

# PRIVATIZATION OF URBAN LAND IN SHANGHAI

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# Introduction

After decades of sluggish economic development, China has once again gained the attention of the international forum both economically and politically. A large economy, easily within the top ten in the world league, its constant growth makes continued economic reform seem inevitable. At the same time, much research is being devoted to the processes and economic consequences of Eastern Europe's transition from socialist central planning to the capitalist market system.<sup>1</sup> In China a different transition is taking place. Central planning remains intact and the government aims for 'market socialism'. Yet in both situations economic privatization<sup>2</sup> is a consuming urge. This book looks at a thus far neglected issue — the privatization of land control under the emerging new system.

Such a change can be collectively described as the privatization of the economy. This is quite different from the privatization of state enterprises in established market economies such as the UK in the sense that the former refers to the restructuring of the whole socio-economic system whereas the latter refers to a normal market transaction of individual state enterprise. In this respect, the focus and consequences of reform and privatization are much larger in China than in any case of public sector reform.<sup>3</sup>

Nevertheless, most of these research studies concentrate on the operation of the price system in the transitional economies (Banuri, 1991; Corbo, Coriceli and Bossak, 1991; and Welfens, 1992). Macro-economic development has always been the centre of attention. Relatively little attention is given to a major sector in the economy normally found in the market economies, namely the real estate and construction sector (exceptions can be found in Bertaud and Renaud 1992). This is understandable because a land market can only become active and important in the economy if the overall economy itself is attractive enough to create internal demand for properties and subsequently draw external investment in real estate development.

Due to the relatively short history of privatization of land markets in the transitional socialist economies, no substantial research has been carried out in this field. Although the effects of the privatization programmes have generated substantial economic research, most tends to look at the macro environment.



In recent World Bank reports (1993) on the transition in two Eastern European economies, only small portions are devoted to discussion on the housing and municipal services sectors.<sup>4</sup> There is, hence, a strong need to probe into the effects of privatization on the operation of land markets in transitional economies. However, such an examination will require an active land market with a certain degree of open market transaction activities. This prerequisite is not always available in the ex-Soviet economies.

In China, the transitional process being undertaken by the state is quite different from Eastern Europe. Instead of moving towards a completely capitalist socio-economic system, China is in transition to market socialism.<sup>5</sup> The existing socialist / planned economic system in China will not be swept away completely. It is to be merged with the incoming market mechanism. The resulting changes in the economic mechanism operating within the existing socialist political framework will be more complicated than the privatization programme in Eastern Europe. This is like transplanting an important organ to a patient. The surgeons must be very careful to avoid rejection reactions in the patient's body, and ensure that the new organ works better for the body.

This unique Chinese merging of market economies into the socialist macro environment, has prompted research interest in the capitalist world. Numerous publications discussing the performance of the various economic reforms in China have emerged as these economic reforms proceed (Ness, 1988; Reynolds, 1988; Crane, 1990; Byrd, 1991 and Guo, 1992). Again, however, relatively little research is devoted to the development of the land market. Yet the Chinese land market, especially in some of the open cities such as Shanghai, has been very active and prosperous since the market reforms were launched in 1988.

Given the growing importance of the real estate market in the Chinese economy,<sup>6</sup> examination of the land market mechanism arising from the Land Use Rights (or LURs) reforms will illuminate the mechanism of reforms in other transitional land markets. Such an examination can be carried out through analysis of recent Chinese market land price behaviour. This is like examining the blood circulation system of the patient after the transplant. If the circulation flow reflects what the doctors envisage the normal patient will experience, then the operation is satisfactory. If not, the doctors must determine the factors affecting the new pattern and try to explain whether such new pattern is healthy. We have to accept the fact that what we normally experience does not necessarily represent the only solution, although it could be the best solution we can think of under certain circumstances. If circumstances alter, then the solution is likely to change as well.

Moreover, examination of the land market mechanism in relation to analysis of the macro economic development of a country should not be underestimated. Walker, Chau and Lai (1995) show that the contribution of the property and

construction sector to GDP in Hong Kong, in addition to its large representation in the stock market, has averaged over 24% since 1980 — greater than any other economic sector including the whole of manufacturing.<sup>7</sup> Judging from the capital investment coming from major Hong Kong investors into China,<sup>8</sup> contribution of this sector to China's economy in the coming years will certainly match the Hong Kong experience if not exceed it.

