

THE UNIVERSITY of TENNESSEE 

KNOXVILLE

COLLEGE OF LAW

*Legal Studies Research Paper Series*

**Research Paper #263  
March 2015**

# **What Will China Do When Land Use Rights Begin to Expire? The Evolution toward Rule of Law in Real Estate**

**Gregory M. Stein**

**Do not cite without author's permission  
Copyright © 2015**

**This paper may be downloaded without charge  
from the Social Science Research Network Electronic library at  
<http://ssrn.com/abstract=2565563>**

**Learn more about the University of Tennessee College of Law:  
[law.utk.edu](http://law.utk.edu)**

# ***What Will China Do When Land Use Rights Begin to Expire? The Evolution toward Rule of Law in Real Estate***

Gregory M. Stein

Associate Dean for Faculty Development

Woolf, McClane, Bright, Allen and Carpenter Distinguished Professor of Law

University of Tennessee College of Law, Knoxville, Tennessee, USA

gstein@utk.edu

## ABSTRACT

China's recent economic success is largely based on the vitality of its real estate market. But China does not permit fee simple ownership; rather, property developers build on land they have the right to use for seventy years or less. The government has not yet answered three critical questions it soon will face: Does the holder of a land use right have the right to renew it? If so, will the government charge for that renewal? And if so, how much?

In predicting how the Chinese government will act, it is instructive to observe past government behavior. First, the government tries mightily to avoid social unrest and upheaval. Second, the government refrains from being the first party to act, preferring to endorse successful private sector experiments. Third, individual government officials and the government itself are important participants in the real estate market. If we assume these features will remain true, it becomes possible to predict how China will respond as large numbers of land use rights begins to approach their expiration dates.

This Article discusses the renewability of the Chinese land use right; describes the government's options when land use rights expire; examines how the government has behaved in the past in an effort to forecast how it will answer these renewability questions; and places the resolution of

these important issues in the broader context of the uneven movement toward rule of law in China.

## TABLE OF CONTENTS

### Introduction

#### I. The Expiration Problem and some Possible Solutions

##### A. Possible Renewal Prices

1. Renewal of the Land Use Right at a Price Equal to Fair Market Value
2. Renewal of the Land Use Right at a Price that is Somewhat Less than Fair

##### Market Value

3. Renewal of the Land Use Right at a Price that is Considerably Less than Fair

##### Market Value

4. Renewal of the Land Use Right for Free

##### B. When Will the Question of Renewal Rights Arise?

#### II. Which Solution is the Chinese Government Most Likely to Select?

##### A. Residential Property

##### B. Commercial and Industrial Property

#### III. The Expiration of Land Use Rights and China's Progress Toward Rule of Law

### Conclusion

## INTRODUCTION

The Chinese land use right is not perpetual. A land use right lasts for a maximum of forty, fifty, or seventy years, depending on the purpose for which the right was granted.<sup>1</sup> The modern Chinese land use right dates back to the late 1980s, which means that most land use rights are still in their first generation and few rights have expired yet. As increasing numbers of land use rights begin to approach their termination dates, the Chinese government will need to answer three key questions: Does the holder of a land use right have the ability to renew that right when it expires? If the holder has this ability, must it pay to renew the right? And if the holder must pay, how much? The government also will need to decide whether the answers to these questions depend on the purpose for which the land use right was granted, perhaps reaching a different answer for residential property than for commercial or industrial land.

In predicting how the Chinese government will act when these questions become more pressing, it is instructive to observe how the government has acted when similar questions have arisen in the real estate market in the past. It turns out that the Chinese government has consistently engaged in several behaviors that it seems likely to continue to follow in the future. First, the government tries mightily to avoid social unrest and upheaval.<sup>2</sup> The government discourages

---

<sup>1</sup> Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanzheng Tiaoli [Provisional Regulations on Assigning and Transferring the Urban State-Owned Land-Use Right] (promulgated by the State Council, May 19, 1990, effective May 19, 1990), art. 12 (China); PATRICK A. RANDOLPH JR. & LOU JIANBO, CHINESE REAL ESTATE LAW 127–28 (2000) (observing that the constitutional amendment authorized the granting of land use rights but that the State Council established the actual durational limits by regulation); *see also* Chengshi Fangdichan Guanli Fa [Law on the Administration of Urban Real Estate], art. 8 (authorizing the granting of land use rights for a fixed number of years).

<sup>2</sup> These principles are even written into China's Property Rights Law. Wuquan Fa [Property Rights Law], art. 7 (“The attainment and exercise of property rights shall comply with laws, social morality and shall not do harm to the public interests and the legitimate rights and interests of others”); *id.* art. 84 (2007) (“In the spirit of providing convenience for production, life of the people, enhancing unity and mutual assistance, and being fair and reasonable, neighboring users of the real property shall maintain proper neighborhood relationship.”).

public protest and has sought in the past to reduce the likelihood that citizens will engage in this type of activity.<sup>3</sup>

Second, the government frequently refrains from being the first party to act when a new legal question arises.<sup>4</sup> Rather, it allows the business community to develop informal practices that the government later endorses or rejects in legislation. Instead of drafting legislation that might prove short-sighted, the government prefers to let the business community have the first opportunity to confront new questions. If the business community responds wisely, the government can then adopt legislation ratifying the practice that has developed. By allowing institutions to develop informally, the government reduces the risk that it will fashion formal institutions that function poorly.<sup>5</sup>

Third, the government itself is a regular participant in the real estate market.<sup>6</sup> It controls major real estate lenders, and it holds equity interests in entities that own and develop real estate. Individual government officials often own interests in major real estate projects. Moreover, it is very common for real estate professionals to forge strong personal relationships with government officials. Because individual government officials and the government itself are active

---

<sup>3</sup> See *infra* Part II.A.

<sup>4</sup> See *infra* Part III.

<sup>5</sup> See, e.g., Peter Ho, *In Defense of Endogenous, Spontaneously Ordered Development: Institutional Functionalism and Chinese Property Rights*, 40 J. PEASANT STUDIES 1087, 1089-90 (2013), available at <http://www.tandfonline.com/doi/pdf/10.1080/03066150.2013.866553> (“Conventional wisdom is that institutions affect the economy and can be intentionally designed, and that formal tenure is a precondition to economic growth. But China does not follow these patterns.”); *id.* at 1090 (“The vexing problem . . . is that socio-economic phenomena are rarely a straightforward matter of cause and effect, yet are in reality the result of mutual interaction”); Peter Ho, *Introduction: The Chicken of Institutions or the Egg of Reforms?*, in DEVELOPMENTAL DILEMMAS: LAND REFORM AND INSTITUTIONAL CHANGE IN CHINA 1, 18 (Peter Ho ed. 2005) (“Rather than conceptualizing economic restructuring in terms of a ‘chicken or egg’ dilemma, we should understand it as an intricate interplay between institutions and socio-economic parameters.”).

<sup>6</sup> See *infra* Part II.B.

participants in the real estate market rather than neutral referees, those officials or the government may personally benefit or suffer depending on how a given problem is resolved.<sup>7</sup>

If we assume that these features will continue to hold true in the future, it becomes possible to predict to how China will respond as large numbers of land use rights begins to approach their expiration dates. This paper proceeds as follows. Part One will discuss the renewability of the Chinese land use right and will describe the government's various options when land use rights expire. Part Two will examine how the government has behaved in the past in an effort to forecast how it will answer these renewability questions. Part Three will place the resolution of these important questions in the broader context of the uneven movement toward rule of law in China's real estate markets.

