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# Urbanization and Real Estate Investment in China

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# Introduction

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A visitor to China is immediately aware of the country's spectacular and accelerating urbanization over the last twenty years. Beijing is in many ways not representative of China, but nevertheless provides a faithful picture of the present urbanization process, given its on-going spacial expansion, the construction of countless high-rises and the disappearance of old, *hutong* districts. The same could be said for Shanghai, Chengdu, Guangzhou, Chongqing, or of Shenzhen and Zhuhai which were created out of nothing along the border of Hong Kong and Macao, or even of so-called second and third circle cities like Tianjin, Ningbo, Wuxi, Qingdao, Guiyang, Yantai or Shijahuang<sup>1</sup>. All illustrate Chinese urbanization as a whole, along with its corollary of unbridled real estate investment.

This simple observation highlights the key issue at stake, namely frenzy. This frenzy has positive sides: architectural creativity, urban innovation in sustainable development for the future, improved living conditions for the new urban class, better sanitation, and more generally impressive networks of urban infrastructure, with real estate investment pulling China's growth above 10%. But it also has negative aspects: the human cost of development based on the servile labor of the *mingongs* (internal migrants), imbalances close to breakdown between cities and the countryside, and environmental costs: the WHO ranks 20 to 30 Chinese cities as amongst the world's most polluted.

This spectacular change, which has no equivalent in the West, is certainly one of the most characteristic and determining phenomena of the profound metamorphosis of contemporary China. If, as Marx said in the *Grundrisse*, a city "concentrates everything which makes a society into a society", then each of these Chinese cities reveals, in all its facets, the distance covered by this old Physiocratic regime during the last sixty years: the acceleration of its history, along with the spillovers of growth and the costs it leads to.

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<sup>1</sup> See *China 40, The Rising Urban Stars*, Jones Lang Lasalle, 2009.

Furthermore, urbanization is henceforth irreversible, save for the will of the Sovereign, and will self-generate and reinforce itself. This is all the more so given that the law has and will continue to follow suit, modifying the very premises of the Chinese regime.

The following pages seek to assess this unprecedented movement and to describe the changes in China's rules of the game, together with the emergence of a more-or-less chaotic real estate market.

# Unprecedented urbanization in China

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Over the long span of Chinese history, it is easy enough to trace the beginnings of urbanization to a distant antiquity and so trivialize its recent nature. Archeological digs indicate that Chinese urbanization began more than 4000 years ago, on a scale that even then had no equivalent in the West, given China's much larger population. But this would be an erroneous view, as China was for a long time a fundamentally agricultural and rural empire, right through to the time of Europe's industrial revolution, which led to far higher urbanization ratios than in China.

## ***The rapid metamorphosis of China's population from being rural to urban***

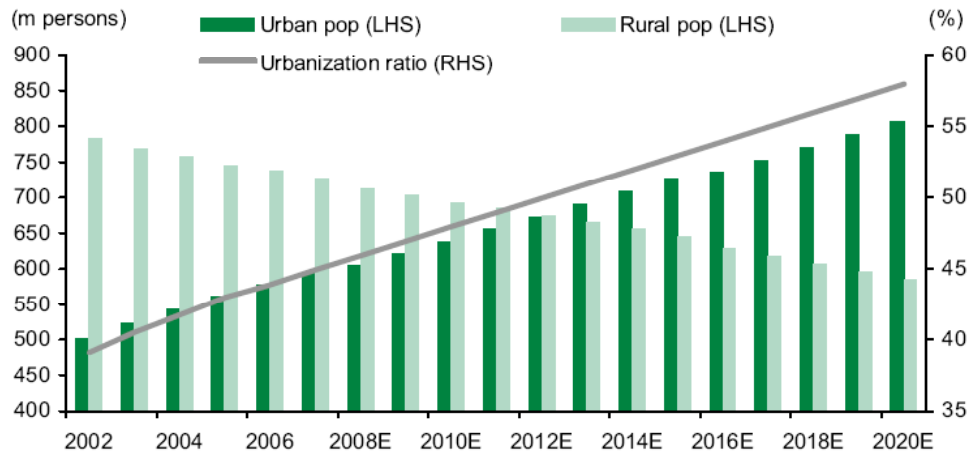
In the 1950s, China still had in fact a very largely rural population and an economy geared to agriculture. It was only during the second half of the 20<sup>th</sup> century that China embarked on urbanization, with an unparalleled acceleration during the era of Deng Xiaoping.