This book stems from the situation where a natural resource (land), whose monetary value had been neglected since 1949, suddenly assumes a very important role in the overall Chinese economy. The emergence of land price as a factor in the Chinese market has not been the gradual process experienced in western economies. How then does this 'from nothing to everything' situation come about? This is a major issue for privatization policy-makers in transitional economies since the solution to this problem may have social and political implications. In addition, the valuation system must be readjusted since the underpinning factors affecting value in the old system and the new are so different. Brabant (1987) states that:

Dispensing with the Dogmengeschichte and metaphysical or other philosophical underpinnings of the law of value, there are basically three questions to be answered:

- i) How should value be determined?
- ii) How should prices be set? and
- iii) Should the law of value play a pre-eminent role in the allocation of scarce resources? ...<sup>9</sup>

Hence, as a first and most important step, revival of the land allocation system based on market land price holds the key to the success of land use rights reforms in China. In the past the non-existence of market price in the land use system was regarded as a major reason for the failure to allocate land to its most profitable user.<sup>10</sup> When the land use rights reforms were introduced, it was hoped that value of land would be reflected properly through the price system. However, a high proportion of land allocation is still carried out on an administrative (without monetary payment) basis. In fact there remains a legal foundation for the allocation of land through an administrative channel.<sup>11</sup>

Administrative allocation of land is not uncommon even under market economies, where governments from time to time need to allocate land for social and institutional purposes administratively without substantial monetary compensation (such as paying nominal land rent only). However, in China as in other socialist countries, the proportion of land areas allocated administratively without monetary compensation far exceeds the proportion conveyed through the market mechanism. For instance, in Guangdong Province in Southern China, land allocated through administrative channels in 1991 accounted for

85% of the total land area conveyed.<sup>12</sup> This phenomenon is due to the extremely high proportion of state enterprises, and even commercial institutions, which require administratively allocated land not only for their functional use but for such welfare purposes as providing cheap housing for their employees,<sup>13</sup> which is not common in a market economy.

To measure the performance of the land market mechanism under the Chinese land use rights reforms, one must examine market land price behaviour not only through western eyes but also from the socialist perspective. The focal point is not just how to establish a western-style capitalist land market in this transitional economy.<sup>14</sup> We must also consider how the market mechanism may react in the transitional period to the incoming factors. This will provide better understanding of transitional behaviour and its long term effects on the land market.

Pricing of land has always been a very alien concept within the socialist system. The use of land is not considered in calculative production costs, the basis for the pricing model of most commodities. To establish a land use (with payment) system in China, the prerequisite is to understand whether the land market allows land value to be properly reflected and allowed to resume its role in the land use allocation system. The basis of land value is its residual nature. Residual land value is a proper proxy of the open market land value which is fundamental to the land economics concept.<sup>15</sup> Needham (1992), in his analysis of land value theory in a market where land is publicly-supplied, regards residual land values as one of the major constraints a public authority has to face when offering a price to acquire land from peasants in the Netherlands. A similar situation exists in China's land market where the government has monopoly power over land. If residual land values set the foundation for the determination of land prices, it should be possible to observe that the behaviour of market land prices achieved resembles closely, although not necessarily completely, that of residual land values achievable in the market under the privatization of land use rights.

In building up the framework of this book from the examination of the privatization of land use rights in China, a sequence of inferences has to be made for the proper construction of the analyses. The following translates this relationship graphically:

- (1) The capitalist theoretical view of land value represents the simulation of residual land value predicted under a market economic environment. It therefore spells out the common factors significant to the determination of land values, although relative magnitudes may vary in different markets. In theory, land prices generated from the market exchange mechanism will show high relevance to this view and, if this is the case in China's real estate market, then the market system created under the land use rights reforms approaches that of the market economy.