## PART ONE: THE EXPIRATION PROBLEM AND SOME POSSIBLE SOLUTIONS

Unlike the common law fee simple, the Chinese land use right has an expiration date. The maximum duration for a land use right is seventy years for residential property, fifty years for industrial property, and forty years for commercial property; by contrast, the Western fee simple theoretically is perpetual. So although the Chinese land use right is not a ground lease, it does display some of the same legal and economic characteristics of a ground lease.<sup>8</sup>

---

<sup>7</sup> *See generally* GREGORY M. STEIN, MODERN CHINESE REAL ESTATE LAW: PROPERTY DEVELOPMENT IN AN EVOLVING LEGAL SYSTEM 46-48 (2012) (describing various ways in which the government has been a participant in the real estate market).

<sup>8</sup> *See id.* at 34-35 (describing the distinctions between the Chinese land use right and the Western ground lease).

Among the biggest questions Chinese real estate law will face in the coming years are whether the holder of a land use right has the power to renew it and, if so, the duration and cost of that renewal. The Property Rights Law addresses this question somewhat obliquely in Article 149, which states:

When the period of time for the right to the use of land for construction of residences expires, it shall automatically be renewed.

Renewal of the period of time for the right to the use of land for nonresidential construction shall be handled in accordance with the provisions of law. Ownership of the houses and other immovables on the said land shall be decided on according to the agreement reached; if there is no agreement or the agreement on the matter is indefinite, it shall be decided in accordance with the provisions of laws and administrative regulations.<sup>9</sup>

Current holders of residential land use rights thus have little clue as to the length or cost of a renewal term, while current holders of land use rights held for other purposes do not even know whether they will be able to renew their rights.<sup>10</sup> If a land use right is not renewed, there is no indication that the government must pay the departing right holder for the value of any

---

<sup>9</sup> Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 149, *available at* [http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content\\_1471118.htm](http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471118.htm). Also relevant is Article 22 of the Law on the Administration of Urban Real Estate, which states that renewals "shall be approved" in most cases and also notes that "the land user shall enter into a new contract for the granting of the land-use right and pay fees for the granting in accordance with the relevant regulations," without any discussion of the method of calculating this renewal fee. Chengshi Fangdichan Guanli Fa [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat'l People's Cong., July 5, 1994, revised Aug. 30, 2007, effective Aug. 30, 2007), art. 22, *available at* [http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content\\_1471592.htm](http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471592.htm).

<sup>10</sup> For a general discussion of the renewability of land use rights, see STEIN, *supra* note 7, at 37-40.

improvements on the land. Given how new the land use right is, only a handful of rights – created initially for less than the maximum term – have come up for renewal, which means that there is little useful history to comfort or alarm the millions of holders of Chinese land use rights. The failure to resolve this uncertainty is likely to impose an increasing drag on the real estate market as existing land use rights age.<sup>11</sup>

## A. Possible Renewal Prices

1. Renewal of the Land Use Right at a Price Equal to Fair Market Value. Begin by assuming that the government will readily renew all land use rights, as Article 149 plainly requires for residential rights.<sup>12</sup> The government might calculate the renewal fee in several different ways. First, the cost of renewing the right may be set in the same manner that the cost of acquiring the right was established in the first instance. In effect, seventy years after the right was created, the government would be treating a renewal right in the same way it treated the initial right when it was first established. If the government decides to act in this way, it would charge the renewing holder a price equal to the fair market value for the land use right at the time of the renewal. The

---

<sup>11</sup> See, e.g., HERNANDO DE SOTO, *THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD* 152-58 (1989) (describing the costs of working around inadequacies in the legal system of Peru). The Chinese Communist Party seems to be aware of this potential problem. See Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform, Adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China on November 12, 2013 (hereinafter, “Third Plenum”), at II.5, available at [http://www.china.org.cn/china/third\\_plenary\\_session/2014-01/16/content\\_31212602.htm](http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm) (“Property rights are the core of ownership. We need to improve the modern property rights system with clear ownership, clear-cut rights and obligations, strict protection and smooth flow. The property rights of the public sector are inviolable, as are those of the non-public sector.”).

<sup>12</sup> Note, however, that Article 58 of the Land Administration Law allows the government to retake possession of land that was previously subject to a land use right if the holder of the right seeks an extension that is not approved. Tudi Guanli Fa [Land Administration Law] (promulgated by the Standing Comm. Nat’l People’s Cong., June 25, 1986, revised Dec. 29, 1988, Aug. 29, 1998 & Aug. 28, 2004, effective Aug. 28, 2004), art. 58(3), available at [http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content\\_1383939.htm](http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383939.htm). This language implies that renewals are not always available as a matter of right. Since the Property Rights Law was adopted more recently, its recognition of the renewability of residential land use rights presumably takes priority over the older Article 58 but has no bearing on nonresidential property.



original holder paid fair market value for the first seventy-year time span and could renew by paying fair market value again, seventy years later, for a second time span.

This raises the question of how the government will assess the fair market value of the land.

Initially, that price was most likely determined by sealed bid or public auction, although there certainly have been plenty of cases in which hand-picked individuals were invited to negotiate behind closed doors, without competition. In part, these first two methods of establishing value may have reflected the fact that China's market in land use rights was new and property values were still unsettled, especially in the first few years of the market. Thus, the government invited investors to bid, under the assumption that the auction would reveal the true market price.<sup>13</sup>

On a renewal, of course, there is no longer any uncertainty as to the identity of the purchaser since a renewal, by definition, is exercised by the party who purchased the land use right the first time. If, as seems likely, the market in land use rights remains well established and relatively stable over the coming decades, it should be fairly easy to establish a fair market value for the property without any need to resort to an auction. When the right was first created, the property market may have been new and unpredictable, so the government established the cost by bid or auction because it had few alternatives. Moreover, if more than one party was interested in acquiring the land use right, these two methods were the fairest methods of making the decision and probably the most remunerative. Seventy years later, the property market will likely remain

---

<sup>13</sup> Chinese land use rights may be sold by negotiated agreement, by government invitation of tenders, or by auction. 2 JAMES M. ZIMMERMAN, *CHINA LAW DESKBOOK* 833 (3d ed. 2010). Regulations that were adopted in 2002 affected the process of acquiring of land use rights, see T. Oliver Yee, *A Bid for a New Future: What Are the Effects and Challenges of the New National Public Bidding Regulations on Land Use Rights Assignment in China?*, 4 *Wash. U. Global Stud. L. Rev.* 447, 449–51, 455–57 (2005) (observing that these regulations aim to preclude the use of negotiated agreements for the transfer of land use rights for business purposes while also noting the problems in implementing these regulations).

well established, and the government should be able to employ other, more suitable, methods of determining the value of the property.

The government might base its appraisal on comparable sales of similar property in recent years. With a mature market, there should be plenty of comparable residential sales that the government can use to estimate the value of the land use right to be renewed. Alternatively, the government might employ an income-based approach and determine the value of the property based on its potential for generating rental income. If it were to use this method, the government would review the recent rental history and operational cost of the property and estimate how much an investor would be willing to pay to generate a comparable return. Finally, the government might simply look at what it would cost to replace the improvements on the property, although this third method may be unsuitable when the only question is the value of the underlying land.

