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What Will China Do When Land Use Rights Begin to Expire?

Gregory M. Stein *

ABSTRACT

China does not permit the private ownership of land. Instead, private parties may obtain the right to use property for up to seventy years. These parties own the structures on the land but not the underlying real estate. China's recent economic boom hinges on the success of its real estate market, but the government has not yet addressed three critical questions it must answer soon: 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?

While it is always perilous to guess how the Chinese government will act, it is instructive to examine how the government has behaved in similar situations in the past. To begin with, the Chinese government expends great effort to avoid social unrest and upheaval. In addition, the government frequently sidesteps new problems and waits to see how the private market responds, later endorsing and officially implementing the most successful outcomes. Finally, both government bodies and individual government officials are heavily invested in the real estate market and thus care personally about the answers to these renewability questions. By keeping these facts in mind, it becomes somewhat less hazardous to forecast how China will act as the first land use rights approach their expiration dates.

This Article addresses the renewability of Chinese land use rights. Part II describes the different paths the government might follow as land use rights begin to expire. Part III assesses how the government has acted in the past in an effort to predict which of these different options the government is mostly likely to choose. Part IV pulls back and seeks to locate the resolution of

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these important questions in the broader context of China's uncertain movement toward the rule of law.

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I. INTRODUCTION

China does not allow the private ownership of land.¹ Instead, the government authorizes private parties to use land while the

1. XIANFA art. 10 (2004) (China) ("Land in the cities is owned by the State. Land in the rural and suburban areas is owned by collectives except for those portions which belong to the State as prescribed by law; house sites and privately farmed plots of cropland and hilly land are also owned by collectives."); Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS arts. 45–69 (China) (delineating different types of property that are publicly or privately owned and clarifying that individual persons may not own land).

government continues to own the underlying land.² The Chinese land use right is not perpetual, however, and lasts for a maximum of forty, fifty, or seventy years, depending on the purpose for which the right was granted.³ 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.⁴ As increasing numbers of land use rights approach their termination dates, the Chinese government will need to answer three essential questions: (1) Does the holder of a land use right have the ability to renew that right when it expires? (2) If the holder has this ability, must it pay to renew the right? And, (3) if the holder must pay, how much? The government also will need to decide whether the answers to these questions vary depending 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 as these questions become more pressing, it is instructive to observe how the government has behaved when new and important questions have arisen in the real estate market in the past. Although predicting

2. XIANFA art. 10 (2004) (China) (“The right to the use of land may be transferred according to law.”); *see also* Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 39 (China) (“The owner of . . . real property . . . has the rights to possess, use, seek profits from and dispose of the real property . . . according to law,” with ownership of real rights referring to “the exclusive right of direct control enjoyed by the holder . . . over a specific property,” *id.*, art. 2); *see generally* Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing 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), Peking U. art. 8 (China) (“The assignment of the right to the use of the land refers to the act of the State as the owner of the land who, within the term of a certain number of years, assigns the right to the use of the land to land users . . .”).

3. Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing 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), Peking U. art. 12 (China) (setting different terms for different uses of the land); 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] (promulgated by the Standing Comm. Nat’l People’s Cong., July 5, 1994, revised Aug. 30, 2007, effective Aug. 30, 2007), P.R.C. LAWS art. 8 (China) (authorizing the granting of land use rights for a fixed number of years).

4. In a small number of cases, governments granted land use rights that lasted for less than the maximum permissible term. For example, in a few instances, twenty-year rights have come up for renewal or soon will. *See, e.g.,* Lucy Hornby, *China Lease Expiries Prompt Property Rights Angst*, FIN. TIMES, May 2, 2016 (“The simmering issue of property rights in China has burst into the open with the upcoming expiry of [twenty-year] residential leases in several wealthy cities and a contentious plan to charge homeowners to renew them.”).

government action in China is risky, Chinese government behavior tends to follow certain patterns, which suggests that the government will continue to act in those ways in the future. First, the government tries mightily to avoid social unrest and upheaval.⁵ The government discourages public protest and has sought in the past to reduce the likelihood that citizens will engage in this type of activity.⁶ In fact, communitarian principles are written directly into China's Property Rights Law.⁷

Second, the Chinese government often refrains from acting as an "early adopter." Rather than responding promptly to new legal questions, the government often chooses to sit on the sidelines and observe how other, more market-driven actors seek to solve new problems.⁸ The government regularly allows the business community to develop informal practices as new questions arise. If the business community responds wisely, with practices that prove successful in these test situations, the government might ratify these practices officially; if it does not, the government will pursue a different path or wait for further, more successful private-sector action.⁹ Instead of adopting legislation or regulations that might prove short-sighted, the government prefers to let the business community have the first opportunity to confront new questions. By allowing institutions to develop unofficially, the government reduces the risk that it will fashion formal institutions that function poorly.¹⁰ This approach preserves the government's credibility and also recognizes that the private market may be better suited to experimenting and weeding out the less promising alternatives.

Third, the government itself is a regular and important participant in the real estate market, as are many highly placed government officials, which means that institutional and personal

5. See *infra* Part III.

6. See *infra* Part III.

7. See *infra* Part III.

8. See *infra* Part III.

9. See *infra* Part III.

10. See, e.g., Peter Ho, *In Defense of Endogenous, Spontaneously Ordered Development: Institutional Functionalism and Chinese Property Rights*, 40 J. PEASANT STUD. 1087, 1089–90 (2013), <http://www.tandfonline.com/doi/pdf/10.1080/03066150.2013.866553> [<https://perma.cc/8US7-WLWY>] (archived Feb. 4, 2017) [hereinafter Ho, *In Defense of Endogenous*] ("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) [hereinafter Ho, *Introduction*] ("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.").

self-interest may factor into government decisions.¹¹ The government owns the underlying land and imposes development restrictions when it grants land use rights to private parties.¹² The government also owns or controls most of the major lending institutions¹³ and holds equity interests in entities that own and develop real estate. Individual government officials often own or control interests in major real estate projects. Moreover, it is very common for real estate professionals to forge strong personal relationships with government officials, even if those officials do not hold equity interests in their projects. Because individual government officials and the government itself are active participants in the real estate market rather than neutral referees, they may personally benefit or suffer depending on how a given problem is resolved. Thus, they are likely to take their own self-interest into account as they fashion responses to these pressing questions.¹⁴

Assuming that these features will continue to hold true in the future, it becomes possible to predict how China will respond as large numbers of land use rights approach their expiration dates. This Article proceeds as follows: Part II discusses the renewability of the Chinese land use right and describes the government's alternatives when land use rights expire. Part III examines how the government has behaved in the past in an effort to forecast how it will address renewability questions. And Part IV places the resolution of these important questions in the broader context of the uneven movement toward the rule of law in China's real estate markets.

II. CHINESE LAND USE RIGHTS: SOME POSSIBLE SOLUTIONS TO THE EXPIRATION PROBLEM

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; the Western fee simple, by contrast, is theoretically perpetual.¹⁵ So, although the

11. See *infra* Part III.

12. See Stephen R. Platt, *Is China Ripe for a Revolution?*, N.Y. TIMES (Feb. 9, 2012), <http://www.nytimes.com/2012/02/12/opinion/sunday/is-china-ripe-for-a-revolution.html> (subscription required) [<https://perma.cc/Z6AW-L3JM>] (archived Feb. 1, 2017) ("Beijing has learned its lessons from the past. We see this in the swift and ruthless suppression of Falun Gong and other religious sects that resemble the Taiping before they became militarized."); *infra* Part III.

13. See GREGORY M. STEIN, MODERN CHINESE REAL ESTATE LAW: PROPERTY DEVELOPMENT IN AN EVOLVING LEGAL SYSTEM 85–102 (2012).

14. *Id.* at 46–48 (describing various ways in which the government has been a participant in the real estate market).

15. Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing Tiaoli [Provisional Regulations on Assigning and

Chinese land use right is not a ground lease, it does display some of the same legal and economic characteristics of a ground lease.¹⁶

Three of 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, what the duration of that renewal will be and what the cost of that renewal will be. The Property Rights Law addresses the first of these questions somewhat obliquely in Article 149:

The term of the right to use land for construction for dwelling houses shall be automatically renewed upon expiration. The term of the right to use land for construction not for dwelling houses shall be renewed according to legal provisions. Where there are stipulations about the ownership of houses and other real properties on the aforesaid land, such stipulations shall prevail; if there is no such stipulation or the stipulations are not explicit, the ownership shall be determined according to the provisions in the laws and administrative regulations.¹⁷

Article 22 of the Law on the Administration of Urban Real Estate muddies the waters still further, stating that renewals “shall be approved” in most cases.¹⁸ That article 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,” but it does not discuss the method of calculating this renewal fee.¹⁹

Current holders of residential land use rights thus have no idea of the length of their renewal terms or the cost of those renewals, while current holders of commercial or industrial land use rights do not even know whether they will be able to renew their rights at all.²⁰ If a land use right is not renewed, neither of these articles suggests that the government must pay the departing holder of the land use right for the value of any improvements on the land, even though that holder may have constructed those improvements at its own expense or bought the property at a price that reflected the value of previously

Transferring the Urban State-Owned Land-Use Right] (promulgated by the State Council, May 19, 1990, effective May 19, 1990), Peking U. art. 12 (China) (setting different terms for different uses of the land).

16. See STEIN, *supra* note 13, at 34–35 (contrasting the Chinese land use right and the Western ground lease).

17. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 149 (China). Note that nothing in Article 149 requires that the renewal term for residential property be for an additional seventy years.

18. 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), P.R.C. LAWS art. 22 (China).

19. *Id.*

20. For a general discussion of the renewability of land use rights, see STEIN, *supra* note 13, at 37–40.

existing improvements. Such an owner may expect, perhaps incorrectly, to receive compensation for the value of these improvements.²¹

China has recognized land use rights only since the late 1980s, which means that just a handful of these rights—created initially for less than the maximum term—have come up for renewal.²² There thus is little useful history to guide the hundreds of millions of current 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.²³ The Chinese Communist Party does seem to be aware of and concerned about the problems that uncertainty in the real estate market can create,²⁴ but important questions about the renewability of land use rights remain unanswered.