In 1980, a mere 19.8% of the population was urban, compared to 23.1% in India. By the end of 2008, the urbanization rate had reached 45.7%, far ahead of India, which was stagnating at 29%. According to a recent report by BNP Paribas (BNPP)<sup>2</sup>, China's urbanization rate should reach 60% by 2020. The urban population rose from 191 million in 1980, to 502 million in 2002, to which a further 100 million may be added five years later. The latter figure is probably an underestimate as it certainly does not include the massive influx of migrant workers who are not declared to the authorities.

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<sup>2</sup> See the report by Isaac Meng, Senior Economist with BNPP, entitled *China: Seeking New Paths*, October 2008.

**Exhibit 32: Urbanization Trend**



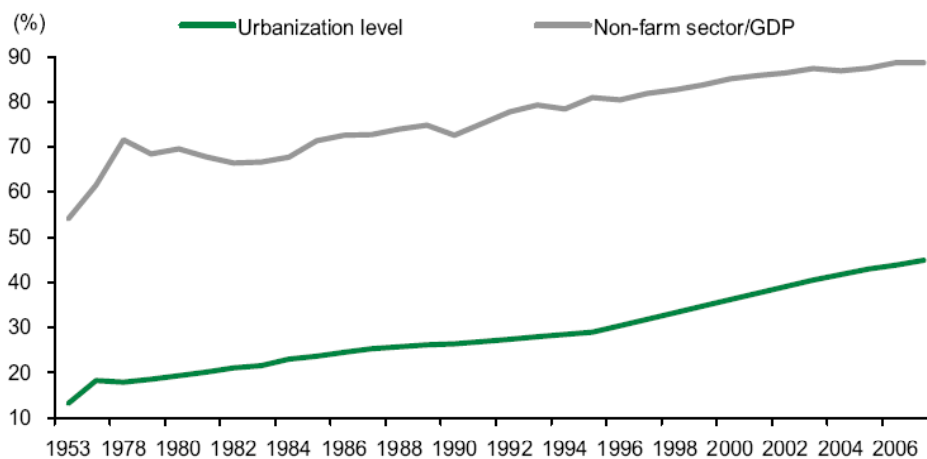
Sources: NBS; BNP Paribas estimates

## The industrialization drive

The acceleration of urbanization is due above all to a reinforcement of industrialization in China, which is likely more important than the natural growth dynamics that have led small towns to become large cities. The level of urbanization is thus intimately correlated with the relative and rising weight of the non-agricultural economy in Gross Domestic Product:

The industrialization of land had already been decreed under Mao. But it was the reformers of the following epoch, the era of Deng

**Exhibit 34: Urbanization Paced Industrialization**



Sources: NBS; BNP Paribas

Xiaoping, who made it an essential and intrinsic axis of expansion and the opening up of China to the world, as well as a means for improving daily life for China's population. Their policy was far more deliberate and determined, while being linked to specific and precise objectives. From the 1980s on, the aim was to concentrate production resources in centers that were to be growth reservoirs, and to focus urban development along China's southeast coast. In the 1990s, a clear decision was made to go for massive urbanization, with only its pace left open to question.

While pursuing this course, the 11<sup>th</sup> Five-Year Plan (2006-2010) opened up a new stage that brought into consideration the need to balance urban development throughout the country's surface area. The aim has been to redirect the development of the southern provinces towards the interior and the northeast, and from the east towards the west. This Plan, for example, favors the urbanization of the maritime belt of the Gulf of Bohai, the regeneration of the industrial base of the northeast, and the development of inland cities like Chengdu and Chongqing.

This new development has been updated and revitalized recently, similar to the way in which favorable tax measures were used to accelerate urbanization as a partial response to the Asian Crisis in the 1990s. China's has adopted a new anti-crisis plan that focuses on infrastructure projects in the center and West of the country, as well as on the reconstruction and development of the Province of Sichuan (including Chongqing), which was struck by a terrible earthquake in 2008. The plan is thus intimately linked to China's growth, and is one of its principle motors, together with its corollary investment in real estate.

## ***The economic effects of urbanization in China***

According to the BNPP report cited above, a one percent increase in the urban population leads to an expansion of five percentage points in the use of raw materials, and construction materials such as cement, steel, copper and aluminum. At the same time, energy consumption rises by 2-3 points.