When appraising the property, an interesting question the government must consider is whether the property will be valued as though it is unimproved or as though it already contains the improvements that are actually on the land. Unimproved property will nearly always be less valuable than improved property, but the improvements will have been built by the renewing owner or a predecessor owner. A land use right holder that has been using land productively may argue that it is being penalized for its own industriousness and success, with the appraisal reflecting an enhanced value that factors in the presence of the improvements the holder constructed or bought. The government might respond to this argument – somewhat weakly – by noting that the original price also factored in this improvement value, since the land use right

was sold in the first instance at a cost that should have reflected the value of the improvements to be built.<sup>14</sup>

Whatever appraisal method the government chooses, it should not be terribly difficult in most cases to ascertain a value for the property. After all, the market will be fairly settled by this time and property values should be somewhat stable and easy to estimate. It remains to be seen whether the party wishing to renew will have any input into this determination, by introducing its own evidence as to the value of the property.<sup>15</sup>

Once the property is appraised, a follow-up question becomes when this amount must be paid. This charge could be payable in one lump sum at the outset, just like the cost for the initial term of the land use right. Alternatively, the payment could be spread out over time, almost in the form of rent, which would allow the holder to pay an annual amount to the government as it receives income from the land or as it uses the land. This second alternative would also allow the government to enjoy receipt of the sale proceeds over a prolonged period of time, which might help it smooth out the rather erratic receipt of funds it currently must endure as it sells off land use rights to fund its operations. In fact, one problem facing local governments today is that

---

<sup>14</sup> At one point, a government official apparently sought to reduce worry among Chinese homeowners about the renewability of land use rights. The official stated publicly that Chinese homeowners need not concern themselves about the renewability of land use rights because residential buildings in China are of such poor quality that they will not last more than thirty years. Not surprisingly, this statement caused considerable panic in the residential real estate market. The official then corrected the earlier statement, announcing that buildings would actually survive for forty or fifty years. *See* STEIN, *supra* note 7, at 40. Given the fast pace of construction and the lack of experience of many Chinese construction workers, the earlier estimate may well be the more accurate one. The one upside of poor construction to these owners, of course, is that the poorer the quality of the building, the less costly the renewal fee may be.

<sup>15</sup> In American condemnation proceedings, for instance, in which the government is requisitioning privately owned land and paying the fair market value of the land to the owner, if the parties cannot agree on a price, then the value of the property is typically determined in an adversarial judicial proceeding. The owner has the right to introduce evidence of value and the ultimate price is determined by a judge or a jury. It is common for both sides to introduce expert appraisal evidence of value.

they rely too heavily on the sale of land use rights to pay current expenses, which means that their well-being is heavily dependent on the health of a very volatile real estate market. Thus, the collection of land use right fees over time might help improve government budgeting and operations.<sup>16</sup>

If the government decides to charge holders fair market value for a second term, it means that renewal rights will probably be very expensive. Every seventy years, the owner is put to the cost of reacquiring the right to use the underlying land for a price that is equal to the fair market price for the upcoming seventy-year term. The government's position would be that the owner purchased the equivalent of a seventy-year lease, that lease has now expired, and the owner has the first right to purchase the equivalent of a second seventy-year lease of the same property. The owner's response would presumably be that it assumed all along that a seventy-year land use right was tantamount to ownership, or as close as China could practically approach fee simple ownership when this system arose in the 1980s and 1990s. The owner would argue that it never expected the government to force it to come up with a huge sum of money once again in order to repurchase land that it plausibly, though incorrectly, thought it already owned.

As a matter of fairness, the appropriate resolution of this disagreement depends on what the parties reasonably expected at the time of the initial purchase. Did the purchaser believe it was buying the right to use the property for a finite period of time, or did the purchaser believe it was buying a fee simple in everything but name, disguised as a seventy-year term because the government had no better political options at the time? The answer to this question may become

---

<sup>16</sup> "Local government officials, interested in raising revenue, sell land use rights beyond the level of municipal need . . . These overzealous practices yield profound, negative, long-term consequences." Chengri Ding & Gerrit Knaap, *Urban Land Policy Reform in China's Transitional Economy*, in *EMERGING LAND AND HOUSING MARKETS IN CHINA* 23 (Chengri Ding & Yan Song eds., 2005).

quite significant, because under this first approach the renewing holder of the right will have to pay a very large sum of money to the government. But whatever the answer to this fairness inquiry turns out to be, the fair answer is not necessarily the answer the government will reach when faced with legal, political, and economic realities.

## 2. Renewal of the Land Use Right at a Price that is Somewhat Less than Fair Market Value. A

second possibility is that the initial holder of the land use right will be able to renew the right at a price that is substantially below fair market value, though still non-trivial. The initial holder of the land use right would have to pay once again to retain control of the land. However, it will not have to pay the fair market value of the property, as it did the first time around, but instead will have to come up with a smaller but still significant sum. If the original holder decides against renewing the land use right at this reduced price, the government could presumably remove the original holder at the end of the seventy years and resell the land use right to any other purchaser at its then fair market value.

If the government were to adopt this reduced price approach, the initial holder presumably would always renew at the reduced price. Such a renewal will then put the renewing party in a position to re-sell the property to another owner at the true fair market value and turn a profit on the renewal-and-sale transaction. No purchaser will be foolish enough to turn down such a substantial price discount even if it no longer wishes to continue to occupy the land, since it can quickly sell the land at fair market value and thereby garner a profit.<sup>17</sup> The owner would be

---

<sup>17</sup> Historically, New York City landlords who wished to convert apartment houses from rental buildings to condominiums or cooperatives were required to obtain the consent of a certain percentage of the existing tenants. As an inducement to these tenants, landlords frequently offered to sell the apartments at reduced “insider prices.” Some tenants would buy the apartment at the insider price and immediately resell it at the fair market price, often for a considerable profit. *See generally* N.Y. Gen. Bus. Law § 352-eeee(2)(d)(ix) (McKinney 20\_\_) (discussing the process of converting rental buildings to ownership).

selling its land and recognizing a gain upon the sale, just as it could have at any earlier point, but some of the overall gain would have to be paid over to the government in exchange for the right to continue to control the land after the end of the initial term.

### 3. Renewal of the Land Use Right at a Price that is Considerably Less than Fair Market Value.

A third possibility is that the initial holder of the land use right will be able to renew the right for a relatively modest cost, perhaps paid on an annual basis. The government could state, for example, that after seventy years, the initial holder can continue to hold the land use right by paying the government one or two percent of its fair market value every year. If this is what happens, then the government will, in effect, have sold the property to the initial holder of the land use right from the outset, but without coming right out and saying so.<sup>18</sup> The modest annual fee would be analogous to the ad valorem real estate taxes that American property owners pay at the city or county level to support local government services such as education.

If China adopts a system such as this, with the owner enjoying a perpetual ownership right conditioned only on paying the equivalent of real estate taxes to the government, then there will be little practical difference between the Chinese and American systems of land tenure.<sup>19</sup> This proposed Chinese approach, however, offers the Chinese Communist Party the ability to deny that the government has actually sold the property to a private citizen, a point that may continue

---

<sup>18</sup> For a thoughtful analysis of the extent to which China has already privatized its land on a de facto basis, see Donald Clarke, *China's Stealth Urban Land Revolution*, 62 AM. J. COMP. L. 323 (2014). I thank Professor Clarke for his comments on this section of my Article.

<sup>19</sup> Under the American system, failure to pay real estate taxes ultimately may lead the government to sell the property at a tax foreclosure sale. The property is sold at public auction, the sale proceeds are used to pay off the overdue taxes, and any excess is returned to the former owner. China would presumably develop similar procedures. However, if China chooses to treat the relationship between government and occupant as closer to that of landlord and tenant, then it might simply treat the failure to pay the annual fee as a breach of lease allowing the landlord to terminate the lease and remove the occupant.

to have political importance in the future. The holder of a land use right will continue to be only that and will not be an owner, but this holder will enjoy all of the rights of common law fee simple ownership.<sup>20</sup>

Of course, if the government were to adopt this third approach – charging the renewing party only a modest amount – the government would receive considerably less money from the holders of land use rights.<sup>21</sup> Thus, while this third option converts the land use right into something approximating a fee simple, it does so at considerable financial cost to the government. In effect, the government would be regarding the money it received for the first term of the land use right as though it were the sale price for the land. The government presumably spent this money long ago, in many cases on infrastructure improvements and other capital projects. By contrast, the government would be treating the smaller amounts of money it receives annually for the renewal term as the equivalent of ground rent or real estate taxes. It would use this money to fund its ongoing operations.

