lesson In Ingenuity: Chinese Farmers, the State, and the Reclamation of Farmland for Most Any Use," *Pacific Rim Law & Policy Journal*, vol. 7, no. 3 (June 1998), pp. 831-857.

<sup>3</sup>See, e.g., Zheng Mengxiong, "Guanyu jinyibu wending he wanshan nongcun tudi chengbao guanxi wenti de sikao" (Thoughts on the Problem of Further Stabilizing and Perfecting Rural Land Contracting Relationships), *Zhongguo Nongcun Jingji* (China's Rural Economy), No. 7, 1997, pp. 38-42.

clarity of thinking, according to this diagnosis, is the key to solving the problem.

I would like to propose an approach that starts from the basic fact that rural cadres do what they do because they *want* to and because they *can*. Therefore, we must inquire into the conditions that make them want to take contracted land away from farmers for development, and the conditions that make it possible for them to do so successfully.

### *Incentives to Convert Arable Land to Non-Agricultural Uses*

The incentives to convert arable land to non-agricultural use are, ironically, contained within the Land Administration Law (the “LAL”) itself as well as in other central government laws and regulations. This fundamental incentive lies in the fact that land used for agricultural purposes is incompletely commoditized, while land used for non-agricultural purposes is relatively completely commoditized. Being commoditized, it has a higher market value. Therefore, there is an incentive to convert agricultural land to non-agricultural land on the part of anyone in a position to realize that higher value.

Land used for agricultural purposes is relatively non-commoditized in several ways. First of all, it is very difficult to transfer rights to such land. Formally, the land remains under collective ownership. This formal ownership cannot change without a process of condemnation by the state and the conversion of the land to state-owned land. Those actually working individual parcels of such collectively-owned land -- that is, the farmers working under *chengbao* contracts -- cannot freely transfer their rights to the land.

Second, those engaged in agriculture are subject to an obligation to make grain deliveries to the state at below-market prices. This obligation operates as an extra tax on agricultural land; a tax that disappears once the land is used for something else. Because agricultural land is subject to this special tax, the state must take extra care to prevent the conversion of agricultural land; this in turn reduces the value of the land by reducing its transferability.

By contrast, land once taken out of agricultural production is subject to far fewer restrictions on its use. First, if it is converted to state-owned land, then long-term use rights can be granted in the land, and these land use rights can be transferred relatively freely -- certainly far more freely than the rights held by *chengbao* contracting farmers in their land. This gives such land use rights extra value.

Second, once the conversion has taken place, the state is much less concerned with the use of the land, and consequently the land is much more likely to be put to its most economically valuable use, with the associated economic benefits going to the organization that is first able to benefit from the commodification.

The incentive to convert agricultural land to non-agricultural uses will be greater as the benefits to be gained from such conversion increase. These benefits are measured by the income from conversion minus the cost of conversion. Ironically, the LAL encourages conversion by artificially lowering the cost of land to the requisitioner below market value. Article 47 of the LAL states that the appropriate measure of compensation for requisitioned land shall be its value in its original use. But given that the original use is agricultural, this value will be artificially low for two reasons: first, because at least some land must be set aside for grain production even where grain may not be the crop with the greatest value, and second, because the land's value when used for agriculture may be far lower than its value when used for another purpose.

Consider, for example, the hypothetical case of a rice paddy beside a beautiful beach in south China. The local government wishes to build a hotel on the land. Suppose that used as a rice paddy, the land produces a net income before taxes of  $N$  yuan per year for a market value of  $Y$  yuan; used for a hotel, which I will assume is the land's most valuable use, the land would produce a net income before taxes of  $5N$  yuan per year, for a market value of  $5Y$  yuan. Article 47 of the LAL requires that upon requisition, the local collective shall receive at best only  $Y$  yuan (assuming that the compensation formula of Article 47 works well in producing a total value based on annual output).<sup>4</sup> The body carrying out the requisition, on the other hand, receives land worth  $5Y$  yuan in its most valuable use -- a use to which it may now be put. Because the local collective was unable to benefit from the value of the land used for a hotel,  $4Y$  yuan of value has been transferred from the local collective to the requisitioning body by means of the conversion. There is no good policy reason why this  $4Y$  yuan of value should not go to the local collective. Indeed, if the requisitioning body were required to purchase the land from the local collective, it would have to pay the full market value of  $5Y$  yuan. By allowing the requisitioning of land for far below market value, the LAL actually encourages the conversion of agricultural land to non-agricultural uses.