A. Possible Renewal Prices

Once the Chinese government decides to address whether land use rights are renewable, and at what price, the government could calculate the renewal fee in a variety of different ways. This Section discusses these options, highlighting the advantages and disadvantages of each. Note that these alternatives overlap to some degree, as will become evident from the discussion that follows.

21. Of course, any owner's expectations as to the compensability and value of those improvements must be shaped by its knowledge of Chinese real estate law, including all of that law's uncertainties. This point demonstrates some of the circularity inherent in any discussion of Chinese real estate law and the renewability of land use rights.

22. See *supra* notes 3–4 and accompanying text.

23. See, e.g., HERNANDO DE SOTO, *THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD* 152–58 (1989) (describing the systemic costs of working around inadequacies in the legal system of Peru).

24. See COMMUNIST PARTY OF CHINA, 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 (Nov. 12, 2013), at II.5, http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm [hereinafter Third Plenum] [<https://perma.cc/H73Y-LRQQ>] (archived Feb. 3, 2017) (“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.”).

1. Renewal of the Land Use Right at a Price that Is 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.²⁵ If the government allows existing holders of land use rights to renew those rights, it next must decide how much to charge for these renewal rights. One possibility is that the government will charge the renewing holder a price equal to the fair market value for the land use right at the time of the renewal. The original holder paid fair market value for a seventy-year term, enjoyed the use of that property for seventy years, and could renew by paying fair market value again, seventy years later, for a second term.²⁶

If the government decides to charge full fair market value for renewals, the price for renewing a land use right would be set in exactly the same manner that the price for acquiring the right was established in the first instance. The only difference would be that the price for the renewal would be the fair market value at the time of the renewal—presumably higher than before—and not the fair market value at the time of the initial creation of the right. In effect, seventy years after the right was created, the government would be treating a renewal right as a new property interest. In this sense, the land use right would closely resemble a lease, particularly a ground lease.²⁷

This approach seems fair in many ways. The original owner acquired a land use right for a fixed period of time at a price that reflected the value of the property for that duration as determined on

25. 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), P.R.C. LAWS art. 58(3) (China). 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.

26. Keep in mind that seventy years is the maximum term of a land use right for residential purposes, which is the example I use in this discussion. Holders of land use rights for other purposes enjoy maximum terms that are shorter. Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zaxing 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), Peking U. art. 12 (China) (setting different terms for different uses of land).

27. For a discussion of the distinctions between a Chinese land use right and a Western ground lease, see Gregory M. Stein, *Acquiring Land Use Rights in Today's China: A Snapshot from on the Ground*, 24 UCLA PAC. BASIN L.J. 1, 42–43 (2006).

the date the right was created. That value presumably factored in the parties' estimate of the total use value of the property over the coming seventy years. For commercial property, this price should have reflected the discounted present value of the income stream the parties projected the property would generate over the life of the land use right, with some adjustments.²⁸ For residential property, which is more likely to be occupied by its owner, the calculation would have had to rely on the imputed rental value.²⁹

Predicting these values in an immature market such as China's circa 1990 would have presented a challenge involving considerable guesswork. And, given how successful the Chinese real estate market has proved to be in the intervening years, it is likely that both parties would have underestimated property values going forward.³⁰ But both parties would have been laboring under these same handicaps, and each would have been taking a business risk. The market, after all, could have failed disastrously, and the price the purchaser was willing to pay presumably factored in the weighted average of the losses the holder of the right might have suffered or the gains the holder might have enjoyed, along with the likelihood of each of those possible losses or gains actually materializing. The fact that the parties knew their relationship would end when the land use right

28. For example, the parties should have factored in their predictions as to appreciation in property values, the inflation rate, and the residual value at the end of the term of any improvements the right holder planned to construct, assuming these improvements could not be removed. See generally MIKE E. MILES ET AL., *REAL ESTATE DEVELOPMENT: PRINCIPLES AND PROCESS* 177–232 (4th ed. 2007) (discussing general methods for establishing the value of investment property). To the extent that the parties were figuring that far ahead (which they most likely were not), the calculation also should include the likelihood that the holder would be permitted to renew the right and the cost of any such renewal. Once again, this last part of the calculation introduces some circularity into assessing the value of the property. See generally *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1034–35 (1992) (Kennedy, J., concurring) (discussing the “inherent tendency towards circularity” in placing a value on property based on an owner’s reasonable expectations that are shaped, in turn, by evolving legal doctrines).

29. Commercial property is frequently appraised by looking at its potential to generate income. By establishing the rental value and noting what the returns are on other similarly risky investments, a party can determine the value of the real estate. Owner-occupied residential property cannot be appraised in this way, because the owner is occupying it rather than leasing it and there is no direct rental income. An appraiser might impute a rent by examining similar properties that are being rented. Or it might resort to looking at comparable sales, under the assumption that those sale prices reflect the market’s assessment of what these properties would bring if they were on the rental market. See MILES ET AL., *supra* note 28, at 55 (contrasting different appraisal methods).

30. I personally observed first-generation low-rise residential buildings in the Lujiazui section of Pudong that were slated for the wrecking ball just a few years after they were built. The government seemed to have underestimated just how successful this commercial area was going to become and was subsequently replacing these shorter residential structures with high-rise commercial towers.

expired allowed them to cap their upside or downside risk. Forty, fifty, or seventy years is a long time, but it is not as long as forever, which is the duration of a Western fee simple. Setting a termination date would leave the parties free to negotiate a new relationship later at a price reflecting the market existing at the time of the renewal, thereby placing a limit on each party's risk.

This analysis raises the question of what method the government will use to establish a fair market value for the land.³¹ 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.³² In part, these first two methods of establishing the value of a land use right 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.³³ Thus, the government invited investors to bid under the assumption that an auction would reveal the "true" market price, or at least help to establish what that price was.³⁴ In this way, the government could resolve two uncertainties: the identity of the purchaser and the price for the land use right.

With 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 that 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 a fairly straightforward task to establish a fair market value for the property without the need to resort to an auction. An auction for a renewal right would be both impossible, as only the current holder of the land use right can renew it, and unnecessary, as it will be easier to establish a fair market value in the future than it was at the time

31. See STEIN, *supra* note 13, at 35–37 (describing different methods by which the government can place a value on land use rights that it will offer for sale).

32. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 137 (China) ("The land used for purposes of industry, business, entertainment or commercial dwelling houses . . . shall be transferred by means of auction, bid invitation or any other public bidding method.").

33. See STEIN, *supra* note 13, at 36–37, 180 (addressing land valuation challenges in China).

34. 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 898 (4th ed. 2014). 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).

the right was first created. The market has matured, and property values have become more stable and easier to determine.

When the land use right was first created, the property market was new and unpredictable, so the government established the cost by bid or auction because it had few alternatives. It did not wish to undercharge, but it had no clear idea what price would be reasonable. The government wanted to maximize its proceeds from the sale of a significant public asset, as it planned to use this money to upgrade urban infrastructure.³⁵ Moreover, if more than one party was interested in acquiring the land use right, these two alternatives were the fairest methods of making the decision and probably the most remunerative. In the future, the property market will likely remain well established, and the government can employ other methods of determining the value of the property if it so chooses.

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 operating costs of the property and estimate how much an investor would be willing to pay to generate a comparable return. The more mature market of the future will be able to deliver this type of data, unlike the nascent market of the late 1980s.

Alternatively, the government might base its appraisal on comparable sales of similar parcels in recent years. With a more established market, there should be an abundance of comparable sales that the government can use to estimate the value of the land use right that is to be renewed. For residential property, this is often the most reliable approach to employ anyway, since owner-occupied residences do not have rental histories and since many other comparable properties are likely to have sold recently.

Finally, the government might simply look at what it would cost to replace the improvements on the property. This last approach is best suited to unique parcels that are neither managed and operated for their rental income nor occupied by their residential owners, since it will be difficult to establish rental histories or comparable sales for this type of property. Schools, libraries, hospitals, and historically significant structures all fall into this category. Note though that this third method may be difficult to employ when the only question is the value of the right to use the underlying land and not the value of the

35. Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing 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), Peking U. art. 50 (China) ("Fees collected by assigning the right to the use of the land in accordance with these Regulations shall be included in the fiscal budget and managed as a special fund, which shall be used mainly for urban construction and land development.").

structure built on that land, as it is hard to determine what the “replacement” cost is if the only property of concern is vacant land.

Another interesting question the government must consider when appraising the property is whether it 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, which means that the government could charge a higher renewal fee under the latter approach.³⁶ If a land use right is up for renewal, the improvements will have been built by the renewing owner or a predecessor owner.³⁷ This means that the current owner either increased the value by improving the property or bought the property at a purchase price reflecting improvements made by an earlier holder of the land use right. If the appraisal reflects an enhanced value that factors in the presence of the improvements that the holder constructed or bought, then a land use right holder that faces renewal and that has been using real estate productively may argue that it is being penalized for its own industriousness and success or for its investment in a prior owner’s industriousness. This owner will wonder why the renewal price should reflect enhancements to the value of the land that it has created or for which it has already paid a prior owner. Stated differently, the land use right holder will wonder why the government should be profiting from improvements someone else built.

The government might respond to this argument—somewhat weakly—by noting that the original price 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 the original parties anticipated would be built. More aggressively, the government might argue that no one anticipated that the improvements that were to be built at the beginning of the

36. There are some exceptions. If existing improvements need to be removed, for example, the property is worth more cleared than improved. This scenario is not unusual in China’s cities, in which developers frequently plan to remove existing residents who are occupying sub-standard housing, raze the improvements, and replace them with higher-end dwellings catering to a more affluent clientele. For a discussion of the process of demolition and relocation, see STEIN, *supra* note 13, at 61–74. See generally Chenglin Liu, *Informal Rules, Transaction Costs, and the Failure of the “Takings” Law in China*, 29 HASTINGS INT’L & COMP. L. REV. 1 (2005) (describing the Chinese process of demolition and relocation).