---

<sup>20</sup> Adoption of China's Property Rights Law, effective in 2007, was extremely controversial, with opponents contending that it is contrary to the basic principles on which the People's Republic was founded. The Chinese government's English-language website refers to the final version of the statute as "the most controversial law since the Communist Party came to power in 1949" and notes that it passed only after an unprecedented seven readings. *NPC's Approval of Key Laws Seen As Promotion of Social Justice by Chinese Academics*, GOV.cn Chinese Government's Official Web Portal, Mar. 16, 2007, [http://english.gov.cn/2007-03/16/content\\_553062.htm](http://english.gov.cn/2007-03/16/content_553062.htm); see also Jianfu Chen, *China's Civil and Commercial Law Reforms: Context and Transformation*, in *LAW, WEALTH AND POWER IN CHINA: COMMERCIAL LAW REFORMS IN CONTEXT* 109, 128 (John Garrick ed., 2011) (describing the law as "a revolution in legal thought and legal development").

<sup>21</sup> This statement is clearly true if the renewing party must pay the entire renewal payment in advance: A fee calculated to be lower than fair market value is, by definition, less than a fee calculated to equal market value. By contrast, if the renewing party pays the fee over time, the fee will be lower under this third approach only to the extent that the government and the renewing party both have full information when establishing the renewal fee. If they do not, then it is possible that an annual fee of, say, two percent of fair market value might eventually turn out to be greater than a single up-front fee, particularly if the property appreciates rapidly and is reassessed regularly to reflect this appreciation.

Note also that the Chinese government has already begun experimenting with the imposition of ad valorem real estate taxes in a handful of jurisdictions, so this third alternative would not be appreciably different from an approach the government is already testing.<sup>22</sup> In those settings, the government is charging these taxes to parties that have already paid the fee for their initial land use right term, so the holder is essentially paying for the initial land use right twice. The proposal above, by contrast, would become effective only upon expiration of the land use right's initial term, and would serve in lieu of a renewal fee. Of course, the government might choose to impose both fees upon renewal, charging the owner a modest fee as consideration for the renewal of the land use right and imposing ad valorem real estate taxes as well.

4. Renewal of the Land Use Right for Free. A fourth possibility is that the government could allow the renewal to proceed without charge, particularly for residential property. If the government were to adopt this approach, it would be treating the earlier sale of the seventy-year land use right as, in effect, the sale of a fee simple. Although the government retained an interest equivalent to a common law reversion, it would now be conveying that reversion to the holder of the original land use right free of charge.<sup>23</sup>

---

<sup>22</sup> *China Approves Property Tax Trials to Curb Prices*, BLOOMBERG NEWS, Jan. 28, 2011, <http://www.bloomberg.com/news/2011-01-28/china-approves-property-tax-trials-in-shanghai-chongqing-to-curb-prices.html>; *China May Expand Property-Tax Trials Beyond Cities of Shanghai, Chongqing*, BLOOMBERG NEWS, Mar. 6, 2012, <http://www.bloomberg.com/news/2012-03-06/china-is-studying-widening-scope-of-its-property-tax-trials-minister-says.html>.

<sup>23</sup> Professor Robert Ellickson argues that this approach “would promote better land stewardship by lessening the short-sightedness that is risked when the temporal division of ownership is mandated.” Robert C. Ellickson, *The Costs of Complex Land Titles: Two Examples from China*, at 21, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1953207](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1953207). Professor Clarke is less concerned, arguing that even under other alternative outcomes, the holder of the right can negotiate with the government at low cost and reach an agreement that maximizes the use and value of the land. Clarke, *supra* note 18, at 359–60.



It seems unlikely that the government would select this alternative, given how dependent it has become on proceeds from the sale of land use rights to fund ongoing government operations. However, the decision might be influenced by future political factors favoring a gratuitous transfer of the reversion from the government to the initial holder of the land use right. For example, if imposition of ad valorem taxes becomes commonplace and widely accepted, the government may no longer need the sudden infusions of cash that resales of land use rights would provide. Moreover, homeowners might well argue that their taxes effectively serve as a fee for the renewal of the land use right and that they should not be charged twice for the use of the same land.

If China were to proceed in this manner, it would be tacitly conceding that it conveyed ownership of the land to the holder when it first granted the land use right. China would have effectively privatized the land, but without acknowledging this fact for forty, fifty, or seventy years. Perhaps China needs this long transition period to soften up any political opposition that might not yet be ready for the government to sell off so much of its land. Recall, of course, that most of this land was privately owned at one time. By deferring acknowledging that it is recreating a system of private ownership of real estate, the Chinese government may also be fending off potential restitution claims from former owners of the property whose land was taken from them for little or no compensation.<sup>24</sup>

It is worth noting that if the government had sold fee simple rights from the outset rather than forty-, fifty-, or seventy-year land use rights, the price differential between the two would likely

---

<sup>24</sup> See Ho, *Introduction*, *supra* note 5, at 17 (“Although hesitant in the beginning, the collapse of the communist world in 1989 increasingly strengthened the central leadership in its conviction that the ideological pillar of state and collective ownership should not be abandoned. . . . For one thing, this determination has succeeded in smothering secret hopes of former owners or their descendants for a return of expropriated land.”).

have been trivial. The fair market value of owned commercial property is nothing more than the discounted present value of all rental proceeds forever.<sup>25</sup> This number is probably not much greater than the discounted present value of all rental proceeds for the next forty or fifty years: The rental proceeds to become due beginning in the forty-first or fifty-first year would be heavily discounted, and there would be great uncertainty as to the value of land so far in the future. The legal difference between the two is that in the actual case, the selling government retained a reversion that would not become possessory for several decades. But this reversion was not terribly valuable at that point, and the retention of this future interest likely had only a minimal impact on the price the government charged or the price bidders should have been willing to pay.<sup>26</sup>

Of course, if the government had conveyed freeholds at these modestly higher prices, it theoretically would have been in a position to hold and invest this price differential and allow the small sum of money to appreciate for up to seventy years (though, like most governments everywhere, it probably would have just spent it!). If the alternative investment had appreciated at the same rate as the property, the government would be no worse off. Rather than being able to resell the land use right at the end of the initial term, it would instead hold the equivalent value as a result of selling a fee for a slightly higher price and investing the portion of the sale proceeds attributable to the reversion.

---

<sup>25</sup> The same should be true for owner-occupied residential property, which can ordinarily be valued at the discounted present value of all future imputed rental income. However, home prices and residential rental rates sometimes do not always coordinate as closely as this model suggests they should.

<sup>26</sup> See Clarke, *supra* note 18, at 351 (noting that, at a 5% discount rate, the reversion that becomes possessory at the end of a seventy-year land use right is worth just 3.29% of the value of a fee simple absolute, and at a 10% discount rate, the reversion is worth only 0.03% of the perpetual right).