It is no answer to say that the LAL contains safeguards to prevent unauthorized requisitioning of land. The point is that the safeguards do not work. In many cases, improper requisitioning occurs and even the minimal compensation provided for in the LAL is not paid. But even where local governments partially follow the rules and pay the compensation provided for in the LAL, the small amount of that compensation provides them with more of an incentive to requisition and convert than they would otherwise have.

#### *Disincentives to Invest in Improvements in Land*

It is well understood that the threat of illegal requisition or otherwise improper redistribution of contracted land deters farmers from making necessary long-term agricultural investments. But the entire structure of the LAL's rules on the legal requisitioning of land and on redistribution also operates with the same effect.

First, the compensation formula, although it attempts to reimburse individuals directly for certain improvements and expenditures,<sup>5</sup> does so inadequately.<sup>6</sup> It provides no formula for calculating the value of fixtures such as buildings: if the amount is calculated solely on the basis of cost, then no account is taken of the value added to the land by the building, which is what induced the investment in the first place. If account is not taken of that value, then the original investment

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<sup>4</sup>The compensation formula is vague in several ways. For example, although it is based on an annual production value, it does not specify whether this is a gross value or some kind of net value. The economic value of an asset is the net income it produces after subtracting the cost of all inputs and taxes, but it is by no means clear that this is what is meant in Art. 47 of the LAL.

<sup>5</sup>See Article 26 of the Detailed Rules for the Implementation of the Land Administration Law, which states that compensation for fixtures and unharvested crops should go directly to individuals -- presumably the persons to whom the fixtures and the unharvested crops belong.

<sup>6</sup>Interestingly, the LAL provides no formula whatsoever for compensation in the case of requisitioned land use rights to state-owned land.

will be discouraged. The formula takes no account of improvements that do not take the form of fixtures, such as irrigation ditches or terracing. While such improvements might figure indirectly into the formula by adding to the annual production, clearly this will not occur if they are made three or fewer years prior to the requisitioning. Since farmers do not know when requisitioning will occur, they cannot be sure that such improvements will ever be compensated for upon requisitioning, and hence will be discouraged from making them. Finally, if the formula is based upon gross output instead of some figure net of costs, it will fail to take account of any improvements that pay off by lowering input costs instead of increasing output. All of these failings operate to discourage farmers from making useful and needed investments in the land they till.

Second, and perhaps more important, the LAL does not give robust rights to those most affected by lawful or unlawful requisitioning: the farmers themselves. It is in the interests of the state for farmers to make needed agricultural investments. Farmers will invest in improvements in the land only when they have some assurance that they will be able to realize the value of those investments: either through increased crop yields or through higher payments of compensation upon requisitioning. It is the farmers that have the greatest interest in opposing illegal requisitioning and in ensuring that the compensation formula adequately reflects the value of their investments, and the state should enlist the aid of farmers in ensuring that conditions exist favorable to increased investment. But the LAL gives farmers virtually no role in the requisitioning process. The lion's share of compensation payments -- the land compensation payments (*tudi buchang fei*) and the resettlement payments (*anzhi buzhu fei*) are paid not to individuals but to a collective body under the control of local cadres. Only that collective body has the right to protest the compensation payments as inadequate.

If we were confident that rural local government were perfectly transparent and democratic, perhaps there would be little need for concern. But the reality of Chinese rural life is that local cadres enjoy a great amount of power that can be checked neither from above nor from below.<sup>7</sup> Even if there were a perfect legal system for protesting inadequate compensation payments (which there is not), by making the local cadres in control of the collective economic organization the persons who decide whether or not to protest, the LAL simply encourages requisitioning bodies to buy their acquiescence with a small bribe. If the farmers themselves had the right to protest inadequate payments, then clearly their acquiescence could not be bought for anything less than the amount to which they were entitled in the first place, and thus there would be no incentives for bribery or other improper practices.

Third, the rules on redistribution of contracted land make land tenure insecure and thus discourage investment. Article 14 of the LAL provides that land can be redistributed -- in effect, that *chengbao* contracts can be broken -- with the approval of the appropriate level of government and two-thirds of the Villagers' Committee. This supermajority requirement is apparently intended to be a safeguard against abuse. In fact, it is no safeguard at all. The relatively poor will always outnumber the relatively rich, and the politics of envy in the Chinese countryside are well known. Thus, a single relatively wealthy farmer will have little incentive to use his wealth to invest in improvements in his land, since it is liable to be taken away at any time by a vote of two-thirds of

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<sup>7</sup>See, e.g., Xu Hejin, "Dui tudi chengbao jingyingquan de zai sikao" (Rethinking Operating Rights Over Contracted Land), *Zhongguo Nongcun Jingji* (China's Rural Economy), No. 7, 1999, p. 35.

his fellow villagers who may decide to apportion his improved fields among themselves.