37. Once again, that developer may have to go to the expense of clearing the lot, which might require the expensive demolition of older structures. Developers often must—controversially—pay for the relocation of the prior residents of decaying structures, which often predate China’s modern real estate market by decades. See generally STEIN, *supra* note 13, at 61–74 (describing the Chinese process of demolition and relocation). Existing structures such as the ones described in the text, however, are less likely to merit immediate removal than those many Chinese developers acquired in the 1980s and 1990s.

land use term would have any residual value at the end of the term.³⁸ Urban land use rights, after all, are sold in anticipation of prompt construction; in fact, Chinese law strongly encourages it.³⁹

The government will thus face some difficult questions, namely which of the three appraisal methods to employ and whether to appraise the property as vacant or as currently developed. However the government answers these questions, 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 the time the term approaches its end, and property values should be somewhat stable and easy to estimate. Appraisers with marching orders setting forth the assumptions they are supposed to employ should be able to come up with values for land use rights.

It remains to be seen whether the party wishing to renew the right will have any input into this determination, such as by introducing its own evidence as to the value of the property or by

38. At one point, a government official apparently sought to reduce worry among Chinese homeowners by publicly opining 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. *If Beijing Is Your Landlord, What Happens When the Lease Is Up?*, CHINA ECONOMIC REV. (June 17, 2013), <http://www.chinaeconomicreview.com/china-land-lease-property-law-ownership-rights> [<https://perma.cc/BU63-GULQ>] (archived Feb. 3, 2017) (“In 2010, the Chinese media buzzed when Chou Bauxing, the vice head of the Ministry of Housing at the time, suggested that Chinese buildings had an average life span of 25 to 30 years. That projection was later contested.”). See also STEIN, *supra* note 13, at 40.

Given the fast pace of construction, the lack of experience of many Chinese construction workers, and the limits on governmental oversight of the construction process, the earlier estimate may well be the more accurate one. See, e.g., *How Will a Slowing China Cope with Rapidly Aging Buildings?*, CHINA ECONOMIC REV. (June 28, 2013), <http://www.chinaeconomicreview.com/Unstable-Foundations-Part-2> [<https://perma.cc/7BW7-4WGM>] (archived Feb. 19, 2017) (“The average lifespan of a Chinese building is 35 years, according to property consultancy Cushman & Wakefield. That’s abysmal compared to the average 74 year life span of US buildings and 132 year lifespan of buildings in the UK.”). 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 price for the underlying land use right may be.

39. 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), P.R.C. LAWS art. 26 (China):

Where one year has elapsed from the date for starting the development as agreed upon in the granting contract and the land is not yet developed, fees for idle land which is equivalent to twenty percent or less of the fees for granting the land-use right shall be collected; where two years have elapsed and the land is still not developed, the land-use right may be reclaimed without compensation

having some role in the selection of the appraiser.⁴⁰ In U.S. condemnation proceedings, 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.⁴¹ In such proceedings, the owner has the right to introduce evidence of value, and the price is ultimately determined by a judge or a jury.⁴² Similarly, in private disputes, such as disagreements over the rental value to be charged during the renewal term of a lease, it is not unusual for a lease to provide that the landlord and the tenant each select an appraiser or arbitrator and that, if these two parties are unable to agree, they will select a third one.⁴³

Once the property is appraised, a follow-up question for China becomes when this amount must be paid. The renewal charge could be payable in one lump sum at the outset, just as the cost for the initial term of the land use right was.⁴⁴ Alternatively, the renewal payment could be spread out over time, much as tenant rent payments are, 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. If the government selects this second alternative, then the renewal of the land use right will more closely resemble a Western ground lease, in which the rent is typically spread out over the term of the lease. 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

40. Cf. N.Y. EM. DOM. PROC. LAW § 508 (McKinney 1977) (“In all proceedings hereunder, the respective judicial departments and the court of claims, shall adopt rules governing the time for filing and exchange of the written appraisal reports . . .”); *id.* § 511 (“If a condemnee fails to file a claim within the one hundred twenty day period, his claim shall thereafter be tried upon the proof presented.”).

41. *Id.* § 501 (establishing jurisdiction of different state courts over different types of acquisition proceedings); *id.* § 512 (requiring court to determine compensation award after such a property acquisition).

42. *Id.* § 512.

43. See, e.g., GERALD J. ROBINSON, REAL ESTATE FORMS: TAX ANALYSIS AND CHECKLISTS ¶ B4.13 (2016) (“The two arbitrators so chosen shall meet . . . and if, within sixty (60) [days the] arbitrators shall not agree, they shall together appoint a third arbitrator . . . The majority of the arbitrators shall determine the fair market rent of the demised premises and render a written certified report of their determination . . .”).

44. Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing 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), Peking U. art. 14 (China) (“The land user shall, within 60 days of the signing of the contract for the assignment of the right to the use of the land, pay the total amount of the assignment fee thereof, failing which, the assigning party shall have the right to terminate the contract and may claim compensation for breach of contract.”).

currently endures as it sells off land use rights to fund its operations. In fact, one problem facing local governments today is that 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 renewal fees over time might help improve government budgeting and operations.⁴⁵

If the government decides to charge holders fair market value for a second term, renewal rights will probably be very expensive. They are almost certain to be more expensive than the initial rights, given that the real estate market will have had decades to appreciate and that formerly vacant property will have been developed. Under this approach, the owner must bear the cost of reacquiring the right to use the underlying land every forty, fifty, or seventy years for a price that is equal to the then-current fair market value of the upcoming term.⁴⁶ In adopting this approach, the government's position would be that the owner purchased the equivalent of a lease, the lease has now expired, and the holder of the expiring right has the first right to purchase the equivalent of a second lease of the same property. The owner's response to this argument would presumably be that owners have assumed all along that a long-term land use right was tantamount to ownership, or as close as China could realistically come to granting fee simple ownership when the system of land use rights arose in the 1980s and 1990s.⁴⁷ The owner would argue that it never expected the government to force it to come up with a huge sum of money for a second time in order to retain the right to use land that it—plausibly but incorrectly—thought it already owned.

This disagreement about the expectations the parties had when they initially entered into the transaction goes to the crux of the problem that China soon must confront. As a matter of fairness, the

45. "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).

46. See *Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanzing 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), Peking U. art. 40 (China) ("Upon expiration of the term of use, the right to the use of the land and the ownership of the above-ground buildings and other attached objects thereon shall be acquired by the State without compensation.").

47. 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. See generally 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").

appropriate resolution of this disagreement depends on what the parties reasonably expected at the time of the initial purchase. The holder of a Western fee simple assumes, based on its knowledge of settled law, that it owns the property forever, while the holder of a leasehold knows that its possessory rights will expire on a fixed date. Did the Chinese purchaser of a land use right in the 1990s reasonably believe it was buying the right to use the property for a finite period of time,⁴⁸ or did the purchaser reasonably believe it was buying a fee simple in everything but name, disguised as a multi-decade land use right only because the government had no better political options at the time?⁴⁹ The answer to this question about owner expectations may become quite significant, because, under the approach discussed here, the renewing holder of the right will have to pay a very large sum of money to the government. To the extent owners make a convincing case, their argument may have an impact on whether the government selects this first option of renewing land use rights at their then-fair market value. The more that owners, as a group, can persuade the government that none of them expected to have to pay so much money to retain the right to use land they thought of as their own, the less likely it is that the government will adopt this approach.

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. The government will have to balance its desire to maximize its income against the fear of causing widespread unrest.⁵⁰ If holders of land use rights recognize the balance the government must strike, as they are

48. "Many homebuyers acknowledge that they don't own their flats and must at some point vacate the buildings they have treated as private property. But the notion is a distant and abstract reality." *If Beijing Is Your Landlord, What Happens When the Lease Is Up?*, CHINA ECON. REV. (June 17, 2013), <http://www.chinaeconomicreview.com/china-land-lease-property-law-ownership-rights> [<https://perma.cc/VJ7T-8WSJ>] (archived Feb. 6, 2017).

49. American regulatory takings law provides a close analogy to this problem. The United States Supreme Court has repeatedly focused on the importance of an owner's investment-backed expectations in determining whether that owner has suffered a taking. *See, e.g.*, *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 124 (1978) ("[T]he Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations."); *Palazzolo v. Rhode Island*, 533 U.S. 606, 617 (2001) ("Where a regulation places limitations on land that fall short of eliminating all economically beneficial use, a taking nonetheless may have occurred, depending on a complex of factors including . . . the extent to which the regulation interferes with reasonable investment-backed expectations . . .").

50. *See* Gregory M. Stein, *Is China's Housing Market Heading Toward a U.S.-Style Crash?*, 29 ARIZ. J. INT'L & COMP. L. 193, 222 (2012) ("[T]he Chinese government . . . wants to avoid the social disorder that might follow if thousands of workers were to lose their jobs, their homes, their health care, and educational opportunities for their children all at once.").

likely to do, they may reasonably conclude that protest, to the extent possible in China, might be a potent negotiating tool.⁵¹

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 somewhat below fair market value, though still nontrivial. The initial holder of the land use right would have to pay once again to retain control of the land, just as it would in the first alternative discussed above. However, the holder of the right would not have to pay the full fair market value of the property, as it did when it acquired the land use right the first time; instead it would only have to come up with a smaller, though 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 when the initial term expires 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 would have a strong incentive to renew because it would be purchasing the property at a price lower than anyone else could obtain and lower than its fair market value. This places the renewing party in a position to resell the property to another owner at the true fair market value and turn a quick profit on the renewal-and-sale transaction. No purchaser would be foolish enough to turn down such a price discount, even if it no longer wishes to continue to occupy the land, since it can resell the land at fair market value and thereby make a profit.⁵² The owner would be selling its land and recognizing a gain on the sale, just as it could have at any earlier point during the initial term, or, for that matter, just as that owner could have if it had owned the land in fee simple all along. Some of the overall gain,

51. Examples of recent protests in China, often successful at least in part, are too numerous to list here. See, e.g., Javier C. Hernández, *More Protests by Labor Vex China Rulers*, N.Y. TIMES, Mar. 15, 2016 (“[G]overnment has also sought to placate workers The approach underlines the political dilemma that labor unrest poses for the Communist Party, which has continued to portray itself as a socialist guardian of worker’s rights even as it has embraced capitalism and welcomed tycoons into its ranks.”).

52. Historically, New York City landlords who wished to convert rent-controlled apartment buildings from rentals 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 2016) (discussing the process of converting rental buildings to ownership).

however, would be paid to the government in exchange for the right to continue to control the land after the end of the initial term.