Conversely, the purchaser of the right, who saved this price differential when purchasing a mere forty, fifty, or seventy years, could similarly have banked the price differential and treated it as a reserve fund to be used to re-purchase the land use right seventy years later. In other words, the real estate developer could have taken the extra money it would have spent had it purchased a fee simple and invested this in an asset that it believed would produce the equivalent return, thereby providing the funds that will be needed to re-acquire the land use right when the initial term expires. This, too, does not reflect the spending habits of the typical real estate developer, who is not likely to be terribly worried about ownership of the land many decades in the future. It also assumes that the developer and each successive owner of the property will transfer this “reserve fund” to the next owner or discount the transfer price by a corresponding sum. And, of course, the investment options facing the government or the developer in modern China are fairly constrained. In fact, there is a good chance that either one of these hypothetical investors would simply have invested the funds in other real estate, which is one of the more attractive investment opportunities in China today.<sup>27</sup>

#### B. When Will the Question of Renewal Rights Arise?

So far, we have assumed that the government will allow initial holders of land use rights to renew those rights. We have considered four possible prices for this resale: fair market value at the time of the renewal; a price that is lower than fair market value but still significant; a trivial price; and free. We have also raised the question of whether the government will demand an upfront payment, as it did when it sold these rights initially, or will accept periodic payments

---

<sup>27</sup> See STEIN, *supra* note 7, at 92 (describing the limited investment opportunities open to ordinary Chinese citizens).

over time. And we have considered different methods of assessing the fair market value of the property.

The discussion to this point has assumed that the holder of the land use right and the government will not devote much energy worrying about these renewal issues until the initial term – perhaps seventy years long – is drawing to a close. In fact, the parties are likely to need to settle these uncertainties many years before this. Owners of a fee simple regularly need to make personal and business plans years in advance. A business may be deciding whether to relocate to larger quarters or to try to expand in place, and either choice will involve making a long-term investment. Or it may wish to sell, and the buyer will want to know the life expectancy of its investment. A homeowner may need to renovate and upgrade her property. Actions such as these typically involve the use of borrowed funds, which means that mortgage lenders also need to be satisfied with the security they will be receiving. It would not be unusual, then, for the looming expiration of a land use right to have a tangible impact on the holder of that right twenty or thirty years before the right is scheduled to expire. Those Chinese policymakers who imagine they can defer making decisions on these questions until, say, 2050 will likely be hearing from holders of land use rights decades before that. In other words, they will need to address these important renewal questions in the next ten or twenty years.

Short-term occupancy arrangements raise all types of moral hazard problems, and even a seventy-year land use right becomes a short-term arrangement as it approaches the end of its term. The holder of a land use right that still has fifty years to run will not balk at paying the cost of a new roof, since it will enjoy all or nearly all of the benefits of that major capital expense; the holder of a right with only twelve years to run is more likely to rely on patches or

lower-quality replacements. Rather than contemplating the lifetime benefits of a higher quality repair, the holder will focus only on the time during which it knows it will enjoy the benefits of that repair.

That time horizon will shrink dramatically years or decades before the first land use rights begin to expire. The holder of a brand new seventy-year land use right will begin its occupancy by treating the property very much like an owner. By year fifty, that holder will begin to behave more like a tenant. Later still, it will act more like the occupant of a hotel room. By the very end of the term, the holder will be treating the property like a rental car. Uncertainty as to the availability, duration, and cost of renewal rights will raise these predictable moral hazard concerns long before a land use right reaches its final weeks.<sup>28</sup>

Lenders will have these same concerns. Property owners considering long-term investments in their property are likely to need to borrow funds. Lenders that make these types of loans demand security interests in the real property to be improved. These mortgages serve a dual function. First, they give the borrower extra incentive to repay the loan. The borrower knows that if the loan goes into default, the lender may foreclose and the borrower will lose the property. Thus, the granting of a mortgage interest to the lender reduces the likelihood that the borrower will default in repaying its debt. Second, the security provides the lender with an alternative source of repayment if the borrower fails to repay the loan. The lender would prefer it if the borrower simply repaid the money. But if the borrower fails to do so, the adequately secured lender can have the property sold at foreclosure and will be repaid from the sale proceeds. Thus, the

---

<sup>28</sup> For a general discussion of the moral hazard issue, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 104–10 (6th ed. 2003).

granting of a mortgage interest to the lender also reduces the consequences of a default to that lender.<sup>29</sup>

These two roles of a mortgage become less effective the shorter the remaining term of the underlying land use right is. Just as the borrower has less incentive to pay the cost of a high-quality roof, the borrower whose term has just a few years left to run also has less incentive to repay its loan. After all, it stands to lose only the remaining term of the right and not a perpetual fee simple, and that term is growing shorter every day.<sup>30</sup> Moreover, the lender's security drops in value over time, as the term of the land use right draws to a close. If the lender has the ability to foreclose on and sell only the remaining few years of a land use right, the bidding will be less vigorous and the price will be lower. Borrowers will become less reluctant to default and less concerned about the consequences of defaulting.

Experienced lenders will recognize these problems before extending the loan, of course. This means that many years before the actual expiration date, lenders will be unwilling to extend significant credit to holders of land use rights. They know that as the land use right nears the end of its term, the borrower has less incentive to repay the debt and less to lose if it does not repay it. As land use rights get close to their expiration, holders of those rights will be unable to borrow funds secured by mortgages on their land.

What does all of this mean for the Chinese real estate market? Holders of land use rights will gradually become less inclined to maintain and repair their property as their initial expiration

---

<sup>29</sup> See generally GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* 1–5 (5th ed. 2007) (describing the basic contours of a standard mortgage loan transaction).

<sup>30</sup> See Gregory M. Stein, *The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan*, 55 WASH. & LEE L. REV. 1207, 1239–44 (1998) (discussing the moral hazard issues that arise between mortgagors and mortgagees).

date approaches. Lenders will become unwilling to extend credit. Real estate will begin to deteriorate. Prices will drop, due to declining property quality, unavailability of mortgage financing, and uncertainty about future renewals. Many years before the first land use rights begin to expire, this uncertainty will become a large and ever-increasing drag on China's real estate markets. That time is not far off.

To avert these problems – which will arise in addition to any other concerns that investors may have about Chinese real estate markets – China will need to inject some certainty into the market for land use rights. It will need to clarify whether nonresidential rights may automatically be renewed by their holders, as residential rights appear to be under Article 149 of the Property Rights Law. The government will need to establish the duration of all of these renewals. And, perhaps most importantly, it will have to come up with a fair, reliable, and predictable method of establishing a price for these renewals, so that investors and lenders can evaluate more accurately the value of individual parcels of real estate.

## PART TWO: WHICH SOLUTION IS THE CHINESE GOVERNMENT MOST LIKELY TO SELECT?

Part One described many reasons why the Chinese government will need to inject some certainty into the real estate market long before land use rights begin to expire in large numbers. It also elaborated on some of the alternative responses the government might reach when addressing the question of renewability of land use rights. Part Two will look at past Chinese government practice in an effort to predict some answers to the questions raised in the previous Part. In other

words, of the possible solutions just described, which one is the government most likely to choose? The government has not yet had much reason to respond to these knotty questions, and the public is not yet pressing for resolutions, though it surely will begin to before long. The public is not worried so far, and the government does not wish to take any potentially controversial action that will be difficult or embarrassing to modify until it has to.

This situation is sure to change in the next ten or twenty years. Holders of industrial and commercial land use rights will wish to renovate or expand but will have little confidence that they will control their property long enough to benefit from the labor and expense, or they will wish to sell but will be unable to persuade potential buyers who fear losing the property too soon. They also will be unable to obtain construction loans from hesitant banks. A real estate industry that is dominated by powerful and well-connected people is likely to press for greater clarity and certainty soon.

Similarly, hundreds of millions of homeowners will become uneasy as the land use rights on which their homes sit begin to approach their termination date. They, too, will have difficulty renovating, selling, or borrowing. And local governments that have sold off all of their most desirable land will wonder how they can fund future government operations with few valuable assets left to sell. These governments will yearn for the greater certainty, predictability, and comfort of regular tax receipts or rental proceeds. China, then, must answer these questions soon, and different powerful interest groups will be pressing the government for resolutions.