The following Table, taken from the same report, summarizes the economic effects of Chinese urbanization, especially relating to the consumption of raw materials and the boost given to the real estate market (CAGR equals Compound Annual Growth Rate):

**Exhibit 35: Urbanization & Investment Driving China Commodity Demand**

Year	Installed generation		Rolled			Auto (10,000 units)	Urban population (m)	Export (USD b)	Property sales (m sqm)
	(GW)	Coal (m tonnes)	Oil (m bpd)	steel (m tonnes)	Cement (m tonnes)				
1990	137.9	1,079.9	2.3	51.5	209.7	514.0	301.9	62.1	29.0
1991	151.5	1,087.4	2.5	56.4	252.6	714.2	312.0	71.8	30.3
1992	166.5	1,116.4	2.7	67.0	308.2	1,066.7	321.7	84.9	42.9
1993	182.9	1,148.0	3.0	77.2	367.9	1,298.5	331.7	91.7	66.9
1994	199.9	1,242.0	3.1	84.3	421.2	1,366.9	341.7	121.0	72.3
1995	226.3	1,360.7	3.3	89.8	475.6	1,452.7	351.7	148.8	79.1
1996	236.5	1,396.7	3.6	93.4	491.2	1,475.2	373.0	151.1	79.0
1997	254.2	1,372.8	3.9	99.8	511.7	1,582.5	394.5	182.8	90.1
1998	277.3	1,250.0	4.2	107.4	536.0	1,630.0	416.1	183.7	121.9
1999	298.8	1,280.0	4.2	121.1	573.0	1,832.0	437.5	194.9	145.6
2000	319.3	1,299.0	4.5	131.5	597.0	2,070.0	459.1	249.2	186.4
2001	338.6	1,381.0	4.7	160.7	661.0	2,341.7	480.6	266.1	224.1
2002	356.6	1,455.0	5.0	192.5	725.0	3,251.0	502.1	325.6	268.1
2003	386.6	1,722.0	5.5	241.1	862.1	4,443.9	523.8	438.4	337.2
2004	429.9	1,992.3	6.4	319.8	966.8	5,091.1	542.8	593.4	382.3
2005	517.2	2,205.0	6.7	377.7	1,068.8	5,704.9	562.1	762.0	557.7
2006	623.7	2,373.0	7.2	468.9	1,236.8	7,278.9	577.1	969.1	606.3
2007	718.2	2,536.0	7.5	568.9	1,360.0	8,887.0	593.8	1218.0	761.9
<b>CAGR 1999-2007</b>	<b>11.6</b>	<b>8.9</b>	<b>7.5</b>	<b>21.3</b>	<b>11.4</b>	<b>21.8</b>	<b>3.9</b>	<b>25.7</b>	<b>23.0</b>
<b>CAGR 1990-1999</b>	<b>9.0</b>	<b>1.9</b>	<b>6.9</b>	<b>10.0</b>	<b>11.8</b>	<b>15.2</b>	<b>4.2</b>	<b>13.6</b>	<b>19.6</b>

Sources: NBS; BNP Paribas

The economic spillovers of this urbanization are seen in the most direct and immediate way through the explosion of real estate investment, as well as the spectacular demand for raw materials and capital equipment goods. It has been estimated, for example, that China consumed more than half of the world's concrete used in 2007.

These spillovers also have a direct impact on urban transport infrastructure (the construction of airports, motorways, and subways), on sanitation, heating and waste collection. The development of infrastructure has accompanied urbanization, leading to a virtuous growth cycle, and has been supported by a reformed legal system (see for example the passing of the law on motorways in 1997).

Indeed, infrastructure projects contribute to greater trade and productivity. Their impact has been increased by China's policy of creating urban clusters, the leading four being Shenyang-Dalian, Beijing-Tianjin-Tangshan, the Yangtze delta (Nanking-Shanghai-Hangzhou) and the Pearl River delta (Canton-Shenzhen-Hong Kong). For example, the infrastructure projects of the latter form part of a regional integration process between Hong Kong and the continent, which continues to be an important zone for imports to southern China as well as for Chinese re-exports (90% of Hong Kong's exports are in fact re-exports, most of which come from southern China and especially Guangdong). The integration process thus covers Guangdong and its neighboring provinces. Furthermore, motorways and railways link Guizhou to Guangdong, which allows the benefits of growth to be spread, while supporting its sources.