This second option creates all of the same problems as the first option but to a somewhat lesser extent, reflecting the fact that the cost of renewing the land use right is somewhat lower. The parties will still face appraisal problems, and the initial holder of the right still might argue that its expectations regarding renewal costs are being disappointed. However, by reducing the renewal price, the government will announce its willingness to accept lower consideration and to give the initial holder of the land use right a break on the price. Whether this price break will be sufficient to reduce objections by the class of renewing property holders will depend, of course, on the size of the price break. This option, if wisely implemented, may reduce the objections that renewing parties might raise under the first alternative, discussed above, at a cost to the government of reduced income from the sale proceeds. But a modest reduction might not be adequate to quell the discontent of parties that need to renew, and, at some point, the government may decide to employ the next option.

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. This proposal is thematically similar to the first two, but this time the government charges a price that is significantly discounted below the fair market value at the time of the renewal. Once again, the price for the renewal of the land use right might be paid in a single lump-sum fee at the commencement of the renewal term, or it could be paid in smaller annual installments. The latter approach would lessen the immediate financial burden on the holder of the right and allow the government to pace its receipt of the proceeds from the sale.

For example, the government might state that, after the initial term of the land use right expires, the holder can continue to enjoy the right to use the land by paying the government 1 or 2 percent of its fair market value every year. The amount of the annual fee could be established permanently at the outset, or it could be subject to periodic reassessment as property values fluctuate. The modest annual fee would be similar in both size and purpose 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.⁵³

53. See, e.g., Jinxia Wang & Ze Peng, *Analysis of the Financial Function of the Real Estate Tax*, 4 J. CHINESE TAX & POL'Y 89, 96–98 (2014) (discussing the central

Were China to adopt a system like 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 U.S. systems of land tenure.⁵⁴ The holder of a land use right will continue to be only that and will not legally be an owner, but this holder will enjoy nearly all of the “sticks in the bundle” that are characteristic of common law fee simple ownership.⁵⁵ This proposed approach, however, offers the Chinese Communist Party the ability to deny that the government has actually sold the property to a private citizen,⁵⁶ providing it with a type of political cover that may continue to be important in the future.⁵⁷ China, once again, will have moved toward a more Western system of land tenure, providing nearly all of the beneficial economic incentives of private ownership of land, while still preserving those elements of public land ownership that remain necessary for internal political and historical reasons.⁵⁸ If this happens, then the government would, in effect, have sold the property to the initial holder of the land use right from the outset, but without explicitly admitting that it is doing so.⁵⁹

elements of a reasonable real estate taxation system, including legitimacy, affordability, political acceptance, and meeting market needs).

54. 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 any other lienholders and then to the former owner. See, e.g., Frank S. Alexander et al., *Judicial Tax Foreclosures*, in *GEORGIA REAL ESTATE FINANCE & FORECLOSURE LAW* § 11:8 (2016) (summarizing recent changes to Georgia’s tax foreclosure sale process). 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. This process might be quicker, would probably afford the holder of the right less due process-type protection, and may deprive the holder of any equity he has built up in the property. It would also cause problems for junior lienholders such as mortgagees, presumably making these parties reluctant to accept liens on property interests that can so easily be wiped out.

55. For a general background on the “bundle of sticks” or “bundle of rights” concept of property ownership, see JESSE DUKEMINIER ET AL., *PROPERTY* 102–103, 218 (8th ed. 2014).

56. See, e.g., Shitong Qiao, *The Evolution of Chinese Property Law: Stick by Stick?*, in *PRIVATE LAW IN CHINA AND TAIWAN: LEGAL AND ECONOMIC ANALYSES* 182, 192 (Yun-Chien Chang et al. eds., 2017) (“Shenzhen’s desired reform [in the early 1980s] faced an ideological challenge from Marxism: how could a socialist country that had abolished private property sell land? In response to this challenge, the reformers separated LURs [land use rights] from land ownership.”).

57. See ROBINSON, *supra* note 43.

58. *Id.*

59. 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). Professor Clarke notes, for example, that

Of course, if the government were to adopt this third approach—charging the renewing party only a small annual fee—the government would receive considerably less money from the holders of land use rights than it might obtain if it charged the higher prices that are discussed above.⁶⁰ Thus, while this third option pacifies land owners because it converts the land use right into something approximating a fee simple, it does so at considerable financial cost to the government.

Government entities in China currently use the proceeds of the sale of land use rights to invest in local infrastructure, meeting needs that had been deferred for decades prior to the 1980s.⁶¹ Without this regular infusion of huge amounts of cash, the government's capacity to undertake major public projects would likely cease.⁶² The government could, however, use the (much smaller) annual proceeds received from the holders of land use rights to fund its ongoing operations. Again, this system would parallel those seen on the local level in the United States, where annual real property tax revenues are used to fund regular city and county government expenses for education, road construction, and other local needs. This would mark a dramatic change from the current Chinese revenue-raising system,

A fee [for the renewal of a land use right] fixed according to a formula is . . . hard to distinguish from a real property tax if the fee is either a flat fee or one based on the value of the property. And nobody thinks that the existence of property taxes is inconsistent with private ownership of land.

Id. at 340. I thank Professor Clarke for his valuable and insightful comments on this portion of my Article.

60. 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 or approach fair market value. If the renewing party pays the fee over time, however, the aggregate amount paid may or may not be lower. The government should be able to set an annual fee that will, when factoring in the time value of money, be equal to what the lump-sum fee would have been. Of course, there is no reason why the government must calculate the annual fee in this matter. Moreover, the government and the renewing party will not have full information about matters such as future inflation and appreciation when establishing the renewal fee. It is possible, therefore, that an annual fee may turn out to be higher or lower, in the aggregate, than a single fee paid at the outset would have been. Moreover, if the government builds in periodic reassessments, it is entirely possible that, over time, the holder of the right will pay more in the aggregate than it would have paid if it had simply renewed the land use right and paid the entire cost at the time of the renewal.

61. See Zhonghua Renmin Gongheguo Chengzhen Guoyou Tudi Shiyongquan Churang He Zhuanrang Zanxing 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), Peking U. art. 50 (China); see also *supra* note 35 and accompanying text.

62. See STEIN, *supra* note 13, at 142–44 (describing how proceeds from the sale of land use rights are essential for funding major improvements to infrastructure).

but it would offer local governments more reliable and more predictable sources of cash for ordinary operational purposes.

If the government charges a significantly lower price for the renewal of the land use right and allows the holder of the right to pay this price in modest annual installments, the government would, in effect, be treating 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 badly needed 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 and would use this money to fund its ongoing operations. This approach might well signify the next stage of China's rapidly evolving real estate market, as it moves away from spending the tremendous amounts required to modernize its roads, bridges, highways, and mass transit, and moves instead toward a more sustainable long-term financing model.

If the government decides that the cost of the land use right will be paid on an annual basis rather than all at the outset, it will face a second question. As noted above, the government will need to decide whether the annual payment the owner of the land use right must make will be permanently fixed from the outset or will be reassessed at periodic intervals during the renewal term of the land use right. If the parties decide to fix the price at the outset, each takes the risk that price fluctuations will move in an unfavorable direction. The government will suffer if property appreciates at an unexpectedly high rate, because the price established for the land use right will reflect original expectations that proved to be too pessimistic. Similarly, the owner of the right will suffer if the price proves, in retrospect, to overvalue land that did not appreciate as rapidly as expected.

Landlords who enter into long-term leases, including ground leases, face similar problems. They sometimes agree with their tenants to build in periodic rent increases of a fixed amount, although those too may under- or over-predict appreciation in land values.⁶³ As an alternative, the parties to the lease might agree to periodic rent increases that will be set by reference to some index, such as one that measures the inflation rate for similar rental properties, or determined by one or more appraisers. In this way, the parties agree to a method by which the rent will remain more or less in line with

63. The advantage of rents that are fixed on day one, of course, is that they are fixed on day one. The tenant knows exactly how much rent it must pay throughout the term, and the landlord knows exactly how much it will receive. Rents that adjust in the manner described in the text, like adjustable-rate mortgages, introduce new uncertainties into the transaction for both parties.

increases in the value of the underlying real estate. This reduces the risk that the parties will miscalculate how well the real estate market will perform in future years, replacing it with a different kind of uncertainty: rents might increase or decrease, and there is no way to know at the outset which way they will move or to what degree.⁶⁴

Tax-assessing authorities in the United States often address this concern by reassessing real estate on a periodic basis.⁶⁵ The goal is to ensure that those owners whose property has appreciated at an above average rate pay an increasing share of local real estate taxes, while those whose property value has suffered relative to their neighbors pay a decreasing share.⁶⁶ Annual payments for a Chinese land use right are analogous to these types of tax payments, and the Chinese government might decide as a matter of fairness that the annual fee levied on owners of land use rights should be recalculated regularly. If the government chooses to act in this fashion, it will make property ownership in China resemble fee simple ownership even more closely than it does now. This approach also builds more flexibility into the

64. Commercial landlords and tenants can also adopt hybrid approaches that divide this risk between the parties. For example, it is common for commercial leases to establish a fixed base rent but to require tenants to pay as additional rent an amount equal to the tenant's share of increases in building operating costs. These costs typically include real estate taxes, insurance, maintenance, and other similar landlord expenses. See DANIEL B. BOGART & CELESTE HAMMOND, *COMMERCIAL LEASING: A TRANSACTIONAL PRIMER* 79–82 (2d ed. 2011) (examining various ways to calculate rent increases as the term of a commercial lease progresses).

65. “[T]he constitutional requirement is the seasonable attainment of a rough equality in tax treatment of similarly situated property owners.” *Allegheny Pittsburgh Coal Co. v. County Comm’n*, 488 U.S. 336, 343 (1989).