China has demonstrated that it is willing to allow its legal system to evolve in synergy with changing business practices.<sup>31</sup> The government does not wish to stifle innovation or damage relatively settled expectations. If anything, the legal system has struggled to stay ahead of emerging business practices, and laws often seem drafted in response to business practices rather than the reverse.<sup>32</sup> In light of this recent history, it is possible to make some predictions. These are only predictions, but they are informed by past behavior that suggests how the government will act in the future.

As noted above, three concerns seem to dictate much of the government's policy toward real estate. The government does not wish to create social unrest. It does not wish to adopt legislation or promulgate regulations until the private sector has had an opportunity to experiment. And the government – along with many officials working within the government – wants to continue to benefit personally from the ongoing real estate boom. If these three trends continue in the future, as seems likely, then it becomes possible to view some of the options described in Part One as more probable than others.

#### A. Residential Property

---

<sup>31</sup> See generally STEIN, *supra* note 7, at 19–28 (demonstrating how laws and business practices have not developed precisely in tandem, with laws often lagging behind the development of business practices).

<sup>32</sup> This informality is seen in other parts of the Chinese economy as well. Rural migrants to China's rapidly growing cities often dwell in informal housing of questionable legality, where they enjoy only limited health, education, and retirement benefits. Nor is this phenomenon unique to China, with other countries also displaying a disjunction between published laws and actual practices. See, e.g., Jean-Louis van Gelder, *Pardoxes of Urban Housing Informality in the Developing World*, 47 L. & Soc. Rev. 493, 494 (2013) (noting the persistence of informal housing arrangements in Latin America); *id.* at 495 (“governments confronted with illegal land occupation may evict informal occupants, but may also formalize their tenure and incorporate these settlements into the legal fabric of the city”).

If the past is a reliable guide, the central government will do whatever it takes to keep the residential market calm and homeowners placid. The very last thing the government wants to do is act in a way that causes hundreds of millions of citizens to believe that their single largest asset is unstable. Thus, it is nearly inconceivable that the central government will act in any way that shakes the confidence of the many recent homebuyers who believe that their home is a solid investment of great and ever-increasing value.<sup>33</sup>

All of this suggests that homeowners will enjoy the right to renew their residential land use right, as Article 149 of the Property Rights Law seems to require. Moreover, the cost is not likely to be excessive. The government might be permitted to charge the renewing right holder the full fair market value of the land (perhaps calculated in a way that *includes* the value of the improvements), but such an approach will seem punitive to many citizens.<sup>34</sup> Property owners will legitimately object to having to repurchase improvements they have already paid for once, and the public outcry would likely be considerable. The government might instead charge the renewing holder the fair market value of the land (calculated *excluding* the value of the improvements), but even this less onerous approach seems difficult to support.<sup>35</sup> Legally, the government might have a reasonable argument that this method is justified and was foreseeable. After all, the homeowner purchased a home on land it knew it would control for only seventy years. However, many homeowners still will claim that they were taken by surprise and did not expect to incur such a large cost for a second time. Some might not be able to afford such a large expense, and the many who were unable to make this huge payment might lose their homes.

---

<sup>33</sup> Local governments might not agree, and might focus more on the revenues they may lose. *See., e.g.,* STEIN, *supra* note 7, at 57-60 (describing tensions between the central government and the provinces over land policy).

<sup>34</sup> *See supra* Part I.A.1.

<sup>35</sup> *See id.*

More likely, the government will allow homeowners to renew their land use rights by making a smaller payment.<sup>36</sup> Given the government's desire to keep the owners of residential property complacent, and given the need of local governments for regular and predictable cash inflows, it seems most likely that the central government will allow homeowners to renew their residential land use rights in exchange for making regular and more modest payments to the government. These charges could be characterized as renewal fees or rent, to maintain the appearance that the government is still the legal owner of the underlying land. Alternatively, they might simply be denominated as real estate taxes, as they are in the United States, which would be a tacit acknowledgment that the holder of the initial land use right now owns the property outright. Financially, the effect is the same: The homeowner keeps the home and must make modest regular payments to the government, which the government then uses to fund its ongoing operations.<sup>37</sup>

As previously noted, some Chinese jurisdictions are already experimenting with imposing *ad valorem* real estate taxes. If these taxes are set sufficiently high, the government might be able to dispense with the renewal fee altogether, or to recharacterize the existing real estate tax as a charge for renewing the land use right. If not, the government might end up levying both charges – the tax and the renewal fee – and enjoying a dual source of income. The important feature either way is that the aggregate amount of these fees remain fairly low. If citizens see these charges as the fair and necessary cost of maintaining their control of real estate while providing the government with funding adequate to carry on its ongoing operations, they are more likely to accept them. Conversely, if they view the government as taking advantage of its

---

<sup>36</sup> *See supra* Parts I.A.2–I.A.4.

<sup>37</sup> *See supra* Parts I.A.3–I.A.4.

power over the use of real estate by charging them an unnecessarily high fee to continue to use land they have been occupying for seventy years, they are more likely to resist.

## B. Commercial and Industrial Property

Commercial and industrial land use rights raise somewhat different issues. Many of the owners of these rights are business entities, perhaps partly controlled by non-Chinese. They are probably more financially sophisticated than the typical homeowner. It is more likely that these owners of business property recognized and understood from the outset that a land use right has a finite duration and that they would someday be called upon to pay a renewal fee, much like Western ground lessees. These owners are more likely to have been active in the growth and evolution of the real estate market during the several decades when it was maturing into a modern system. This means that they fully understand what rights they do and do not own and that they participated in the process of experimentation that led to the current system of land use rights.<sup>38</sup> And many of these sophisticated owners of business property will have personal connections with the government officials who will be making these important decisions, the type of *guanxi* that has been so important in Chinese commercial real estate development to date.<sup>39</sup>

---

<sup>38</sup> The same may well be said of many owners of residential property, of course. Much residential property has been acquired solely for investment purposes, and many of these owners are sophisticated investors who are holding the apartments vacant with the intent of selling them at an appreciated price. See, e.g., *22.4% Urban Homes Lying Vacant in China: Report*, CHINA DAILY, June 12, 2014, available at <http://english.peopledaily.com.cn/business/n/2014/0612/c90778-8740395.html> (observing that nearly fifty million residential units were vacant in China in 2013, while noting the difficulties of obtaining reliable figures on vacancy rates).

<sup>39</sup> See, e.g., Rita Yi Man Li and Yi Yut Li, *Is There a Positive Relationship between Law and Economic Growth? A Paradox in China*, 9 ASIAN SOC. SCI. 19, 25 (2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2290481](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290481) (describing *guanxi* as “a type of human capital,” “an important asset for both individuals and firms,” and “an alternative reward and punishment system”).

These factors can cut both ways. To some extent, these elements suggest that the current holder of a land use right for business purposes will be permitted to renew that right but will have to pay a fee that is closer to the fair market value of the land.<sup>40</sup> As business entities, these owners are more likely to understand the economics of China's current system of property rights and to assume that they will have to pay a large fee to renew their rights when those rights expire. This is particularly true of foreign entities that may have been exposed to ground leases and other similar devices in their past transactions elsewhere. These business entities are less likely to be surprised by the imposition of a large fee at a time that was made evident from the beginning. They are not naïve, and they are unlikely to take to the streets solely due to somewhat unwarranted business frustration. And these owners also recognize that commercial property is still a valuable asset that others may prize: If the original holder of the right is willing to pay a high price for the land use right, there is no reason the government would not let that party renew, but if not, the government can find other parties eager to pay the going rate for the land.