## ***The unquantified cost of urbanization***

Urbanization is undoubtedly the motor of China's (near) double-digit growth. It is fuelled by investment in real estate in particular. Yet it is impossible to ignore the enormous social and environmental costs involved.<sup>3</sup>

### **Social costs**

In social terms, China was rapidly obliged to arbitrate between two contradictory objectives: finding the labor needed for its urbanization and at the same time firmly controlling internal migratory flows. This migration is potentially massive given the attractiveness of the life style favored in cities, and could lead rapidly to chaotic urbanization. At the end of 2008, China had to deal with 225 million migrant workers (according China's National Bureau of Statistics).

The so-called *hukou* system has made it possible to direct migrant worker flows from the countryside to the cities. The system is similar to the workers' passes which existed in 19<sup>th</sup> century France. It was set up in 1958 with the aim of allocating a fixed place of residence to every Chinese citizen. At the time, there were two types of *hukou*: an agricultural *hukou* and a non-agricultural *hukou*. An agricultural *hukou* gave rights to an agricultural job, whereas a non-agricultural *hukou* provided access to employment and residence in urban areas, as well as access to all the social advantages provided by municipalities. This system was at first extremely rigid and allowed little transformation. But it has evolved continuously. Today the *hukou* is mainly used as a means for controlling flows of migrant workers within the frontiers of the People's Republic. The distinction between an agricultural and non-agricultural *hukou* has disappeared in many provinces, so that the real value of a *hukou* lies in the place it assigns. Thus, *hukous* granted for residence in large cities are the most sought after and also the most difficult to obtain, whereas requirements for medium-sized towns are more flexible. A migrant worker seeking to obtain a *hukou* in large town must also meet strict conditions in terms of professional skills, his/her financial situation, and state of health, which are similar to what may be demanded for immigration to a foreign country.

Under these circumstances, many migrant workers often give up on getting a *hukou* as their employers often do not help them obtain one for the locality in which they work. They are *de facto* deprived of access to basic public services. They can find no other work than for the job that justifies their internal migration, and effectively become virtual subjects to the wishes of little-scrupulous

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<sup>3</sup> J. Allaire, "L'émergence chaotique du marché foncier chinois", in *Études Foncières*, No. 125, January-February 2007, p. 30-34.

employers. Such workers are especially vulnerable, and practically servile. The *hukou* system is without a doubt severe and unjust, but from the Chinese point of view it is the price of development; the end of urbanization perhaps justifying the means. It has to be admitted that whatever the costs of the *hukou* system, it has allowed the Chinese authorities to manage migrant worker flows and to prevent the uncontrolled and chaotic urbanization found in some developing countries (for example, in Mumbai in India or Lagos in Nigeria). The strict control of people's place of residence has also helped to prevent the emergence of shantytowns, and to keep unemployment as well as crime at relatively low levels in urban areas. China is nevertheless aware of the need of social progress and has implicitly recognized this on paper, by adopting a new labor law in 2007 (which came into force in January 2008), in order to avoid the worst abuses.

The social costs of Chinese urbanization at break-neck speed may thus be measured in terms of the problems generated for part of its forgotten peasant population. Peasant revolts have characterized Chinese history, and have proliferated since 1990, in reaction to (sometimes unwarranted) local taxes, abusive expropriations or the construction of polluting industries, all of which may be accompanied by corruption among local authorities.

### **The environmental cost**

The environmental cost of Chinese urbanization is shared by the whole population. The rise of energy consumption adds to pollution problems in the countryside as it does in cities. This is due to the intensive use of cheap fossil fuels like coal, which China has in abundance. This pollution is a serious threat to the quality of life in the medium term in all parts of the country, and a looming public health problem. The problem of water has also been high up on the authorities' agenda for a number of years. Paradoxically, many Chinese incorrectly see water as an abundant resource, due especially to its low price. Much water is also wasted, notably in certain industries that are not encouraged to implement more efficient production techniques, given the relatively low cost of this resource. But China's reserves are low and shortages real. It is estimated that China has only 2100 m<sup>3</sup> of water per inhabitant, which is a third of the world average. The situation is particularly worrying in the cities of the North, like Beijing, which are generally situated in arid regions and far from the large rivers which span the South of the country.

To meet the environmental challenges of urbanization, China is at the same time a laboratory of all manner of innovations relating to urban planning, and stresses its intentions to meet international preoccupations.