66. Tax assessment schemes nonetheless are plagued with inequities. For example, many jurisdictions reassess property when it is transferred. Under this approach, long-term owners often end up assessed at a rate that undervalues their property relative to newcomers, an attribute commonly referred to as the “Welcome, Stranger!” problem. The stated reason is to ensure that owners who have resided in the community for years are not forced to leave because their real estate taxes shoot up when property values appreciate. The result, though, is that newcomers are paying a disproportionately high cost for local services, often because they are not yet as well connected politically as their more established neighbors. See, e.g., *Nordlinger v. Hahn*, 505 U.S. 1, 12–13 (1992):

[T]he State legitimately can conclude that a new owner at the time of acquiring his property does not have the same reliance interest warranting protection against higher taxes as does an existing owner. The State may deny a new owner at the point of purchase the right to “lock in” to the same assessed value as is enjoyed by an existing owner of comparable property, because an existing owner rationally may be thought to have vested expectations in his property or home that are more deserving of protection than the anticipatory expectations of a new owner at the point of purchase In short, the State may decide that it is worse to have owned and lost, than never to have owned at all.

pricing system and allows government revenues to keep pace more closely with government expenditures.⁶⁷

This discussion proceeds from the assumption that Chinese government bodies raise funds by selling land use rights rather than by imposing real estate taxes. Note, though, that the Chinese government has recently begun to experiment 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.⁶⁸ In these experimental settings, the government is imposing *ad valorem* taxes on 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, or, more precisely, it would be the modified form that the renewal fee would take. Of course, nothing stops the government from choosing to impose both, charging the owner an annual fee as consideration for the renewal of the land use right and imposing *ad valorem* real estate taxes as well.⁶⁹

67. Shortfalls in revenue can also be addressed simply by raising tax rates. That approach, which is typically unpopular politically, raises additional funds without addressing any inequities in relative tax payments by different residents. Whatever your property is deemed to be worth, you simply pay more in taxes. Reassessment, by contrast, can reduce inequities without necessarily raising any additional funds: some people's assessments go up, others go down, and total tax collections may rise or fall. Tennessee law prohibits using the reassessment process by itself as a means of increasing overall tax revenues. Tenn. Code Ann. § 67-5-1701(a)(3) ("[E]ach governing body, in the event of a general reappraisal as determined by the state board, shall determine and certify a tax rate which will provide the same ad valorem revenue for that jurisdiction as was levied during the previous year.").

68. See *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> [<https://perma.cc/49E6-N4BW>] (archived Feb. 19, 2017); *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> [<https://perma.cc/78PG-G9HS>] (archived Feb. 25, 2017).

69. These taxes should not be confused with the different transfer and gains taxes that are imposed when real estate changes hands. The government often raises or lowers these taxes when it wishes to cool the market down or heat it up. See generally STEIN, *supra* note 13, at 116–17. Note, however, that real property taxes can also accomplish these same goals. See Yansheng Zhu, *The Practical Choice for Real Property Tax Reform*, 4 J. CHINESE TAX & POL'Y 114, 116 (2014) ("Expansion of RPT [real property tax] will increase the cost to hold real properties, which in turn will curb enthusiasm for investment housing and eventually affect the total demand on the real property market, fulfilling the goal to cool down the market.").

4. Renewal of the Land Use Right for Free

A fourth possibility is that the government could allow the renewal of the land use right to proceed free of 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 landlord's common law reversion, it would now be conveying that reversion to the holder of the original land use right free of charge.⁷⁰

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. Government officials might also worry that they could be accused of disposing of public property for too low a price. 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 the imposition of *ad valorem* taxes becomes commonplace and widely accepted, the government may no longer need the sudden infusions of cash that the renewals of land use rights would provide. Moreover, homeowners might well argue that this new tax effectively serves as a charge for the renewal of the land use right and that they should not be forced to pay twice for the use of the same land.

If China were to proceed in this manner, it would be tacitly conceding that it conveyed fee simple ownership of the land to the holder when it first granted the land use right.⁷¹ China would have effectively privatized the land, but without acknowledging this fact for forty, fifty, or seventy years.⁷² Perhaps China needs this long

70. 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* 21 (Yale Law and Economics Research Paper No. 441) (Feb. 16, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1953207 [<https://perma.cc/Q5SZ-85VL>] (archived Feb. 19, 2017). 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. See Clarke, *supra* note 59, at 359–60.

71. See Clarke, *supra* note 59, at 340 ("If 'automatically' [as used in Article 149 of the Property Rights Law] means 'at no cost,' then – assuming the rule applies to all extensions, not just the first – we are seeing the restoration of fee simple ownership: a possessory right that lasts forever.")

72. There are at least some indications that China is considering this option. A recent opinion piece in *China Daily* argues that residential property owners should be allowed to renew their land use rights without charge. Yang Junfeng, *Exempt Homeowners from Paying Fee for Land Use Rights Renewal*, CHINA DAILY (June 15, 2016), http://www.chinadaily.com.cn/2016-06/15/content_25716034.htm [<https://perma>

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.⁷³

Recall also that most of this land was privately owned at one time. By deferring acknowledgment that it is reestablishing a fully privatized system for the 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 with little or no compensation.⁷⁴ Former owners whose land was appropriated and their descendants still might attempt to bring claims for compensation when the initial term of the land use right expires. But, the longer the government can postpone addressing this issue, the less likely it is that claimants will bring these cases or even know that they have cases to bring.

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 have been trivial. The fair market value of owned commercial property is nothing more than the discounted present value of all rental proceeds forever, adjusted to reflect anticipated appreciation and tax benefits.⁷⁵ This number is probably not much greater than the discounted present value of all rental proceeds for the next forty or fifty years with the same adjustments: the rental proceeds 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 the land or any associated tax benefits so far in the future. The legal

.cc/NE8F-BCXS] (archived Feb. 6, 2017). The author notes some strong reasons for imposing these fees, observing that

[t]he Property Law talks about “automatically renewing” land use rights, which tends to indicate “unconditional” renewal. But if land use rights could be “unconditionally” renewed for free, why did legislators bother to stipulate the time limit for it? More importantly, automatic free renewal of land use rights is equal to permanent ownership of land, which would turn land use rights into property rights and would be a drain on State-owned assets.

Id. The author ultimately concludes, however, that residential owners should not be charged for renewing their land use rights because of the “heavy burden on homeowners” and as a “guarantee [of] basic fairness.” *Id.*

73. See ROBINSON, *supra* note 43.

74. See Ho, *Introduction*, *supra* note 10, 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.”).

75. See MILES ET AL., *supra* note 28, at 205–32. 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 do not necessarily coordinate as closely as this model suggests they should.

difference between the two is that, in the actual case, the Chinese government retained a reversion that would not become possessory for several decades. But this reversion was not terribly valuable at that time, 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.⁷⁶

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 the differential between the price for the fee simple and the price for the land use right and to allow that small sum of money to appreciate for up to seventy years (though it is unlikely that it would have done so). 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 immediately investing the portion of the sale proceeds attributable to the reversion in an asset that produced an identical return.

Conversely, the purchaser of the land use right, who saved this price differential when purchasing a mere forty, fifty, or seventy years rather than a fee simple, could similarly have banked the price differential and treated it as a reserve fund to be used to repurchase 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 it will need to reacquire 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.

Of course, there is much guesswork involved in predicting future values and discount rates, particularly in a market that is as immature as China's was in the late 1980s. Moreover, the investment alternatives facing the government or the developer in modern China

76. See Clarke, *supra* note 59, at 351 (noting that, at a 5 percent discount rate, the reversion that becomes possessory at the end of a seventy-year land use right is worth just 3.29 percent of the value of a fee simple absolute, and at a 10 percent discount rate, the reversion is worth only 0.03 percent of the perpetual right). In other words, if the fee simple value of property is \$1 million dollars and the discount rate is 10 percent, the price differential between selling a residence in fee simple and selling a seventy-year land use right for that residence is only \$300.

are fairly constrained.⁷⁷ In fact, there is a good chance that one of these hypothetical investors—the government or the purchaser of the land use right—would simply have invested the funds in other real estate, which is one of the more attractive investment opportunities in China today.⁷⁸ To the extent this real estate investor is real rather than hypothetical, it probably did just that.

5. Distinguishing among these Four Options

It seems likely that the government will allow holders of land use rights to renew them, because any refusal would introduce tremendous instability into China's real estate market.⁷⁹ The discussion above has introduced four different ways in which the Chinese government might resolve the question of how much to charge for the renewal of land use rights, assuming, as is likely, that it decides to allow the current holder of a right to renew it. As the discussion makes obvious, however, these four options are not distinct alternatives as much as they are different points along a spectrum.

If we assume that holders of rights will be permitted to renew them, then the principal unanswered questions are whether they must pay and how much. The discussion above selects four price points along the spectrum from 100 percent of fair market value to zero and describes the benefits and drawbacks of choosing each of those points. The closer the price is to zero, the more satisfied holders of land use rights will be, as they will be permitted to retain their property rights without incurring significant additional costs or any additional costs at all. But the closer the price is to zero, the more difficulty the government will have finding the funds to support infrastructure development and other government services. The more the government decides to treat renewal rights as a source of future funding, however, the less happy owners of Chinese real estate will be. The government will have to select some point along this spectrum and will have to estimate the costs and benefits of each of these points.

77. See STEIN, *supra* note 13, at 90–92 (describing the limited investment opportunities available to ordinary Chinese investors today).

78. See *id.*

79. See *supra* notes 98–101 and accompanying text (describing the Chinese government's fear of instability). Holders of residential land use rights appear to have the legal right to renew, unlike holders of industrial or commercial land use rights. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 149 (China).

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

So far, this Article has assumed that the government will allow initial holders of land use rights to renew those rights. Section A considered four possible prices for this resale: a price that is equal to 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 a price of zero. It also noted the different methods the government might use when assessing the fair market value of the property. Section A further 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 over time.

The discussion to this point has assumed that the holder of the land use right and the government will not devote much energy to worrying about these renewal issues until the initial term—perhaps seventy years long—is drawing to a close. The government began granting land use rights in the late 1980s, and those rights did not start to boom in popularity until the 1990s. This means that the first round of residential land use rights will not begin to expire until about 2058, although a small fraction of these rights may have been granted for less than the maximum permissible term. Even industrial and commercial land use rights have many years to run.

The parties are likely to need to settle these uncertainties long before land use rights begin to expire, however. Those who own or control real property make personal and business plans many years in advance. A business may be deciding whether to relocate to larger quarters or expand in place, and choices such as these involve making long-term investments. A business also may wish to sell its property interest, and the buyer will want to know the life expectancy of its investment. Homeowners may need to renovate and upgrade their property, which typically involves the use of borrowed funds, meaning that mortgage lenders also need to be satisfied with the security they will receive.