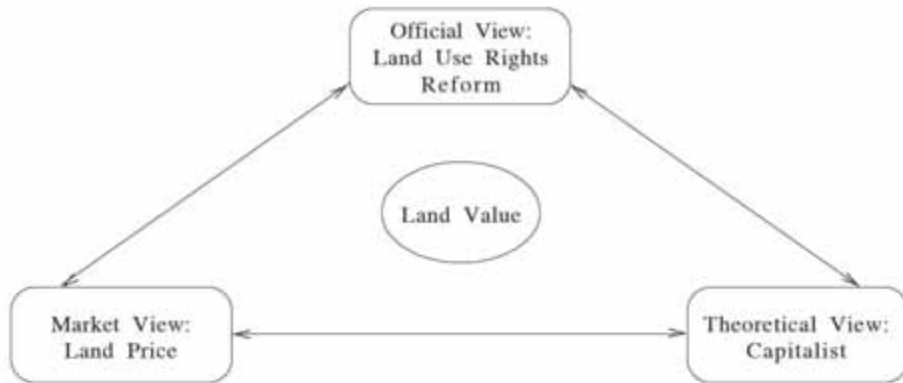


Figure 1.1 Different Views of Land Value

- (2) The market view represents the mentality of the market exchange mechanism created under the land use rights reforms. Land prices are achieved according to the prevailing 'view' of the market mechanism. Normally, land prices achieved will behave quite similarly to that of the theoretical view. This shows that market land price and residual land value originate from the same nature in the market economy. On the other hand, if the market land prices show very different attributes from the theoretical view, it implies that China's land market is either unique or very immature. In any case, the market economic principles in land price determination cannot be applied to China for the time being.
- (3) The official view represents the determination of land prices from the government perspective. As the government is the sole owner of land and monopolizes the land use rights market, the pricing policy of land use rights may be more or less shaped by the official view after considering the existing market supply and demand situation. This view exhibits a reference point to which the market may possibly react as the sale of land use rights in China is monopolized by the local authorities which have full power in setting market land price by way of private treaty grant. If this view also corresponds to the theoretical view, we can expect that the market environment created under the transitional economy is functionally acceptable and western philosophy in land price behaviour can be applied in the examination of China's land market.

## Structure of the Book

This book starts with a brief introduction to the concept of value in socialist economies. This is a core concern in the convergence of market and socialist

systems during the process of privatization. The extent to which the existing socio-economic system allows 'value' of commodities to facilitate the reinstatement of the price mechanism will be determined by the influence the old ideology of value under socialist system can exert. Value under the socialist doctrine is heavily influenced by the concept of production cost, in particular the amount of labour input. Hence the exchange value of a commodity is not considered as important as the production cost function of the commodity. A direct result of such an ideology is the exclusion of some commodities which do not have a production function for their existence. Land is a classic example. Without a production cost function, it becomes almost impossible to assign a value figure to land under the socialist concept of value. This produces difficulties when a market mechanism is created for such commodities without any precedents to follow. This underlies the rationale of the pricing behaviour of land in the transitional economies.

To illuminate the contrast between the socialist rationale of land value and the experience in the capitalist world, discussion of land price behaviour under market economies is necessary. The establishment of land value as a residual sum in the market economy shows that land value depends on the extent of economic activities undertaken on and above land. It is determined by how profitable the product on land (essentially properties) can be. This is a completely different angle from the traditional socialist view of value.

With the comparison basis thus established, we then proceed to the factual background of the privatization of the urban land market in China. There is no official inauguration date for the launch of the land use rights reforms. However with the amendments of Article 10 the People's Republic of China's Constitution in April 1988, land use rights (LURs) are officially segregated from landownership. LURs can now be priced and traded openly in the market and private developers can develop whatever they see as the highest and best use once they have obtained the LURs from the administration.

Any new system created within an established system will trigger a reaction. The urban land management system in China is no exception. Following the Land Use Rights reforms, certain new bureaucracies have been created. In addition to the redistribution of powers, there are also new players and new rules in the market. Until now, the intermingled effects have not been observed.

Besides the bureaucratic system, the major 'market' element in the LUR reforms is the revitalization of market land price. However, since the strict socialist economic system did not regard land as having any value, land was not 'priced' in China after 1949. Because there are no market reference points, the land price baselines have to be devised by the authority. Here the benchmark pricing model comes into play. A benchmark land price is an official guide to the average land price in a specific location or zone. Each local authority will have a benchmark land price table covering various districts within its

jurisdiction. However, a breakdown analysis shows that the derivation of benchmark prices depends to a large extent on the production cost function. The 'cost-portion', as it is, accounts for a very large proportion in the make-up of the benchmark land prices. Such dominance of the concept that 'cost-equals value' is also observed in the valuation practice of the assessment of asset values for the state enterprises.

If the new urban land market in China is so immature and unique, should there be any expectations that residual land value can be realized in the market? An empirical analysis comparing market land price behaviour and a simulation of residual land value based on appraisal technique shows that there is, at least in Shanghai. Based on transaction records in Shanghai's property market, a set of simulated residual land values has been obtained. From regression analysis, it is shown that the market factors that determine residual land values in market economies can also be applied to explain the behaviour of simulated residual land values in Shanghai, albeit not market land prices.