Balanced against these factors is the reality that real estate entities in China are often partly owned by the government and largely financed by the government. In addition, real estate developers in China often have the type of *guanxi* with government officials that ordinary homeowners can only dream about. These well-connected entities are exactly the types of parties that are likely to get sweetheart deals from the government.<sup>41</sup> The previous paragraph

---

Personal relationships of this nature can sometimes mature into corruption, a problem of China is actively taking steps to combat. *See, e.g.*, Third Plenum, *supra* note 11, at X.36 (“We will strengthen the Party's unified leadership over the work of improving Party conduct, upholding integrity and fighting corruption. We will reform the Party's discipline-inspection system, improve the leadership system and working mechanism to combat corruption, and reform and improve the function of anti-corruption coordination groups at all levels.”).

<sup>40</sup> *See supra* Parts I.A.1–I.A.2.

<sup>41</sup> *See supra* note 39.

lists several reasons owners of commercial and business property are more likely than residential owners to understand why they should pay fair market value for their renewals. This paragraph, however, recognizes that well-connected holders of business property may not actually have to pay full fair market value to renew their land use rights.

It is impossible to know just how these factors will coalesce and interact, particularly since these decisions will not need to be made for another ten or twenty years, when China's overall economic outlook may be far different. But on balance, it seems likely that holders of commercial and industrial property will be permitted to renew their land use rights, are likely to have to pay for these renewals, and will probably have to pay an amount that is somewhat more than residential owners pay for their renewals, though perhaps not as high as full fair market value at the time of the renewal.

If this is what ends up happening, the result seems fair and sensible. All holders of land use rights will be able to renew them. Residential owners will be charged a modest renewal fee, perhaps on an ongoing basis. They will continue to control their home, they will pay a fair price, and they will not be displaced. They will probably grumble about the need to pay the government for the right to continue to control property they view as their own – who, after all, does not complain about paying their property taxes? – but they will largely recognize and accept the need to pay and will not create too much of a stir.

Holders of commercial and industrial property will also be able to renew them. They will pay a somewhat higher fee than their residential counterparts, though probably considerably less than fair market value. They, too, will not be displaced from their property. Domestic and international investors will accept these renewal fees as a foreseeable and reasonable cost of

doing business in China. The market will continue to function with little upheaval, and the government will enjoy the ongoing proceeds of this more reliable funding source.

If these predictions prove true, residential property owners will pay relatively less for the right to continue to control their land than commercial or industrial owners will pay. The business community's taxes and renewal fees will partially subsidize residential owners. This is a common feature in Western markets, where tax rates are often set at a higher rate for business property than for residential property.<sup>42</sup> Of course, the businesses that pay these higher fees are in a position to force these costs forward into the economy, by pricing their land costs into the goods they produce and sell and the services they provide. Every citizen who purchases goods made in China or enjoys services provided in China will be paying for what it costs to supply these goods and services, including the increased cost of the land where the good was manufactured, stored, and ultimately sold or the service was offered. Meanwhile, the market will continue to function smoothly during and after the years when the first wave of Chinese land use rights must be renewed.

### PART THREE: THE EXPIRATION OF LAND USE RIGHTS AND CHINA'S PROGRESS TOWARD RULE OF LAW

Real estate professionals in China seem to be comfortable operating in a world of legal ambiguity. In fact, much of China's recent development occurred before there was a

---

<sup>42</sup> See, e.g., *Tax Rates: City of Boston*, available at <http://www.cityofboston.gov/assessing/taxrates.asp> (setting forth a rate of \$12.58 per thousand dollars of value for residential property and \$31.18 for commercial, industrial, and personal property and noting that this rate differential "allows for the shifting of a portion of the tax burden of residential property onto commercial/industrial and personal property").

comprehensive property law to govern it, with the Property Rights Law not effective until 2007. Other business laws filled some of this gap,<sup>43</sup> but it is evident that China's real estate community has been willing to function with only a limited understanding of what might happen if problems arise. Even with the adoption of the Property Rights Law, there are still many open questions, which means that real estate professionals continue to make important decisions in a legally unclear environment. The law as practiced differs from the law as officially published, and the former often informs and shapes the latter. This pattern seems likely to continue, which means that we can make some educated guesses as to how China's real estate market will evolve in the future.

At the same time, the trend in the world of Chinese real estate seems to be toward greater formalization. China now has a wide array of laws governing property relationships, and much of the earlier legal uncertainty has been reduced. Real estate professionals have gained skills and experience and have become better at what they do. They have a track record, they have successful business models, and they have greater confidence in the legal environment in which they conduct their business. These professionals undertook experiments in an unsettled market, the government endorsed some of those experiments, and their business models became more

---

<sup>43</sup> When the modern Chinese real estate market began to re-emerge, there was no official law governing property rights. Other early statutes, however, partially plugged this gap. China adopted the General Principles of the Civil Law (GPCL) in 1986, *Ming Fa Tong Ze* [General Principles of the Civil Law] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), *available at* [http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content\\_1383941.htm](http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383941.htm), and this early law served as a basic business law blueprint. After the GPCL became effective, market professionals were more confident about legal protection of their investments and recognized that more detailed statutes would follow. During the next two decades, China adopted other laws to govern business relationships. Adoption of the Property Rights Law, which did not become effective until 2007, was actually one of the last steps in that process. But while that law was one of the last to be enacted, other laws already served to regulate business relationships.



formalized.<sup>44</sup> Moreover, the most successful “early adopters” have done better than their less profitable competitors in figuring out how to succeed in China and now have every incentive to solidify their advantages by ensuring that future changes are gradual. Thus there is an ongoing trend toward the rule of law in China’s real estate market.

Those pioneers who undertook early real estate transactions were truly working in a Wild West environment. They certainly could have waited for greater clarity, but these early market leaders feared missing an opportunity that might not arise again in their lifetimes. They foresaw the possibility of huge gains in an emerging market, and they were willing to take the risks inherent in an uncertain legal environment in exchange for this tremendous upside, a bet that appears in retrospect to have been a wise one for many.

Legal change came slowly, for practical and political reasons. Practically, it simply was not possible for China to adopt all the laws it needed immediately. The task was just too big. Moreover, the leadership wanted to learn from these early adopters, who were willing to create and use untested new models in the hope that the government would later endorse them. The government’s goal was to let entrepreneurs experiment, see what worked well and what did not, and nurture the most successful methodologies that the market developed.

---

<sup>44</sup> See generally DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 7 (1990) (describing how organizations and institutions co-evolve in “a feedback process”); see also Van Gelder, *supra* note 32, at 497 (“settlements often actively attempt to establish their ‘legality’ through strategies of noncompliance with, and adaptation to, the official legal system in order to ultimately enforce formal recognition by the latter, which gives rise to a dynamic and evolving relationship between the two”); *id.* at 510 (discussing the effects of “presenting the authorities with a *fait accompli* that is difficult to return to its original form and residents in these settlements also progressively attempt[ing] to convert the informal tenure into legal tenure through processes of negotiation, contestation and adaptation.”).

Politically, China could not stray too far from Communist principles discouraging the re-privatization of real property.<sup>45</sup> Rather, it created the land use right, a compromise that allows private entities to control real property that is still technically owned by the state. By following this approach, China was able to enjoy many of the economic benefits of private ownership of real estate without technically relinquishing public ownership and unleashing a political backlash.<sup>46</sup>

Once the land use right became more stable and predictable, the first round of entrepreneurs grew more confident that their business models would continue to succeed. They were already doing well, and the government was acting to insure that they could continue to do so. Greater legal and political predictability supplanted the earlier uncertainty. Moreover, those earliest entrepreneurs have developed the experience, confidence, and *guanxi* they need to ensure that they will remain industry leaders in the future.