According to Jean-François Dulet, lecturer at the Urban Planning Institute of Paris and at Sciences Po, editor of a website on Chinese cities ([villeschinoises.com](http://villeschinoises.com)): "with the gentrification of Chinese society, the quality of life has become an important matter for certain

inhabitants. This is accompanied by the desire of companies working in green industries to stimulate their own industrial innovation, as China is seen a huge market”.

Reality, however, does not match declared intentions. From this point of view, the project for an ecological city at Dongtan, at the extreme east of Chongming, China’s third largest island and at the mouth of the Yangtze, is symptomatic. The project was very ambitious: to create a 100% ecological city from scratch, using no fossil fuels and emitting no CO<sub>2</sub>, while capable of accepting 50,000 to 80,000 inhabitants, and up to 500,000 by 2040. Construction should have started at the end of 2006 and be finished by 2010 for the Universal Exhibition in Shanghai. But work has not yet to seriously begin, as costs are exorbitant relative to Chinese living standards.

The Chinese authorities are aware of this somewhat black, though realistic picture of urbanization. They are not blind to all the costs induced by rapid development, as shown by new policies relating to energy, transport and infrastructure. Repeated mention of these issues in public policy pronouncements suggest that they understand the risks and opportunities at stake (e.g.: the creation of green cities). In all cases, urbanization demands a new social contract, which seems clearly more favorable to China’s urban population (in exchange for no political protests) than to its rural inhabitants. The contract is meant to last, and to durably change the nature of the Chinese regime: if not its authoritarianism, then at least its communism in principle. Such change is being reinforced by profound legislative transformations.

# **Legislative change accompanying Chinese urbanization and the creation of a real estate market**

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From the above, it is clear that urbanization in China is primarily the result of a strong, deliberate public policy since the Deng Xiaoping era, aimed at transforming the economy inherited from the Mao era. This transformation is necessarily accompanied by gradual, but deep change in the rules of the game, which may even modify, perhaps in an understated way, the very nature of the regime and its future.

## ***The mismatch of China's imperial and Maoist legacy with the needs of urbanization***

Instead of changing rules, China has been introducing fundamentally new rules, concerning private real estate property that China has practically never known throughout its long history. Private real estate property was indeed recognized in principle under the imperial regime, but in a very restricted way, reserved for a feudal elite and allowing for the expansion of towns only at the will of the Emperor. It disappeared entirely under the communist regime, in favor of public property.

To gauge the extent of legislative progress that has accompanied the drive to urbanization in recent years and the birth of a veritable real estate market, it seems useful to identify the major historical changes in China's real estate regimes<sup>4</sup>.

### **Imperial China**

The legal status of real estate changed little for much of the imperial period. In politics, the emperors were more interested in ensuring the expansion and defense of the empire and their own power, rather than carrying out audacious agrarian reforms. Land reform also threatened to call into question the economic rights of a minority on

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<sup>4</sup> See "La Propriété en Chine", in *La Chine et le Droit*, No. 5 January-March 2009, and P.A. Randolph and J.B. Lou, "A brief history of Chinese Real Estate Law" in *Chinese Real Estate Law*, January 2002.

the land who were the main source of China's wealth. Under the last dynasty – the Qing dynasty from 1644 to 1911 – the Chinese empire experienced demographic growth (in the 17<sup>th</sup> and 18<sup>th</sup> Centuries). Control over land became a major political issue, but nevertheless did not lead to a liberalization of land ownership.

The end of the Qing dynasty was not favorable to deep change of China's institutions either, given domestic troubles and China's need to defend its territory against European powers, Russia and Japan.

The private ownership of land and real estate was finally recognized at the end of the imperial era, but limited in practice to an elite including the ruling aristocratic class of large landowners. Ownership remained relatively concentrated in rural areas, which represented the vast majority of China's land, so that very many peasants had no land.

### **The Republic of China (1911 to 1949)**

The Republic of China did not overturn the principles of private landownership established by the imperial regime. Still, Sun Yat-sen, the first president of the young republic, did have an ambitious project for agrarian and land reform, aiming to ensure equality of access to the use of land.

Sun Yat-sen quit the presidency in February 1912 without having been able to undertake planned reforms. Between 1912 and 1928, power was first held by a quickly contested president who soon gave way to conflict among warlords. Political instability continued from 1928 to 1949, as a result of the Sino-Japanese war and the struggle between the Kuomintang and the Communist Party.