Finally, the aftermath of the LUR reforms is discussed and lessons drawn from the privatization of urban land in China. This provides a basic understanding of the market mechanism of the land market under the land use rights reforms in this transitional economy.

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- <sup>1</sup> For instance, Corbo, Vittorio, Coricelli, Fabrizio and Bossak, Jan (eds) (1991), *Reforming Central and Eastern European Economies: Initial Results and Challenges*. Washington, DC: World Bank; or Milor, Vedat (ed.) (1994), *Changing Political Economies: Privatization in Post-Communist and Reforming Communist States*. London: Lynne Rienner Publishers.
  - <sup>2</sup> For instance, see Earle, John S., Fryman, Roman and Rapaczynski, Andzej (eds) (1993), *Privatization in the Transition to a Market Economy*. London: Printer Publishers.
  - <sup>3</sup> Bachman, David (1990), *ibid*.
  - <sup>4</sup> *Lithuania: The Transition to a Market Economy* (1993) and *Latvia: The Transition to a Market Economy* (1993). Washington, DC: The World Bank.
  - <sup>5</sup> For a detailed discussion of market socialism, see Bardhan, Pranab K. and Roemer, John E. (1993) (eds.), *Market Socialism: The Current Debate*. Oxford: Oxford University Press.
  - <sup>6</sup> According to the Shanghai Statistical Yearbook 1994, the contribution of the real estate industry to GDP in Shanghai grew from 0.115% in 1980 to 0.504% in 1990 to 1.745% in 1993.
  - <sup>7</sup> Walker, Anthony, Chau, Kwong-Wing and Lai, Wai-Chung (1995), *Hong Kong in China: Real Estate in the Economy*. Hong Kong: Brooke Hillier Parker.
  - <sup>8</sup> *Capital to China: Who's Doing What Where*. Hong Kong Research, May 1993: Credit Lyonnais Securities (HK).

- <sup>9</sup> Brabant, Josef, M.V. (1987), *Regional Price Formation in Eastern Europe*, page 23. Dordrecht: Kluwer Academic Publisher.
- <sup>10</sup> Song, Qi-Lin (1992), *Urban Land Use in Modern China*. Beijing: China Construction Industry Press.
- <sup>11</sup> Provisional Regulations on Administratively-Allocated Land Use Rights, 1992.
- <sup>12</sup> Au, G. (1992), 'Planned Supply of Land and Market Mechanism,' *Chinese and Foreign Real Estate Times*, 26, Issue 9, 1992. (Published in Shenzhen in Chinese.)
- <sup>13</sup> Frisbie, John (1992), 'Housing Local Employees,' *The China Business Review*, pp. 26-7, September - October, 1992.
- <sup>14</sup> For instance, see Dowall, David E., 'Establishing Urban Land Markets in the People's Republic of China,' *Journal of American Planning Association*, Vol. 59, No. 2, Spring 1993; or Kaganova, Olga Z., 'Creating An Urban Real Estate Market in Russia,' *Real Estate Issues*, Spring/Summer 1993.
- <sup>15</sup> Ratcliff, Richard U. (1949), *ibid.*



## Conclusion

Until recently, people were debating whether there was a real estate market in China following the initiation of the land use rights reforms in 1988.<sup>1</sup> With a transaction volume of over 400 pieces of land between 1988-1993 and a further 200 pieces in 1994, it is beyond doubt that an active land market has developed in Shanghai. Prices realized in this market for the sale of LURs are by definition market land prices. It can also be argued that these market land prices are 'open market land prices' as recent land sale records are being made public by the local authority so that people can know the prevailing market selling prices for LURs in Shanghai.

There is therefore an established market mechanism, created by privatizing LURs in China, under which land is allocated according to the market price of LURs. Non existence of an active market is not the cause of any failure of the mechanism in this particular transitional land market. The examination of the privatization of land use rights in China does not therefore emerge from the argument whether there is a land market or not, but from observations of the deviation of the nature of this market from other mechanisms of market economies. The most acute observations can be made from examination of land price behaviour. Unlike other studies on land price behaviour,<sup>2</sup> this research compares the actual market land price behaviour with a simulation of residual land value based on existing market conditions in Shanghai. The reasons for employing simulations are several.

