



## Land sale venue and economic growth path: Evidence from China's urban land market



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### A B S T R A C T

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This paper explores the impacts of different land sale venues on the economic growth path, and hence Chinese local officials' incentive structure and their strategic balance between political promotion and rent creation. By investigating the panel data of 30 provinces and municipalities from 2000 to 2009, empirical results suggest that the proportion of land sale through public auction has positive effects on local GDP growth. The implication is that local officials who choose land sale venues may be judged on the basis of their impacts on local economic performance, because China's political promotion is largely GDP-based. However, descriptive statistics further reveal that local officials tend to sell commercial and residential land but not industrial land through public auction, indicating that local officials may have a strategic balance between their political promotion incentive and rent seeking incentive. In conclusion, it is the incentive of climbing further up the career ladder that drives local officials to give up some of, if not all, their rent seeking incentive in urban land transactions.

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### Introduction

According to the [North, Wallis, and Weingast's Model \(2009\)](#), social orders in limited access societies (or natural states) are maintained by the creation of economic rents to the elites, whereas social orders in open access societies are maintained by the open competition of economic rents by any entities. Economic performances of the latter societies, according to their survey, far outperform the former ones. Transition from natural states to open access societies requires institutional arrangements and doorstep conditions that allow impersonal exchanges instead of personal elite privileges. Developed countries have both competitive democracies and market economies to strengthen one another, which foster impersonal exchange and enable the price mechanism to function. In developing countries with limited access societies however, unless the dominant coalition finds it beneficial to elites by expanding impersonal exchange, this transition will not initiate.

China is no doubt a country with limited access politically, but whether the economy is totally dominated by the elites is dubious. With regard to China's urban land market, this paper intends to examine the economic system at work to find out why local officials, or elites, tend to sell land by public auction at the expense of

less economic rents. In the past, most land was granted to the sitting state owned enterprise tenants by private negotiation, and the land price was intentionally depressed to attract foreign investment ([Xie, Ghanbari, & Redding, 2002](#)). In recent years however, land sales by public auctions have increased significantly.

One explanation for such change is that with the recent development of the real estate market, local officials tend to collect more land sale revenues from the urban land market ([Zhang, Sun, & Loungani, 2010](#)). In fact, local governments supported the real estate boom by providing developers with favorable financial support, development feasibility and flexibility. In return, local governments benefited from the real estate boom by acquiring higher income ([Li, Chiang, & Choy, 2011](#)). Between 2000 and 2009, the annual growth rate of land sale revenue was 27.1% ([CSY, 2010](#)). According to China Statistical Yearbook, in 2009 the national-level fiscal income was about 3260 billion RMB ([CSY, 2010](#)). Meanwhile, China Land Sources Bulletin 2009 suggests that the national-level land sale revenue in that year was about 1500 billion RMB. The national average proportion was as much as 46.0%, indicating that local governments benefited a great deal from the real estate boom as increase in land sales provides an important source of fiscal income.

In general, land sale values nationwide have increased by nearly 800% since the first quarter of 2003, with half that rise occurring since 2009 ([Wu, Gyourko, & Deng, 2010](#)). Increasing real estate price also stimulates the skyrocketing land bidding price ([Peng &](#)

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Wheaton, 1994; Zhang, 2008). However, many land parcels are still sold by private negotiation, due to rent seeking opportunities between local governments and real estate developers (Xie et al., 2002; Tian & Ma, 2009). The problem is, while local officials expect to reap the benefits of increasing land sale revenues through public auction, they would incur sizable loss in the economic rents generated through private negotiation. Is there a strategic balance?

The research hypothesis of this paper is that in light of their incentive structure, local officials thrive to balance their political promotion incentive and rent seeking incentive in land transaction. In the urban development context, local officials tend to increase public land sales in the residential and commercial markets, which in turn will increase not only land sale revenue but also economic growth. In particular, to explain the increase of land auction, the first research proposition is that land sale by public auction is conducive to local economic growth, and hence local officials' political promotion. To explain why residential and commercial land parcels are auctioned while industrial land parcels are not, the second research proposition is that industrial land is most conducive to local officials' economic rents, thus most industrial land is still sold by private negotiation.

### Negotiation versus auction

Negotiation, defined as a common decision-making process involving two or more parties with different interests to achieve an agreement (Young, 1991), is prevalent in many activities. During negotiation, participants must consider not only economic benefits and costs, but also political, legal, social, cultural, behavioral, technological, and psychological issues (Urbanaviciene, Kaklauskas, & Zavadskas, 2009). Auction on the other hand, requires bidders' efforts to formulate optimum tendering price through open process. The major difference between private negotiation and public auction in the urban land market is that the former creates rent seeking opportunities while the latter dissipates such behaviors (Tao, Su, Liu, & Cao, 2010).