It would not be unusual or surprising, 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. Chinese policymakers who imagine that they can defer making decisions on these questions until, say, 2050—which is to say, long after their service has ended and someone else must address the problem—will likely be hearing from holders of land use rights decades before that. In other words, policymakers will likely need to address these important renewal questions in the next ten to twenty years, and perhaps even sooner than that.

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. For example, 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. In fact, purchasers of land use rights today acquire those rights with the intention of undertaking new construction, which is required under Chinese law.⁸⁰ These owners obviously expect to recoup their investment, and they probably construct buildings with an anticipated life span that is equal to or shorter than the term of the land use right.⁸¹

The holder of a right with only twelve years to run, by contrast, 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.⁸² Of course, if the holder knew that it had a guaranteed right to renew the land use right at an easily ascertainable price, and if it planned to exercise that right, its time horizon would be longer. The holder of the land use right would feel more like the owner of a fee simple, a tenant under a longer-term lease, or the initial holder of the longer-term land use right. But at this point, Chinese law and practice have not yet provided that assurance to holders of land use rights, which means that current law creates incentives not to invest in maintaining or improving structures that are situated on aging land use rights.

The time horizon of the holder of a land use right will shrink dramatically years before the date on which the right is set 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. Nearly any improvement it makes will have an expected life of less than seventy years, so there is no reason for that owner not to invest. In fact, it most likely acquired that right with the intention of undertaking new construction.⁸³ By year fifty, that holder will begin

80. See *supra* note 39 and accompanying text.

81. See *supra* note 38 and accompanying text.

82. For a general discussion of the moral hazard issue, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 136–37, 161, 551–52 (8th ed. 2011).

83. It is important to distinguish here between the initial holder of the land use right and the party that occupies the improvements that are built on that land. If the holder of the right is a developer, it probably plans to sell residential units as soon as they are complete, which means that the developer's time horizon is actually much shorter than seventy years. But it knows that its market of potential buyers plans to hold the property for the long term and will want to be able to sell it at some point in the future, so it should be cognizant of what these prospective buyers will be seeking. The ultimate occupant probably will not build the unit on its own – most urban dwelling units are individual apartments in much larger structures—but it plans to acquire and hold a completed unit for its own occupancy and eventually sell it. And, of course, many residential units in China are nothing more than investment commodities, bought and sold much like other financial assets. A significant number of these units will remain unoccupied for a considerable length of time, so it is difficult to

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 treat the property like a rental car.⁸⁴ 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, discouraging owners from investing for the long term.⁸⁵

Lenders will have these same concerns. Property owners considering long-term investments in their property are likely to need to borrow funds. Lenders that extend these types of loans demand security interests in the real property to be improved. These mortgages serve a dual function.⁸⁶ 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 and perhaps its entire investment. Thus, the granting of a mortgage interest to the lender reduces the likelihood that the borrower will default in repaying its debt.⁸⁷

Second, the security provides the lender with an alternative source of repayment if the borrower fails to repay the loan. The lender would prefer that the borrower simply repay the money—its goal is to lend money out and receive repayment of those funds plus interest, and it has little interest in foreclosing unless it absolutely must—but, if the borrower fails to repay the debt, the adequately secured lender can have the property sold at foreclosure and will be repaid from the sale proceeds.⁸⁸ Thus, the granting of a mortgage interest to the lender also reduces the consequences of a default to that lender.⁸⁹ The mortgage, then, decreases both the likelihood that

know what their owners are looking for in terms of durability. See STEIN, *supra* note 13, at 38.

84. *A Nation of Homeowners?: Why a Dispute in Wenzhou Has Rattled Property Investors Across China*, WEEK IN CHINA (Apr. 29, 2016), <https://www.weekinchina.com/2016/04/a-nation-of-homeowners/> [<https://perma.cc/SD8A-QWF2>] (archived Feb. 6, 2017) [hereinafter *A Nation of Homeowners?*] (quoting one Wenzhou government official as saying “[a]n apartment on a 70-year lease is like a brand new car. Those expiring in two or three years are like second-hand vehicles which have been driven for more than 10 years”).

85. *Id.* (“[U]ncertainty could become a factor for purchasers in the secondary market in the not-too-distant future”).

86. See generally GRANT S. NELSON ET AL., *REAL ESTATE FINANCE LAW* 1–5 (6th ed. 2015) (describing the basic contours of a standard mortgage loan transaction).

87. 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).

88. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS arts. 179–80 (China) (providing for the foreclosure of a mortgage).

89. See generally NELSON ET AL., *supra* note 86, at 578–698 (discussing the foreclosure process in detail).

the borrower will default and the negative effect on the lender if the borrower does.

These two purposes 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. Or, stated more accurately, the lender's security is rapidly declining in value as the expiration date for the land use right nears, so the borrower has less and less to lose with each passing day. After all, the borrower stands to lose only the remaining term of the right, not a perpetual fee simple, and that term is growing shorter.⁹⁰ From the lender's perspective, it is watching its security drop in value over time as the term of the land use right draws to a close.⁹¹ 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, since the purchaser at foreclosure will be acquiring only the shrinking term of the land use right. Thus, 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, during the later years of the term, when the expiration date is approaching, lenders will become less and less willing 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 fails to repay that debt. Thus, as land use rights approach their expiration, holders of those rights will be unable to borrow funds secured by mortgages on their land.

Landlords and tenants under Western ground leases are quite familiar with this problem, and they deal with it in a variety of productive ways. Landlords may provide tenants with the ability to extend the lease near the end of the term. This reduces the moral hazard problem noted above by increasing the duration and value of the tenant's interest in the real property before the tenant has any reason to lose interest in maintaining it. The tenant that wishes to remain on the premises and improve them can extend the lease and know that it will benefit personally from those improvements. It thus has more in the way of security to offer to prospective lenders.

Many ground leases contain built-in renewal options, although even if a tenant renews its lease one or more times there will

90. See Stein, *supra* note 87, at 1239–44 (discussing the moral hazard issues that arise between mortgagors and mortgagees).

91. Of course, if the loan is amortizing in full or in part, the amount of the debt is also shrinking over time. For an example of this phenomenon, see NELSON ET AL., *supra* note 86, at 2–4.

ultimately be a termination date.⁹² In other cases, the parties will negotiate a lease extension many years before the original lease ends: rather than agreeing in the original lease to give the tenant a unilateral right to extend the lease, the parties instead negotiate an extension on mutually acceptable terms partway through the lease term. This approach is common, for example, in Hawaii and in London, where ground leases underlying residential dwelling units are common.⁹³ It also is not unusual for the tenant under a ground lease to enjoy a right to purchase the property in fee simple at the end of the term.⁹⁴ In fact, these purchase options are not terribly different from the four alternatives discussed in the previous Section⁹⁵ in that they provide the parties with a greater level of certainty about what happens when the initial term expires and how much the tenant will have to spend if it wishes to remain on the property. Ground leases, though, are more likely than land use rights to establish either a renewal price or a method of establishing that price long before the initial term ends. In other words, landlords and tenants operating under ground leases have learned how to reduce uncertainty and the associated moral hazard.

What does all of this mean for the Chinese real estate market? As the initial expiration date approaches, holders of land use rights will gradually become less inclined to maintain and repair their property, lenders will become less willing to extend credit, real estate will begin to deteriorate, and no one will have sufficient incentive to repair it. Prices will then drop due to declining property quality, unavailability of mortgage financing, and uncertainty about future renewals. All of this will start to happen many years before the first land use rights expire, as uncertainty becomes a large and ever-increasing drag on China's real estate markets.

92. Some states limit the duration of leases by statute. *See, e.g.*, CAL. CIV. CODE § 718 (West) (limiting leases of different types of real property to terms ranging from 35 to 99 years).

93. Ground leases are common in Hawaii for reasons particular to the history of that state. For a good background description of Hawaiian land ownership, see *Haw. Hous. Auth. v. Midkiff*, 467 U.S. 229, 232–34 (1984). The opinion notes, “In the mid-1960’s, after extensive hearings, the Hawaii Legislature discovered that, while the State and Federal Governments owned almost 49% of the State’s land, another 47% was in the hands of only 72 private landowners.” *Id.* at 232. A similar phenomenon is seen in London, for reasons that are not entirely dissimilar. *See, e.g.*, Julie Satow, *Rising Costs a Concern for Land-Lease Building Owners*, N.Y. TIMES (June 12, 2015), https://www.nytimes.com/2015/06/14/realestate/rising-costs-a-concern-for-land-lease-building-owners-in-new-york.html?_r=0 (subscription required) [<https://perma.cc/25FY-HAJU>] (archived Feb. 6, 2017) (“Many buildings in London are subject to ground leases that can run for 1,000 years; the queen is often the landowner.”).

94. *See generally* GERALD J. ROBINSON, *Hybrid Financing, in* FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 8.03[2] (2017) (discussing split financing and sale-leasebacks with repurchase options).

95. *See supra* Section II.A.

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 can be under Article 149 of the Property Rights Law.⁹⁶ The government will also need to establish the duration of all of these renewals. And, perhaps most importantly, the government 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 long-term value of individual parcels of real estate.

III. WHICH SOLUTION IS THE CHINESE GOVERNMENT MOST LIKELY TO SELECT?

Part II listed and examined several important reasons why the Chinese government will need to inject some certainty into the real estate market long before land use rights expire in large numbers. It also elaborated on some of the alternatives the government might consider when addressing the renewability and renewal cost of land use rights. Part III will look at past Chinese government practice in an effort to predict which of these alternatives the government is most likely to select, as well as to forecast some answers to the other questions raised in the previous Part. In other words, of the possible solutions just described, which one is the government most likely to choose and how will it be implemented? 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 do so before long. Until that happens, the government does not wish to take any potentially controversial action that will be difficult or embarrassing to modify in the future.