It is generally accepted that residual land value is the correct basis from which market land price behaviour is examined. Needham (1992) provides a theory of land price in a market where land for building developments is supplied collectively by the local authority. A single municipality is subject to three sorts of market constraints in setting land prices, namely:

- (1) the existing-use value of land to be acquired for development
- (2) the price at which other municipalities in the region dispose of building land
- (3) the residual value of land for marketable uses.

In theory, these three factors should provide a solid basis for analysis of land price behaviour in Shanghai. However, this is impossible. The first difficulty



is the absence of existing use value figures, because in the past land was allocated administratively to state enterprises without reference to objective valuation.<sup>3</sup> Extrapolations from rent figures are worthless because where rent is payable, it is very much distorted by heavy government subsidy.<sup>4</sup>

Secondly, it is dangerous to compare markets within China. Regional markets are unique because not all cities and towns in China have the same degree of privatization of LUR. Varied rates of economic growth in different regions have increased interregional differences in living standards.<sup>5</sup> Shanghai's market is very appealing to major developers given its historical background, whereas Shenzhen, for instance, was little more than a village 15 years ago. Whereas Guangdong Province attracts Hong Kong investors especially,<sup>6</sup> Shanghai attracts not only major Asian investors but also many international ones.

This leaves the final factor. Residual value of land for development has a major influence on land prices if the land market is coherently interrelated with the property market. This is because residual land value depends on the estimation of the gross development value receivable from land which invariably relates to the performance of the property market (the major source of income in an urban context).

Residual land value therefore maintains this coherent relationship between property and land in the market, even in a market where massive redevelopment preparation work and resettlement costs are required such as in Shanghai.

The empirical test results generated from the regression model have shown that although the market land prices are prevailing market 'prices' for LURs in Shanghai, they differ from theoretical residual land values. There is a discrepancy between the perceptions of land price and land value in all economies. Tappan (1993) illustrates this difference by saying that:

Appraised value is not necessarily the price paid or received for a property, although it might be. Certainly, there is nothing absolute or guaranteed by an appraisal, especially the price set by the market. Appraisal value is more often an informed opinion backed by experience and the education credentials of an appraiser.<sup>7</sup>

Such a discrepancy observed in Shanghai however appears to originate from a much more complicated background than just short term market disequilibrium. The regression analysis from Tables 17 and 21 has shown that it is possible to simulate a set of residual land values in this land market which bear a closer relationship with the market factors than do the prevailing market prices of land use rights. This is observed from the higher adjusted  $R^2$  found in the simulated residual land value than that found in the market land price.

The empirical results have also shown two important phenomena. Firstly, they show that the Shanghai land market is not a unique market where the

nature of land value is completely different from that we experience in market economies. The relatively high adjusted  $R^2$  obtained from the simulated residual land value shows that it is possible under the existing market conditions in Shanghai to generate a set of market land prices which could be obtained in a market economy. Secondly, market LURs factors cannot explain actual market land price behaviour completely. Non-market factors have a strong influence in the transitional market.

Therefore, we can say that it is possible to apply market land price theories developed under market economies to estimate land price behaviour in a transitional socialist economies such as Shanghai. From the empirical results, the theoretical residual land values show a very strong relationship with some of the common market factors and the variations in the residual land values are highly explainable by these factors.

This, however, is only true if the actual market land price realized approaches the residual land value, indicating a relatively efficient market mechanism in allocating land to the highest bidder. The empirical tests show that these market land prices are not behaving in a manner that resembles residual land value, rendering the theoretical market principles concerning land price behaviour incapable of being applied in this market.

If the market land price behaviour under the privatization programme in Shanghai cannot be completely explained by the factors influencing market demand and supply, then elements affecting the operation of the market mechanism should be examined. An obvious element is the political aspect of the privatization programme in the transitional economy. Land is a social asset in a socialist economy the pricing of which becomes a political process rather than a pure market mechanism.

Since the sale of LURs is mainly carried out through private land grant. Political factors have the opportunity to dominate at this stage of the market until it is completely transformed into a purely market-driven one. As a result, analysis of the determinants of land prices in Shanghai is not dependent solely on the principles of the market economy culture.

Examination of the political aspect of the privatization programme of land use rights has been made by comparing the actual market land price behaviour and the official view of the determination of guideline or benchmark land prices. The determination process of the official benchmark pricing model described in Chapter Three and the influence of the 'component structure' in the determination of market prices of LURs analysed in chapter 7 have shown that there is a close relationship between the ways the market mechanism created under the privatization programme determine land prices and the ways the local authorities prescribed their view in the determination of guideline land price at the beginning of the land use rights reform.

