



# Land reallocation reform in rural China: A behavioral economics perspective



Lei Feng<sup>a</sup>, Helen X.H. Bao<sup>b,\*</sup>, Yan Jiang<sup>c</sup>

<sup>a</sup> Department of Land and Real Estate Management, School of Public Administration and Policy, Renmin University of China, Beijing 100872, PR China

<sup>b</sup> Department of Land Economy, University of Cambridge, Cambridge CB3 9EP, UK

<sup>c</sup> Center for Applied Statistics, School of Statistics, Renmin University of China, Beijing 100872, PR China

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## ABSTRACT

Based on prospect theory, we develop a theoretical framework to unify divided views on land reallocation reform in China. Our theoretical framework and empirical verification explain the driving forces behind the success of the rural land reallocation reform in China. We find that rural land reallocation reform in China is characterized by induced and imposed institutional changes. The relationship between induced and imposed institutional change is complementary instead of competing. The decision and frequency of land reallocation are affected by both local endowment and central government policy. Empirical findings also suggest that land reallocation reform in China is incremental, with interim policy targets from different stages taking gradual effect. The incremental implementation of the “No Reallocation” policy is the reason behind the widespread, diversified land reallocation practices across the country; this policy also contributes to the success of rural land reform in China. The theoretical model can be used to study a wide range of government-led institutional changes in China, such as affordable housing schemes and the National New-type Urbanization Plan (2014–2020).

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## Introduction

Rural land market reform in China can be traced back to the introduction of the Household Responsibility System in the late 1970s. After three decades of market reform and urbanization, 36.3% of Chinese still lives in rural areas,<sup>1</sup> which account for over 70% of the total land area in China; the agricultural sector contributes only 10% to the national GDP (National Bureau of Statistics, 2014). The proportion of rural population is still well above developed nations' average of 20%. As revealed in the nation's first urbanization plan in March 2014, China will speed up the country's urbanization process to foster sustainable and healthy economic growth. Rural sector plays an important role in this challenging undertaking. Theories of development economics suggest that agricultural growth is crucial for industrialization and economic development (see e.g., Schultz, 1964; Hayami and Ruttan, 1971).

Improving productivity in rural China is of great importance for food security and the national economy. To achieve this goal, one of the most effective tools is granting land-use rights and residual income rights to rural households (Lin, 1992; De Soto, 2000).

In rural China, arable lands are jointly owned by groups of rural residents in the same village. The term “collective” is coined for such groups of rural households. Under a collectively owned land right system, a piece of land on per capita basis is allocated to each villager. Payoff for individuals is determined not by their own productivity, but by the overall productivity of their collective. Specifically, output from individuals are pooled first and then equally distributed among all members of the collective. Collectivization achieves the ideological goal of equal access to land. However, the system is inefficient because villagers are not provided enough incentives to contribute to the collective and their motivation to free-ride is strong (see e.g., Kojima, 1988; Kochin, 1996). In the late 1970s, the Household Responsibility System emerged quietly through experiments by villagers who were supported by their local governments. The System essentially gave villagers the right to retain residual income from lands allocated to them and marked the start of the Decollectivization Reform (Diamond, 1985).

Decollectivization is one of the most important institutional changes in the history of modern China because it fundamentally

\* Corresponding author. Tel.: +44 1223 337 116.

E-mail addresses: [fenglei@mparuc.edu.cn](mailto:fenglei@mparuc.edu.cn) (L. Feng), [hxb20@cam.ac.uk](mailto:hxb20@cam.ac.uk) (H.X.H. Bao), [jiangyan73@163.com](mailto:jiangyan73@163.com) (Y. Jiang).

<sup>1</sup> This figure includes residents who actually live in rural areas only. Unregistered migrant workers (18% of the total population by the end of 2013) that live in urban areas are not included. Unregistered urban residents do not have access to basic urban public services such as education, medical care, and pensions.

altered the land-use rights system in rural China and significantly improved agricultural productivity (see e.g., Nolan, 1983; Kojima, 1988; Lin, 1992; Gaynor and Putterman, 1993; Li et al., 1998; Deininger and Jin, 2003). It also fueled the industrialization and urbanization processes by moving surplus rural labor force to other sectors (Lin, 1992; Binswanger et al., 1995). Empirical evidence shows that employment share in the agricultural sector dropped by almost 50% from 1978 to 2007 while productivity growth rate outperformed all other sectors for most of this period (Zhu, 2012, Table 2, p. 111). The success of the Household Responsibility System was celebrated by the public and formally recognized by the central government (see Ash, 1988 for a chronological account of the agricultural reform in China). The next challenge in Decollectivization Reform is to adjust the system so it can keep up with the rapid urbanization and economic reform in China, an objective that can mainly be achieved through land reallocation reform.