In China, local governments have overwhelming power in land acquisition and disposition in both urban and rural markets. In the urban context, land is owned and allocated by city land bureaus, through which local governments control the allocation of land leases for construction and development purposes (Lu, 2010). In the rural context, local governments have adopted compulsory pricing and administrative levy to requisite rural land and turn it into urban usages (Xu, Tang, & Chan, 2011). The dominance of local governments in land acquisition and transaction has its own problems. In particular in the 1990s, most land pieces were sold through private negotiations in hidden processes between local officials and investors. Such procedure in many cases deprived cities of allocating land resources for best uses, and represented a major source of corruption (Cai, Henderson, & Zhang, 2009; Tao et al., 2010).

To prevent corruptions from urban land sales, the central government has implemented a series of reforms. The most relevant measure was in 2002, when a law banning negotiated sales was issued with the last date for any negotiated sales being August 31, 2004. In 2006, the central government again issued an order to stop giving land to real estate developers for free or at very low prices. These measures were consistent with changes of the central government's position in land revenue distribution. In 1998, the Land Management Law was amended so that the central government could share 30% of revenues from leasing newly acquired land (Tian & Ma, 2009), thus being conducive to the central government's fiscal coffers. Meanwhile, land sale through public auction is also in line with local governments' revenue collection incentive. Demarcated by the 1994 tax and fiscal reform, the incentive of local governments was largely reshaped. Changes were made to

centralize fiscal revenues while keeping local authorities responsible for fiscal expenditures (Tao & Yang, 2008). As more than 70% of expenditure has been assumed by local governments since 1994, they had to seek extra revenue sources (Wong, 2000). Public land leasing helps to include private firms into local government's alternative revenue sources (Deng, 2003). Therefore, a more competitive, market-based pricing mechanism in the urban land market which encourages more land to be sold by public auction rather than private negotiation would allow local officials to reap the most revenue from selling land parcels (Tao et al., 2010), but at the loss of rent seeking opportunities.

### Local governments' incentive structure

Theoretically, thriving markets require not only an appropriately designed economic system, but also a secure political foundation which credibly commit the state to honor economic and political rights (Weingast, 1995). If the political system provides local governments with no incentive to increase tax base or provide public goods, governmental over-regulation of efficient business can be overwhelming, such as the case in Russia (Berkowitz & Li, 2000; Zhuravskaya, 2000). Being reflective of past pitfalls, China's economic success heavily rests on a foundation of political reform which provides a considerable degree of credible commitment to the market (Cao, Qian, & Weingast, 1999; Montinola, Qian, & Weingast, 1995). Institutional reform in terms of fiscal decentralization encourages local elites to carry out more experiments that boost economic growth (Chhibber & Eldersveld, 2000). Moreover, local officials have endeavored to build infrastructure, offer tax incentive and simplify administrative or regulatory rules to attract business investment in local economies (Cheung, 2008; Tao et al., 2010).

While the fiscal system is decentralized, China's governance structure remains a top-down mandate (Zhang, 2006). Therefore, local governments' incentives to bail out inefficient projects largely depend on the trade-off between political benefits and economic costs (Qian & Roland, 1998). Under the authorization political system, the central leaders can use personnel control to induce desired economic outcomes, by relating provincial leader's turnover probability to their economic performance. For example, Blanchard and Shleifer (2001) maintained that Chinese local officials' performances are judged by local economic growth. Li (1998) discussed the reward-punishment mechanism under the multidivisional-form structure of the Chinese economic system, which induces intense regional competition among local officials. Li and Zhou (2005) found that when the annual GDP growth rate increases by 1%, the chances of political promotion at provincial level will increase by 0.15% for provincial leaders. The positive correlation between chances of political promotion and local economic performance is similarly confirmed by Chen (2004). Since late 1990s, Chinese local governments have become more aggressive in pursuing industrialization and urbanization to boost regional economic development. While promoting economic growth is beneficial to achieve Chinese local officials' political promotion objective, the correlation between land sale venue and economic growth path in China remains unexplored.

### Land sale venue and economic growth path

We follow the work of Kiyotaki and West (2004) to extend the neo-classical development economics literature by including land as a factor of production. The major extension is a constant return to scale production function in which the output  $Y_t$  follows the Cobb-Douglas function in labor  $N_t$  and a composite in capital  $K_t$  and land  $L_t$  with constant elasticity of substitution.

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