If anything, greater adherence to the rule of law has locked in the first-mover advantage of these professionals. They developed rules and practices that benefited themselves, and now they want to institutionalize those rules and practices. Their knowledge, skill, size, and business connections, combined with a legal system that encourages innovation less than in the past, all help to ensure that these leaders will remain influential in the real estate business. In today's real

---

<sup>45</sup> See STEIN, *supra* note 7, at 28-31 (discussing the controversial legislative history of the Property Rights Law); see also PETER HO, INSTITUTIONS IN TRANSITION: LAND OWNERSHIP, PROPERTY RIGHTS, AND SOCIAL CONFLICT IN CHINA 41 (2005) (“Land policy-making is, therefore, an alternation between restraining practices that exceed legal boundaries and giving space to experimentation by formulating intentionally unclear policies and laws.”).

<sup>46</sup> For a valuable discussion of the sequencing of Chinese legal and economic development, see Alice Xie, *Revising the Law-Growth Hypothesis: A Case Study of Reform-Era China*, 6 NW. INTERDISC. L. REV. 155, 178 (2013) (“Not only can economic activity flourish in the absence of law, but it may actually stimulate and inspire the development of the legal system.”); *id.* at 157 (“China is a case in point of how alternative mechanisms to the rule of law, and indeed wholly alternative systems, can sustain such conditions to yield spectacular economic growth.”).

estate market, there still is experimentation and there still are unanswered questions. But there also is more experience, more formal law, and more of the attributes of a rule-of-law system. And the people with the most to lose want that trend to persist.<sup>47</sup>

For that trend to continue, though, there must be greater certainty as to the renewability of land use rights. Current holders of those rights care greatly about whether they will be able to renew their rights, for how long, and at what price. As those land use rights begin to approach their expiration date, the holders of these rights will lobby for greater clarity.<sup>48</sup> Given the extent to which the stability of China's real estate markets depends on the answers to those questions, it seems certain that the government will have to respond sooner rather than later. Early entrepreneurs may have benefited initially from an unpredictable system with little clarity and many unresolved questions. But now that they have become leaders in their fields, they want just the opposite: Transparency, certainty, and the absence of doubts about the future. These are the ways in which they can protect their existing investments and discourage competition from the next generation of upstart real estate developers. Homeowners similarly want the comfort of knowing they will not be displaced or forced to pay huge renewal fees.<sup>49</sup>

---

<sup>47</sup> See Li and Li, *supra* note 39, at 25-27 (noting how *guanxi* has served as an informal enforcement system in China but suggesting that it needs to be supplanted by rule-of-law principles as the Chinese economy becomes more complex and China's citizens become more mobile).

<sup>48</sup> To some extent, this statement presumes that these rights holders will like the answers once the uncertainty is clarified. If rights holders suspect that they will not enjoy the right to renew, or will have to pay dearly for that right, they might actually prefer a vaguer answer. After all, they would rather have an unclear answer than a clear rejection, in the hope that they can use their influence to push for change before the answer is firmly set.

<sup>49</sup> See HO, INSTITUTIONS IN TRANSITION, *supra* note 45, at 16 (noting, in 2005, that "intentional institutional ambiguity has yielded important gains in land tenure reforms, but . . . further deferring the clarification, protection, and registration of collective land ownership will lead to social instability").

What we have seen in China, then, is a move from experimentation and intentional vagueness toward greater precision and emphasis on the rule of law.<sup>50</sup> The Chinese government was not in a position to answer difficult questions about its real estate markets during the 1980s and 1990s, so it invited informal research instead. A large number of entrepreneurs accepted this invitation, with a willingness to risk operating in an uncertain market. These risks were more than offset by the potential for huge gains, and many of these leaders were amply rewarded for their wagers. Through trial and error, they established business practices that worked.<sup>51</sup> The government observed these early efforts, encouraged further ones, and gradually adopted laws that endorsed successful approaches. Others then began to participate in these more stable and settled markets, making somewhat safer bets and presumably receiving commensurately lower rewards. By then, though, the earliest entrants had had the time to establish a considerable head start.

Now that they are leaders in their fields, these first generation entrepreneurs want to preserve their advantages. Rather than allowing themselves to be superseded by the next generation of risk-takers, they would prefer to clarify the rules, reduce the odds of losing what they have created, and clamp down on competition. To achieve these goals, early business leaders are likely to want less ambiguity and uncertainty and clearer answers to unresolved questions. Chief among these is the question of what will happen to the land underlying a successful development

---

<sup>50</sup> China's move toward the rule of law has not been without its setbacks, of course, and the Chinese Communist Party is aware of Western unease about China's progress. At the Third Plenary Session of the 18th Central Committee of the Communist Party of China, the Central Committee adopted a Decision stating, "We should work harder to accelerate socialist democracy in a systematic way by adopting due standards and procedures. We should build a socialist country with the rule of law, and develop people's democracy with wider, more adequate and sound participation." Third Plenum, *supra* note 11, at I.2, available at [http://www.china.org.cn/china/third\\_plenary\\_session/2014-01/16/content\\_31212602.htm](http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm).

<sup>51</sup> See Ho, *In Defense of Endogenous*, *supra* note 5, at 1110 ("The great mistake in the study of institutional change is to take a snapshot of that which is in flux. Institutional change implies a shift in the endogenous, spontaneously ordered 'rules of the game' over time and space.").

when the initial term of the land use right expires. This pressure for greater certainty suggests that China will be required to resolve these questions many years before these rights expire. The nation will have to inject greater confidence into the real estate market and provide comfort to investors who worry about maintaining their gains.

For all of these reasons, it seems likely that the government will seek a solution that is acceptable to the market and will consult with leaders in the field as it moves forward. Government and business leaders will need to work together to devise a solution that maintains stability in the real estate market while allowing the government to receive steady and predictable funding to enable its own continued operation.

## CONCLUSION

Part One of this paper raised the open questions about renewability of land use rights that China must soon address. It then described several possible answers to these questions. Part Two suggested which of these possible answers is most likely to be the one the government chooses. While no one can foretell the actions of the Chinese government with any great conviction, these predictions are based on past government behavior. These answers may not turn out to be correct, but they are probably the most likely ones out of all the alternatives.

Part Three then focused on the movement in China toward greater formalization and emphasis on the rule of law. This Part suggested that the leading players in China's real estate market and government have reasons for wanting to resolve these uncertainties soon. In sum, it seems likely

that China will resolve these important questions in a particular way and will not wait a long time to arrive at these answers.

If these predictions prove to be true, several interest groups in China stand to gain. First-generation real estate developers will continue to enjoy the benefits of their risky investments that turned out well. They will be able to renew their land use rights – though probably at some considerable cost – and will continue to control their real estate projects. They will also preserve their positions as industry leaders. Investors in these projects will similarly continue to enjoy gains from their investments. Homeowners will maintain ownership of their residences, preventing the type of instability that is anathema to the Chinese government.

Different levels of government will benefit in several ways. In addition to enjoying the benefit of social harmony, local governments will also receive cash payments in the form of ad valorem property taxes, renewal fees for land use rights, or both, and these fees will probably be adequate to meet ongoing governmental needs. To the extent that they are investors in the real estate markets, governments at every level will enjoy the same financial benefits as other investors. And individual government officials will benefit personally, as investors in particular projects and through the maintenance of personal relationships with powerful real estate developers.

The general public will enjoy greater stability. Homeowners, as just noted, will not be displaced. Investors will feel greater confidence in the soundness of their real estate assets. Taxpayers will know that the governments to which they pay their taxes are more fiscally sound than in the past. Real estate markets will mature and have a more solid footing in the rule of law. And generalized unrest will be unlikely.

In short, we can predict that China will answer these essential questions in the near future. And we can also predict that the answers to these questions will lend further solidity and maturity to China's real estate market and to the nation as a whole.