In decollectivization, the land is still collectively owned. Although the exchange of land-use rights was endorsed by the central government in 1984, the rural land rental market was only formally established in 2002 when the Rural Land Contract Law was passed by Congress. The development of the rural land rental market (i.e., rural land-use rights exchange market) has been slow. Land reallocation remains the only effective way of adjusting land allocation to meet demographic changes and economic development in rural China (see e.g., Kung, 1995, 2000; Liu et al., 1998; Benjamin and Brandt, 2002). Broadly speaking, land reallocation has two types. A full reallocation (*da tiaozheng*) takes back all or most land holdings and redistributes them among all households in the collective. A partial reallocation (*xiao tiaozheng*) only involves land holdings and households affected by demographic changes. Understandably, full reallocations are less frequent than partial reallocations in practice because it is associated with a greater level of land rights insecurity.

Determining the frequency and scale of land reallocation is a delicate issue (Wang et al., 2011). Land-use rights should be granted to households for a sufficiently long period of time to justify long-term investment in land holdings. Frequent and/or large-scale reallocation results in tenure insecurity, and consequently discourages investment in land holdings (Li et al., 1998; Brandt et al., 2002; Jacoby et al., 2002). By contrast, rapid urbanization in China causes fast demographic changes in rural China (Cai and Wang, 2010; Peng, 2011). Timely reallocation is necessary to address resource mismatch and ensure equal access to farmland by all members of collectives. How can tenure security and land-use efficiency be balanced? What is the driving force of land reallocation? These important questions cannot be answered without understanding the dynamics between the local and central governments in land reallocation.

Lin (1989) claims that institutional change can be broadly classified into two categories. The first one, induced institutional change, is usually initiated by and experimented in private sectors and adopted by the government after being proved successful. The second type, imposed institutional change, is prescribed top-down by the state and is often associated with drastic social, economic, or legal adjustments. The difference between these two types of institutional change rests in involved political and economic risks. Induced institutional change is allowed or even encouraged by the central government when the reform involves low political risk and significant economic gains, whereas imposed institutional change is preferred for decisions that may cause substantial political loss but great economic uncertainty (Zhang, 2012). Consequently the payoffs must be sufficiently large to justify imposed institutional changes such that the expected gains can outweigh the expected costs. Imposed institutional changes are also necessary when parties with conflicting interests are involved. Without such top-down

interventions the supply of institutional changes might not be sufficient due to rent-seeking behaviors and free-rider issues (Lin, 1989; North, 1990; Lin and Nugent, 1995).

According to this framework, the Decollectivization Reform started as induced institutional change. The Household Responsibility System was first experimented with in remote and disadvantaged villages in China, where the stake of failure is low. The success of the System later ignited nationwide adaptation and led to the formal reorganization by the state. However, the nature of the current stage of decollectivization (i.e., land reallocation reform) is still open for debate. If left unsupervised, land reallocation is likely to pose a serious threat to tenure security and discourage farmland investment. Therefore, state intervention is inevitable. One would expect that both imposed and induced institutional changes are in force. However, empirical evidence suggests that state intervention is ineffective.

First, stylized evidence shows that the goals of the local and central governments do not align. For example, Deininger and Jin (2009) find that almost 30% of the villages surveyed in their study have undergone land reallocation since 2000. However, as early as in 1984, the state has stipulated that land-use rights should be contracted to villagers for a minimum of 15 years, which was extended to 30 years in 1993. Land-use rights are taken back from villagers before the end of their contract when lands are reallocated, which negatively affects tenure security, farmland investment, and agricultural productivity. A “persistence of seemingly inefficient institutions” is at work (Kung and Bai, 2011). This condition is in stark contrast to the “federalism with political centralization” model, where the local government is given incentives and the freedom to foster economic growth while the central government maintains a strong and disciplined control by rewarding or punishing local administrations (Blanchard and Shleifer, 2001). This model is recognized as the key success factor of the economic growth of China (Blanchard and Shleifer, 2001; Xu, 2011). However, it does not seem to work for land reallocation reform. Land reallocation rules laid out by the central government are duly ignored by local governments.

The academia also pays little attention to the role of the government. Most studies on land reallocation are based on the induced institutional change hypothesis (see e.g., Brandt et al., 2004; Yao, 2004a, 2004b; Kung and Bai, 2011; Wang et al., 2011), and the results are mixed. Some empirical evidence supports the induced institutional change hypothesis (Yao, 2004a, 2004b), but other studies favor the transaction cost hypothesis (Kung and Bai, 2011).<sup>2</sup> Brandt et al. (2004) find rent-seeking behaviors and the duty of village leaders to meet tax and quota obligations as the most important reasons to reallocate land. They conclude that the best way to enhance rural land tenure security is to change the incentives for village leaders. The theoretical framework and empirical findings from these studies provide valuable insight into rural land reallocation reform in China. However, the role of state intervention hardly has any evidence. Some researchers justify this approach by stating that the policies of the central government are simply ignored by local authorities (see e.g., Brandt et al., 2004, p. 629). Others choose to seek alternative economic justifications for this apparent inefficiency, such as the transaction costs hypothesis tested in Kung and Bai (2011). The role of state intervention is discussed in some studies (see e.g., Deininger and Jin, 2009) but never formally incorporated in the theoretical framework of any of the studies. This approach is convenient for establishing econometric models,

<sup>2</sup> Transaction cost theory and induced institutional change theory are closely related. Reducing transaction cost is one of the important considerations in induced institutional change theory. Whether their relationship is complementary or substitutive is still open to debate.

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