In the next ten to twenty years, holders of industrial and commercial land use rights will wish to renovate or expand but will have little confidence that they can control their property long enough to benefit from the labor and expense. They also will be unable to obtain loans from hesitant banks to fund construction or renovation costs. These holders of land use rights might wish to sell but will be unable to entice potential buyers who fear losing the property too

96. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 149 (China).

soon. A real estate industry that is dominated by powerful and well-connected people is likely to press for greater clarity soon.⁹⁷

Similarly, hundreds of millions of homeowners will become uneasy as rights to the land on which their homes sit approach their termination date. Like industrial and commercial owners, they will have difficulty renovating, selling, or borrowing. And local governments that have sold off rights underlying much 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 proceeds from the resale of land use rights. Before long, powerful interest groups will press the government for answers. China must provide those answers soon.

By examining recent Chinese history, it is possible to make some predictions as to how the government will respond to questions about the renewability of land use rights. These are only predictions, but they are informed by past behavior that offers clues to future government action.

As noted above, three concerns seem to dictate much of the government's policy toward real estate. First, the government does not wish to create or exacerbate social unrest. As the nation's recent explosive economic growth begins to slow, the government fears that it will be unable to pacify restless citizens who were willing to accept certain incongruities as long as their economic status kept improving.⁹⁸ The people of China have enjoyed continuous improvements in their standard of living, but, if that were to change, a government that came to power "at the barrel of a gun" fears that it could lose its power in much the same way.⁹⁹ Although Chinese law purports to protect private property rights, it also places limits on those rights. China's Property Rights Law even includes provisions that require property owners to take communitarian principles into consideration.¹⁰⁰ But if restrictions on property rights prove to be too

97. See Rita Yi Man Li & Yi Yut Li, *Is There a Positive Relationship Between Law and Economic Growth? A Paradox in China*, 9 ASIAN SOC. SCI. 19, 25 (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290481 [<https://perma.cc/48VC-3BXQ>] (archived Feb. 4, 2017) (discussing *guanxi*).

98. *A Nation of Homeowners?*, *supra* note 84 ("[I]f the fee is set at a third of the property's current value – the figure that emerged from Wenzhou this month – the howl from homeowners will be heard across China.").

99. See, e.g., Platt, *supra* note 12.

100. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS art. 7 (China) ("In acquiring or exercising a real right, one shall abide by the law, respect social morals and may not damage the public interests or the legitimate rights and interests of any other person."); *id.* art. 84 (2007) ("In the spirit of providing convenience for production, life of the people, enhancing unity and mutual assistance, and being fair

great, the government fears what might happen next. Tens of millions of homeowners who must either come up with large amounts of money or lose their homes are unlikely to make this unappealing choice placidly, and the government knows that.¹⁰¹

Second, the government does not wish to adopt legislation or promulgate regulations until the private sector has had an opportunity to experiment. China has demonstrated that it is willing to allow its legal system to evolve in synergy with changing business standards.¹⁰² Its government has little experience in addressing these types of questions, while its vibrant entrepreneurial class seems more than willing to experiment with new business methods and practices. China's government does not wish to stifle innovation or damage relatively settled expectations.¹⁰³ If anything, the legal system has struggled to keep pace with emerging business norms,¹⁰⁴ and laws often seem to be drafted in response to the development of successful business practices rather than the reverse.¹⁰⁵

and reasonable, neighboring users of the real property shall maintain proper neighborhood relationship.”).

101. See, e.g., Ren Wei, *China's Grey-Area for Property Buyers: Homeowners Face Doubts over Renewing Land-Use Leases*, SOUTH CHINA MORNING POST (Apr. 19, 2016), <http://www.scmp.com/news/china/economy/article/1936991/chinas-grey-area-property-buyers-homeowners-face-doubts-over> [<https://perma.cc/NH9Y-CWC9>] (archived Feb. 1, 2017) (“Millions of homeowners across the mainland are watching what happens in Wenzhou fearing that their own property investments could be thrown into question when their leases expire.”).

102. See generally STEIN, *supra* note 13, 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).

103. See, e.g., Clarke, *supra* note 59, at 343–45 (observing how Chinese accounting principles regarding amortization of buildings constructed on land use rights have varied to reflect legal changes in the meaning of those rights).

104. See, e.g., Qiao, *supra* note 56, at 191–93 (describing how Shenzhen experimented by creating land use rights before they were legal, Guangdong Province then legalized them, and the Chinese Constitution and Land Administration Law then were amended to authorize the creation of land use rights; the author observes how this change in practice was motivated by private and public actors seeking to imitate practices in Hong Kong); *id.* at 204 (observing how China is “rearranging the sticks [in the property “bundle”] to adapt to social and economic developments, which often run well ahead of the legislature” and “try[ing] to accommodate new changes in reality . . . through gradual policy and legal reforms”).

105. 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 (“[G]overnments 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.”).

Third, the government—along with many individual officials working within the government—wants to continue to benefit personally from the ongoing real estate boom.¹⁰⁶ The government owns a valuable asset—urban land—and it needs the continuing proceeds from the sale of rights to that land.¹⁰⁷ It uses sales contracts as a rudimentary form of zoning by including use restrictions in those contracts.¹⁰⁸ It controls many of the nation's major lenders.¹⁰⁹ It participates as a partner in numerous lucrative real estate projects.¹¹⁰ Individual government officials also invest in many of these real estate developments, despite the obvious conflict of interest such investments can create.¹¹¹ And real estate developers often have strong personal relationships with government officials.¹¹² Any prediction as to how the government will act in the future must acknowledge the personal stake that many decision makers have in the outcome of this process. If these three trends continue in the future, as seems likely, then it becomes possible to view some of the options described in Part II as more probable than others.

A. Residential Property

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. Many residential units are owned by their occupants, while many others are owned by individual investors who treat one or more vacant apartments as their retirement nest egg.¹¹³ Nothing is more likely to cause public unrest

106. See STEIN, *supra* note 13, at 46–48 (discussing government participation in real estate ventures).

107. *Id.* at 57–58, 97.

108. RANDOLPH & LOU, *supra* note 3, at 391–92 (setting forth the provisions regulating land use contained in one of the official forms of contract for granting land use rights on state-owned land).

109. Gregory M. Stein, *Mortgage Law in China: Comparing Theory and Practice*, 72 MO. L. REV. 1315, 1341–52 (2007) (discussing how the Chinese government controls most of the nation's leading banks).

110. See Zhe Huang, *The Transformation of Social Obligations of Land Rights on State-Owned Land in China*, 42 PUBLIC SECTOR 100, 107 (2016) (“After the municipal government reclaimed its control over urban land, it quickly established its own real estate development business and partnered with commercial developers to undertake new real estate projects.”) (footnote omitted).

111. STEIN, *supra* note 13, at 87–88, 135–38 (describing these conflicts of interest).

112. *Id.* at 36, 44–50, 135–136 (discussing these types of personal relationships).

113. See, e.g., Joe McDonald, *China Housing Slump Sparks Fear for Economy*, S.D. UNION LEADER (June 12, 2014), <http://www.sandiegouniontribune.com/sdut-china-housing-slump-sparks-fears-for-economy-2014jun12-story.html> [<https://perma.cc/S9PR->

than hundreds of millions of people losing their homes, their retirement income, or both.¹¹⁴ 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.¹¹⁵

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 theoretically be on solid ground were it to charge the renewing right holder the full fair market value of the land (perhaps even calculated in a way that maximizes its own profits by including the value of the improvements), but such an approach will seem punitive.¹¹⁶ Property owners will object to having to repurchase land use rights they have already paid for once, particularly when the value of that right has been enhanced by improvements they either built themselves or purchased from someone else. 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.¹¹⁷ Legally, the government might have a reasonable argument that this method is justified and was foreseeable. After all, the homeowner built or 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 an expense this large, and the many who are unable to make this huge payment might lose their homes and their largest investment. Social norms and expectations would influence, and probably outweigh, the government's technically legal ability to charge the then-current market price.¹¹⁸

More likely, and given the government's desire to keep the owners of residential property somewhat pacified, the government will allow homeowners to renew their land use rights at a more

XSF2] (archived Feb. 1, 2017) ("Investors who own multiple apartments often leave them vacant while they wait for prices to rise, prompting complaints by would-be renters about lack of supply. China had 49 million such vacant apartments in August [2013], or 22.4 percent of the total of 218 million.")

114. See *supra* notes 98–101 and accompanying text.

115. Local governments might not agree, and might focus more on the revenues they may lose. See, e.g., STEIN, *supra* note 13, at 57–60 (describing tensions between the central government and the provinces over land policy).

116. See *supra* subsection II.A.1.

117. See *id.*

118. See, e.g., *A Nation of Homeowners?*, *supra* note 84 (quoting one comment posted to an online bulletin board as saying, "So we are back to 1956. The government can simply nationalise our private properties at will")

modest cost.¹¹⁹ Furthermore, it seems probable that the government will permit renewing parties to pay for their renewal rights in regular installments of a lesser amount rather than requiring a single large payment at the commencement of the renewal term. Many homeowners are unlikely to be able to come up with the amount needed to renew a land use right in one single payment, even if the price is calculated at well below fair market value. Moreover, governments will no longer have to meet the huge infrastructure demands they have faced for the past quarter-century but will need regular and steady revenues to pay for ongoing operational costs.

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. Practically and 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.¹²⁰ Denominating the charges as rent or renewal fees, however, allows the government to maintain the fiction that it still has a reversionary right in the underlying land, a fiction that may remain important for internal political reasons.¹²¹

Such an approach would reduce the likelihood that the government will face massive public protests—the first criterion noted above—which it greatly prefers to avoid. This option also goes a long way to meeting the third criterion discussed above, by maintaining the ongoing health of China's real estate markets. Local governments will prefer an option that helps to maintain the huge direct and indirect investments that they (and individual government officials) have made in the real estate market. The local economy will not suffer, nor will the net worth of the officials who have to make the relevant decisions.

The second criterion, concerning the government allowing experimentation before it acts, is a bit more difficult to address. To the extent that Chinese government bodies have allowed experimentation before endorsing successful options, they have done so in settings in which the private market must decide how to behave. In other words, they allow private business people to test out different alternatives where feasible. The issue of land use right renewals, by contrast, is one in which the government must choose among options that only the government can exercise: private citizens

119. See *supra* subsections II.A.2–II.A.4.

120. See *supra* subsections II.A.3–II.A.4.

121. See *supra* note 47.

cannot extend the terms of land use rights on their own. However, it is possible that some government bodies will have the opportunity to test out different approaches before many others must make their decisions. For example, the city of Wenzhou granted a large number of leases for an initial period of twenty years, some of which have already expired.¹²² When the government announced that it would charge a renewal fee of approximately one-third of the value of the property, there was considerable public disapproval, which people elsewhere in China followed closely.¹²³ It is quite likely that other Chinese cities are watching Wenzhou closely and will learn from its experiences when their own property owners' land use rights approach their expiration dates.