### **China under Mao (1949 to 1976)**

After the flight of Chiang Kai-shek, victory by the Communists and the declaration of the People's Republic of China on October 1<sup>st</sup> 1949, land reform came back on the agenda as a priority of the new regime, which had promised land redistribution. Mao Zedong launched a program of agrarian and land reform that was part of a more general policy entitled the "New Democratic Revolution". This program involved the State expropriating landowners without compensation, with the view of farming land collectively.

This was followed by a period of social and economic chaos that lasted 30 years through to the late 1970s and included the Great Leap Forward (1958 to 1961) and the Cultural Revolution (1966 to 1976). This period was accompanied by legislative uncertainty concerning land. On several occasions, the regime introduced and repealed exceptions to the prohibition of the principle of private land ownership. In urban areas, State enterprises received land they

needed within the framework of a free distribution regime. Some still benefit from this regime.

The Maoist system had considerable perverse effects preventing real urbanization in China and actually ran the risk, perhaps deliberately, of retarding it. First, it led to poor use of land, given the lack of a real estate market and any commercial value for land. To take a simple example, reusing industrial wasteland was too expensive because supposedly free land did not encourage the more costly destruction and reconstruction of existing sites, but rather encouraged converting (already scarce) agricultural land into new industrial sites. Next, free land deprived authorities of financial resources that were vital to financing modern infrastructure. Mao's successors corrected these errors by allowing new land rights to emerge and by permitting an essentially urban real estate market to appear.

### **The emergence of real estate law under Deng Xiaoping**

As of 1978, Deng Xiaoping launched the policy of the four modernizations (agriculture, industry, science and defense). He pushed forward reforms to decollectivize agricultural land, which was distributed among peasants who were allowed to exploit it quite freely.

The successes of this policy led to it being progressively extended to urban areas, and then to the implementation of a "socialist market economy" model. In 1982, the National Popular Assembly adopted the fourth Constitution of the People's Republic of China, which asserted the principle of the public property of land. A distinction was made between agricultural land held collectively by peasants (the collective property regime) and non-agricultural land in urban areas or in the large conglomerations of the North and the West, which were recognized as State property. This distinction has not been modified since, even in the property law of 2007. The principle of the public ownership of land still stands in Article 10 of the Constitution.

### **The deepening of reforms from 1986 onwards**

In 1986, however, Deng Xiaoping extended reform of Chinese land rights whose new principles were defined in the *Land Administration Law* (or Land Law). In order to make better use of the State's landholdings, the Land Law introduced into China's legal system the concept of the "right of use" of land, under which the State can grant individuals the right to use land for a given period, in exchange for payment. This law's symbolic importance is significant, as the State *de facto* recognizes the quasi-right to private landownership, thus reassuring peasants of the status of the land accorded to them, and above all it allows transactions of land to be envisaged. The latter are the foundation of the major developments of private real estate in

urban and semi-urban areas, and have accompanied the urbanization of China.

The first version of the Land Law did not expressly permit the transfer of rights among private individuals. In practice, cities like Shenzhen, Shanghai or Tianjin were chosen as of 1987 to experiment with a system of conceding private property rights for the use of State land, to the benefit of those private individuals authorized to ultimately cede, rent or mortgage the land-use rights ultimately. This regime was extended nationwide in 1990, when China's State Council promulgated the *Decree Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas*, which allows land use rights to be ceded between private individuals and companies.

The legal regime of agricultural land held by peasants' collectives followed a similar evolution and farmers have been able to obtain land use rights from collectives, represented by village administrations.

Chinese land law today is therefore based on two principles, mentioned above: i) the State and peasants' collectives retain ownership of land, but ii) individuals or companies can obtain the right to use land once they have obtained usage rights. In principle, the use of land is strictly controlled by the Chinese authorities via the establishment of annual, national and local land use plans that define the nature of land (agricultural land held by peasants' collectives, urban land with building permits or land not allocated for use but held by the State). The authorities set the ratios between agricultural land and building land, within the framework of land registries in rural areas and urbanization plans in urban areas. They also fix limits on industrial, commercial and residential areas in cities. Only land held by the State can obtain land-use rights for an activity that is not agriculture.

### **China's New Property Law of 2007**

On March 23, 2007 the National Popular Assembly adopted a general law on property, or more precisely on "real rights". This strengthened and completed changes over the preceding 20 years. This text, which was much commented in the general and specialized press, does indeed constitute a minor revolution. But it does not signify, as is pointed out above, the emergence of private property, let alone the pure and simple privatization of land. The new law does not challenge the essential public ownership of land. For a long time still, private agents will thus only be able to obtain the right to use land for a set period of time, from both the Chinese State and rural communities.