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It is, of course, always possible to find something to criticize in any law, since no law can be perfect, and something is always going to be overlooked or resolved in the wrong way. The crucial question is whether there is a well functioning system in place for dealing with those gaps and errors. It is in this respect, I think, that the biggest problems with the current land use regulatory regime lie.

A noteworthy feature of the Chinese legal system, both traditional and modern, has been the state's insistence on monopolizing its operation. In other words, the Chinese state has traditionally been reluctant to allow the resources of the legal system to be mobilized by individuals on their own initiative. It has been almost unthinkable that mere individuals without official status should be able to use state power for their own ends through a process which, at least ideally, does not require the discretionary approval of a state official. (While the approval of a judge is, of course, needed for the vindication of a legal claim, that approval is supposed to be based on an objective assessment of what the law requires, not on the judge's discretion.)

Thus, as discussed above, except in some rare cases, individuals do not have the right to contest requisition compensation as inadequate. Only officials speaking in the name of the collective have that right. But it is the affected individuals who have the most vital interest in the amount of compensation. It is simply impossible for central government officials to oversee every requisitioning to ensure that the proper compensation is paid, yet the central government was unwilling, in the LAL, to give at least some of that power in effect to those persons with the greatest stake in ensuring that the correct, lawful decision is made.

Similarly, consider the provisions of Articles 73 and 82 of the LAL and the way in which they deal with violations of the LAL. Article 73 states that where there is an illegal land sale or transfer, unlawful income will be confiscated. Article 82 states that where land has not been properly registered, those responsible shall be ordered to register it properly. Both these Articles represent bureaucratic, top-down approaches to regulation. Another approach, however, would be a bottom-up approach to regulation, in which the state attempted to achieve its aims by making it in the interest of people to act in accordance with law and, perhaps most important, to ensure that others acted in accordance with law as well. Take, for example, the phenomenon of illegal land transfers. One solution might be simply to say that the state would not recognize as valid any unlawful transfer of land and would continue to defend the rights of the original transferor. If such were the case, it is hard to imagine that any potential transferee would be willing to pay any money for rights that were not recognized and that were useless -- as they would be if the transferor were allowed simply to pocket the money and continue to use the land. Astonishingly, the LAL does not actually state that unlawful transfers are invalid. It merely states that the transferor's income will be confiscated, but does nothing to deter the transferee.

By the same token, the problem of failure to register land could be dealt with by providing that unregistered interests in land simply would not be recognized by the state. A transferee of an interest in land would thus insist on having the transfer registered in order to be sure of guaranteeing its rights. Of course, some transferees might wish to keep the transaction secret, but it would be at their own risk and thus there are unlikely to be many such secret transactions.

In land law as in other areas of law, it is fruitless to attempt to achieve perfection. This is true in all societies. Yet in some societies the legal system seems to work better than in others. This is not because those societies have more perfect or more complete laws. It is because they have well functioning institutions for dealing with the imperfection and incompleteness of the law. Take, for example, the notion of “due process” in the United States Constitution. Surely this is as vague as anything in Chinese law that has been criticized Chinese legal scholars -- for example, the term “[when] the anger of the people is very great” (*minfen jida*). Yet the United States Supreme Court has managed to produce a vast body of jurisprudence on the subject such that in a great many areas, we now have a fairly good idea of what it is supposed to mean, and the Supreme Court's views really matter. The task for Chinese legal scholars is not, therefore, simply to bemoan the fact that laws are imperfect, but to create institutions for dealing with that imperfection; not to attempt to foresee and provide for every possible situation in the law, but to create institutions that will be able to deal in a regular and predictable fashion with unforeseen problems as they arise; not to hope that local officials will have a change of heart and begin to obey central directives, but to put a weapon in the hands of those who have most to gain from seeing those central directives obeyed. Thus, it is critical to discard the model of land regulation in which all initiative comes from above, and to replace it with a model that includes a significant role for those who are best informed about the local situation and who have the greatest interest in enforcing central laws: the citizens of rural China.