As previously noted, some Chinese jurisdictions are already experimenting with imposing *ad valorem* real estate taxes.¹²⁴ If these taxes are set sufficiently high, the government might be able to dispense with the renewal fee altogether or 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 remains fairly low. If citizens view 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 regard the government as taking advantage of its position as the owner of the underlying 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 individuals or entities. They are probably more financially sophisticated than the typical homeowner. Thus, it is more likely that owners of business property recognized and understood from the outset that a land use

122. See Lucy Hornby, *China Lease Expiries Prompt Property Rights Angst*, FIN. TIMES (May 2, 2016), <http://www.ft.com/cms/s/0/952be9a4-0abe-11e6-b0f1-61f222853ff3.html#axzz4EEo4z5kG> (subscription required) [<https://perma.cc/32ML-5HL3>] (archived Feb. 4, 2017).

123. *Id.* (“Wenzhou has asked homeowners to pay up to a third of their homes’ value to renew their rights, according to a city government document, sparking an outcry across China. The Property Law of 2007 says land-use rights can be renewed but does not specify the criteria for doing so.”).

124. See *supra* note 68 and accompanying text.

right has a finite duration and that they would someday be called upon to pay a renewal fee, much like with Western ground lessees.¹²⁵ These owners are more likely to have been actively involved 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 should 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.¹²⁶ Furthermore, many of these sophisticated owners of business property have personal connections with the government officials who will make these important decisions, the type of *guanxi* that has been important in Chinese commercial real estate development to date.¹²⁷

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.¹²⁸ 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

125. Cf. Julie Satow, *Rising Costs a Concern for Land-Lease Building Owners*, N.Y. TIMES (June 12, 2015), https://www.nytimes.com/2015/06/14/realestate/rising-costs-a-concern-for-land-lease-building-owners-in-new-york.html?_r=09 (subscription required) [<https://perma.cc/RT7K-TXMZ>] (archived Feb. 4, 2017) (describing a similar phenomenon in New York and other Western locations). Given the limited business experience of domestic Chinese real estate investors when land use rights were first becoming popular, it is entirely possible that some of these first-round investors did not fully comprehend all the terms of the deals into which they were entering. At the same time, it would be hard for them to argue, in a nation with no recent history of private property ownership, that they thought they were acquiring a property interest analogous to a common law fee simple.

126. 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 apartments vacant with the intention of selling them at an appreciated price. See, e.g., *22.4% Urban Homes Lying Vacant in China: Report*, CHINA DAILY (June 12, 2014), <http://english.peopledaily.com.cn/business/n/2014/0612/c90778-8740395.html> [<https://perma.cc/K3FJ-Y3LB>] (archived Feb. 4, 2017) (observing that nearly fifty million residential units were vacant in China in 2013, while noting the difficulties of obtaining reliable figures on vacancy rates).

127. See Li & Li, *supra* note 97, at 25 (2013) (describing *guanxi* as “a type of human capital,” “an important asset for both individuals and firms,” and “an alternative reward and punishment system”).

Personal relationships of this nature can sometimes mature into corruption, a problem China is actively taking steps to combat. See, e.g., Third Plenum, *supra* note 24, 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.”).

128. See *supra* subsections II.A.1–II.A.2.

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 more knowledgeable business entities are less likely to be surprised by the imposition of a large fee that should have been evident to them from the beginning. They are not naïve, and they are unlikely to take to the streets solely due to business frustration that is somewhat unwarranted. 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 to renew the land use right, there is no reason the government would not let that party renew, but if the original holder is unwilling to pay a high price, 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 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.¹²⁹ These well-connected entities are exactly the types of parties that are likely to get sweetheart deals from the government.¹³⁰ The discussion above gives several reasons why owners of commercial and business property are more likely than residential owners to understand why they should pay fair market value for their renewals. These well-connected holders of business property, however, 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 many of these decisions will not need to be made for another few 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 will pay for their renewals, though perhaps not as high as full fair market value at the time of the renewal.

This 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 homes, they will pay a fair price that they are willing to accept, and they will not be displaced. They may 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

129. See *supra* note 127 and accompanying text.

130. *Id.*

and accept the need to pay and will not create too much of a stir, particularly if the renewal rate is relatively low.

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 and not terribly different from similar charges that other nations impose. 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 thus 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.¹³¹ Of course, the businesses that pay these higher fees are in a position to force these costs forward into the economy by pricing their increased 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 more fully for what it costs to supply these goods and services, including the increased cost of the land where the good was manufactured, stored, or ultimately sold, or where 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.

IV. THE EXPIRATION OF LAND USE RIGHTS AND CHINA'S PROGRESS TOWARD THE 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 comprehensive property law to govern it, with the Property Rights Law not becoming effective until 2007.¹³² Other business laws filled some of the gaps,¹³³

131. See, e.g., CITY OF BOSTON, HOW WE TAX YOUR PROPERTY (2017), <http://www.cityofboston.gov/assessing/taxrates.asp> [<https://perma.cc/9D9N-G7VJ>] (archived Feb. 4, 2017) (setting forth a rate of \$10.59 per thousand dollars of value for residential property and \$25.37 for commercial, industrial, and personal property and noting that "[t]he City of Boston operates under a property tax classification system. This allows us to charge different rates for residential and commercial property.").

132. Wuquan Fa [Property Rights Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007), P.R.C. LAWS (China).

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 one can make educated guesses as to how China's real estate market will evolve.

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 the earlier legal uncertainties have been considerably 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 both in China and elsewhere, and they have greater confidence in themselves and 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 formalized.¹³⁴ 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

133. 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), P.R.C. LAWS (China), and this early law served as a basic business law blueprint. After the GPCL became effective, market professionals were confident enough about legal protection of their investments that they were willing to participate in the real estate market, and they 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.

134. 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 105, at 497 ("[S]ettlements 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").

ensuring that future changes are more 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 tremendous potential returns. This bet appears in retrospect to have been a wise one for many of the earliest investors in the Chinese real estate market.

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 and the country was changing too rapidly. 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.

Politically, China could not stray too far from the communist principles that discouraged the re-privatization of real property.¹³⁵ 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.¹³⁶

Once the new land use right became fairly 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 ensure that they could continue to do so. Greater legal and political predictability thus supplanted the earlier uncertainty. Moreover, those earliest

135. See STEIN, *supra* note 13, 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.”).

136. 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.”).

entrepreneurs developed the experience, self-assurance, and *guanxi* they needed to 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 from which they profited, sometimes spectacularly, and now they want to institutionalize those rules and practices and continue to enjoy their benefits. The knowledge, skill, size, and business connections of these first-generation investors, 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.¹³⁷ In today's real 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 who have the most to lose want that trend to persist.¹³⁸

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 approach their expiration date, the well-connected holders of these rights will press for greater clarity.¹³⁹ Given the extent to which the stability of China's real estate markets depends on the answers to these questions, it seems certain that the government will have to respond sooner rather than later.

Early risk-preferring entrepreneurs may have benefited initially from an unpredictable system with little clarity and many unresolved questions. Now that they have become leaders in their fields, however, 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 limit competition from the next generation of upstart real estate developers.

137. See Huang, *supra* note 110 ("The first generation of such private developers had certain advantages either because of their unique relationship to government officials or party leaders or because of their unique social status.") (footnote omitted).

138. See Li & Li, *supra* note 97, 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).

139. 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 probably prefer continued legal murkiness to a clear rejection, in the hope that they can use their influence to push for more favorable change before the tentative answer becomes firmly set.

Homeowners similarly want the comfort of knowing that they will not be displaced or forced to pay huge renewal fees.¹⁴⁰

What China demonstrates, then, is a move from experimentation and intentional vagueness toward greater precision and emphasis on the rule of law.¹⁴¹ 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 and action 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 pioneers were amply rewarded for their wagers. Through trial and error, they established business practices that worked.¹⁴² 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 advantage. Rather than allowing themselves to be superseded by the next cohort of risk-takers, they would prefer to clarify and institutionalize the informal rules from which they have already benefited, 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 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, which is to say not long from now.

140. See HO, *supra* note 135, 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”).

141. 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 24, at I.2.

142. See Ho, *In Defense of Endogenous*, *supra* note 10, 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.”).

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 broadly 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. Thus, it seems likely that China will follow the path suggested above: it will allow all land use rights to be renewed, it will charge a modest renewal fee—however it is denominated—that the public is willing to bear, it will allow that renewal fee to be paid in small installments over the life of the renewal, and it will likely impose a lower rate on residential users than on commercial and industrial users.¹⁴³

V. CONCLUSION

Part II of this Article raised the open questions about renewability of land use rights that China must soon address. It then described and analyzed several of the possible answers to these questions. Part III suggested which of these possible answers the government is most likely to choose. While no one can foretell the actions of the Chinese government with great confidence, these predictions are based on past government behavior and are thus more probable than other alternatives.

Part IV then focused on the movement in China toward greater formalization and emphasis on the rule of law. It suggested that the leading players in China's real estate market and government have reasons for wanting to resolve these uncertainties soon. In particular, it seems likely that China will decide these important questions in a manner that largely maintains the status quo 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 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. And homeowners will maintain

143. See *supra* note 131 and accompanying text.

ownership of their residences, preventing the type of instability that is anathema to the Chinese government.

The different levels of government will benefit in several ways. In addition to enjoying the benefits 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 set so that they are 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, both as investors in particular projects and through the maintenance of personal relationships with powerful real estate developers. The central government will also be satisfied, as this approach is unlikely to lead to mass public discord.

The general public benefits from this greater stability as well. 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 government to which they pay their taxes is 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, since so many parties will have a stake in preserving this system.

In short, China will likely answer these essential questions in the near future. And its answers will serve to solidify China's real estate market as that market and the nation continue to mature.