The goal of the text is, however, to set in legislative stone existing legal concepts and to adapt them to the new requirements of an economy based on cities, which is boosted by the latter, and which is progressively shifting towards the market. The law thus seeks to

provide a certain number of useful precisions. First, the text confirms that land use rights are indeed real rights, which may be ceded freely, mortgaged or rented out. These rights benefit from protection equivalent to that of full property through the payment of an indemnity in the case of “requisition” – i.e. compensation whose principle and scope are also reinforced by the new law.

Apart from restating concepts whose confirmation was still useful, the law above all improves the security of real estate transactions, a preoccupation that did not exist previously and that is inherent in the birth of a real estate market and its opening up to foreigners. In the same way and for the same reasons, the new law provides useful precisions to concepts that were insufficiently developed, but which are essential to reassuring individual agents, free in their investment choices. For example, the concept of co-ownership, which in China covers both co-ownership in general and co-ownership in residential buildings (similar to “ownership by storey” in Swiss law) is set out clearly in the new text. In particular, the law sets out (more clearly than in the past) the separation of common property in buildings and strictly private property, as well as the way in which property lots are divided in buildings. These are detailed considerations, but they are not without symbolic significance in a country that at one point, wanted to abolish all distinctions between the public and private domains.

Lastly, the law defines more precisely what types of property can be mortgaged. In other words, it confirms that real estate is indeed the first component of capital and the most important instrument for obtaining credit both for companies and individuals, as is the case in capitalist economies.

This new piece of legislation does not however meet all expectations, revealing perhaps some of the resistance to completely killing all concepts inherited from communist orthodoxy. For example, it only makes very limited progress on the sensitive subject of the renewal of land use rights when they expire. For residential property, with clear social significance, renewal will be “automatic” (suggesting there will be no competitive tendering). But it provides no indication about the possible requirement of paying any complementary indemnity, nor any details concerning other types of usage rights, especially in commerce and industry. There are still a number of years left before the first land-use rights granted in 1980s expire, and it seems likely that China, pragmatic as always, will improve further the safety of its law and that it will introduce all the legal foundations of a capitalist economy, step by step.



## **The consecutive emergence of a real estate market**

The introduction of transferable usage rights has inevitably stimulated the creation of a real estate market. While in the early 1980s there was practically no property market in China, by 1991, 3700 developers were authorized to operate. The usage rights ceded by the State covered all types of real estate (office buildings, hotels, shopping centers, etc.). Since then, the real estate sector has become and remained one of the locomotives of Chinese growth.

Its expansion also follows more or less directly from the campaign to stimulate economic growth, which was launched in 1998 by the central government. This campaign encouraged local governments to develop gigantic infrastructure projects in order to meet growth objectives. The government also moved to promoting home-ownership by households. The abolition in 1998 of free social housing in cities boosted home buying by private individuals. The share of real estate in total investment jumped from 4% in the early 1990s to 18% in 2002.

The real estate sector has been a consequence and a reflection of massive urbanization in China and a strategic part of the economy. In the first five months of 2009, it alone accounted for a quarter of all fixed investment, growing by 6.8%. In 2007, real estate investment stood at \$370 billion, or 10.25% of GDP, while the sale of land-use rights accounted for 60% of tax revenues in some municipalities<sup>5</sup>.

However, following a period of exponential growth that contributed to creating a speculative bubble, the real estate market experienced a sharp downturn in 2008, with prices in coastal areas plummeting by 25% to 40%. If, in 2006, the government adopted measures aimed at limiting foreign investment in the sector, so as to combat hot money phenomena, in 2009, the trend changed and the government has relaxed these restrictions to support the sector. Other measures back this greater flexibility, such as the cut from 30% to 20% of mandatory downpayments for new property developments in order to lighten capital requirements, along with the temporary exoneration of stamp duty (registration duties) and capital gains taxes on certain real estate transactions. Signs of an upturn have already emerged.

In any case, though the number of unoccupied premises is currently at a peak, China's housing needs for a rapidly-urbanizing population allow room for optimism. The market is likely to shift more towards supplying mid-range rather than luxury housing (as is the case today), the latter seen as being more profitable but harder to sell

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<sup>5</sup> Figures given by Reuters, quoting the *National Bureau of Statistics*.

in the present context and not adapted to the real needs of the population.

## **Market disorders**

Though this first cycle has been completed, the Chinese real estate market is still recent, immature and disordered. This follows on from a clumsy learning process of real estate *Monopoly* by the main actors, who have generated problems of corruption by cohabiting with ever-present public authorities. Moreover, the current market has not permitted the optimal use of land resources.

Given the very important role of the authorities, investment in the real estate sector in China requires intensive networking (*guanxi*) with local authorities, which retain control of land, as shown above.

The government has formulated a system of classifying land according to future use, in order to reconcile the imperative need of protecting agricultural land, while accompanying and encouraging the urbanization of the population and the development of a real estate market. This leads to constant intervention by public administration. Before buildings can be constructed on agricultural land, the authorities have to grant building permission. This has been a weighty process since 1999, when the Ministry of Land and Resources published a *Ruling on the procedures for examining and accrediting areas destined for construction*, obliging individuals or companies wishing to obtain the conversion of land use to provide local authorities a whole set of documents. These include a feasibility study of the project, information on finance and participating parties, and above all propositions on how to compensate the loss of agricultural land due to the project.

In order to ensure that this procedure is effective, decisions on accrediting use are not left in the hands of local authorities alone. The real estate sector indeed provides significant revenues from the sale of usage rights, tax receipts and employment. As a result, local officials have always encouraged property development in their districts, often not protecting agricultural land much. The accreditation process controlling the conversion of land involves local officials from the Ministry of Resources, as well as the political authorities of provincial government. At each stage, local officials of the Ministry must pass their conclusions on to government representatives at the same level. This twofold verification has to rise up the government hierarchy to reach the appropriate level of authority, for the conversion of land to be approved in the last resort, and for expropriation orders to be issued. Depending on the project, this authority may be the provincial government, or the State Council (at the national level).

To get through this extremely complex procedure, property developers have to lobby intensely at all levels. Such efforts are all the more arduous as each level of control has the power to block or considerably delay any project. The procedures have led to numerous scandals, as certain officials have not hesitated to bargain their accreditation. In February 2009, the former Director of Planning of the Chongqing municipality (in the South-West of China) was condemned to death with a two-year reprieve by the Intermediate Popular Tribunal for having accepted bribes running to 17.96 million Yuan (\$2.63 million) from property developers in exchange for his accreditation of certain construction projects<sup>6</sup>.

This cumbersome system leads to a lack of market transparency<sup>7</sup>. As a result, it is difficult for a local promoter to operate outside his/her province of origin, as it is hard for foreigners to enter the sector. Only a small number of large companies have been able to overcome these constraints, thanks to strong lobbying at all levels. These characteristics also explain why the Chinese real estate sector is dominated by Chinese companies, which are usually directly or indirectly controlled by municipalities.

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<sup>6</sup> In China, the death penalty may be accompanied by a period of reprieve, at the end of which the condemned person may have his/her sentence commuted to life imprisonment for good behavior.

<sup>7</sup> See "Middle Kingdom Transparency" in *Real Estate Transparency Index*, Jones Lang Lasalle, 2008.

## Conclusion

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The move away from a planned economy and the apprenticeship of capitalism, which is sometimes uncontrolled in the real estate sector, have led to a series of imbalances between cities and the countryside. They have also led to not insignificant levels of corruption and market malfunction. In this light, Chinese society cannot yet claim to be harmonious. But at the end of this period, it is possible to think that the worst imbalances (in terms of the human and environmental costs of urbanization), which were wittingly accepted for a long time in order to allow the country to open up and to promote break-neck growth, are tolerated less and less and becoming politically intolerable. Urbanization has definitively and deeply modified daily life in China and the expectations of the population, even if these are not expressed in the ballot box.

These changes seem irreversible. They are self-fulfilling and reinforced by law. A new land property regime has been progressively developed over the last twenty years. Numerous further laws have been introduced which are indispensable to providing a framework for urban development of all sorts (for example, laws concerning motorways or public markets), and to correcting related excesses (the new labor law, the law on property, the emergence of environmental law). These fundamental texts have profoundly changed Chinese law in general and have progressively modified the nature of a republic that has just celebrated sixty years of apparent continuity. As time passes, the new laws may be considered to contradict the declared principles of the existing regime. And in a surprising turnaround of events, they indicate the emergence of a certain type of “bourgeois” law, in real and metaphorical terms, facilitating access to ownership for new urban residents, the defense of their interests and their private lives.