Official guideline land prices established by the local authorities at the

beginning of the LUR reforms in some of the open cities served as a benchmark for local governments when selling LURs to developers, as most local authorities did not have direct experience in the operation of the land market before the reforms. However, the nature of the guideline land prices has incorporated such socialist views of value that the actual pricing of LURs inevitably is also structured by this behaviour. The effect of this concept, that pricing of marketable commodities depends on the production cost function of the commodities, plays a major role in determining land prices in the specific land price behaviour of Shanghai.

This 'cost element' in the market price of land use rights can be regarded as rent-in-kind. Shih (1992) explains this element as comprising the cost of resettlement of the original residents, the costs of *qi tong yi ping* (which means the costs of the 'seven connections' such as gas, water, electricity, and the cost of site preparation) and the costs of social infrastructures such as primary schools and police stations.<sup>8</sup> Wang (1992) gives a very detailed discussion of the reasons for the popularity of rent-in-kind among Chinese local governments and points out the misconception that some people in China still equate land value with costs such as that of infrastructure.

Charging rent-in-kind is not unique to this mixed 'market/planned' economy but also exists in capitalist land markets such as in the UK in the form of planning gains. Hence, the idea of charging rent-in-kind should not prevent the determination of land prices in the market from being market-oriented so long as the total land rent and rent-in-kind together resemble the nature of residual land value. This however is not observed in market land prices in Shanghai.

In a planned economy, determination of value in general depends on the production cost function because of the belief in the labour-embodiment of value. Land per se has no value basis in this situation as there is no production function. When a planned economy is to be replaced by a market one, land rent will emerge as products on land, i.e. real properties, are developed, exchanged and commodified in the market. Land values at this stage should represent the summation of the net present values of all future incomes of land but this is not yet happening in Shanghai.

On the other hand, the mixed 'market/planned' operation of the land market as happening in China may not be absolutely undesirable. At the beginning of this important economic reform, control may be necessary in the pricing of such a finite resource in China. Uncontrolled transfer to a market system from a transitional phase may not be the best solution to the economic problems which the reforms are designed to deal with. Yeung and Zhou (1991) comment that only by selectively learning from Western countries and after due reflection and absorption would a Chinese viewpoint and methodology evolve to unravel the mysteries.

In addition, to achieve a complete reform, an overhaul in the whole socio-economic system is required especially in the housing sector and in labour and wage reform. Such 'shock-therapy' as has been experienced in Eastern Europe without convincing success is seen as inappropriate to China. The Chinese authorities, bearing in mind the political and economic implications of complete market reform, have therefore opted for a much more 'planned' privatization programme for land use rights.

Consequently and perhaps unconsciously, some of the less desirable ideological legacies of the planned economic system remain and have become incorporated into the new privatization programme for political purposes. This makes the market reform less capable of being analysed on the basis of market economic phenomenon, as Zhou (1992) notes:

... a typical statement of this invention-oriented way of thinking is 'China's economy is very particular and exclusive from any explanation by any theory of our predecessors. Chinese reform is unprecedented, thus no theories and experiences are available for reference' ...<sup>9</sup>

This also coincides with Ishihara's analysis of China's economic reforms in the transitional period into a market system that:

China's leadership is now facing a double-sided issue of, on one hand, how to gradually change over from administrative control by central and local government plans to control through economic means and, on the other, how to use economic regulators to guide sectors of the economy no longer under the plans ... The spread of multiple prices is one problem which has occurred in the transition period from a mandatory planned economy to a market economy ...<sup>10</sup>

This renders the application of some market factors which are normally relevant to the determination of land prices less efficient in explaining land price behaviour in Shanghai despite the presence of an active market mechanism. This is mainly due to the ideology that value is a function of the production cost. Therefore, cost becomes the subconscious guide to the 'formulation' of value. The irrationality of this logic is pointed out by Zhou, who says that:

... the artificial price-vector equation in the input-output model they use illustrates that the prices of products should be determined by the sum of input costs, depending upon a fixed input structure, plus a certain average profit. This approach entirely rejects the role of the demand side. It neither includes the aggregate demand, nor

the existence of any demand elasticity for any given price . . . (Zhou *ibid*).

From a different perspective, the 'cost structure' of market land price does not entirely dominate the determination of market land price. Although it is not possible to explain market land price behaviour in Shanghai solely by open-market factors, it is possible to examine and analyse this behaviour from market appraisal principles of land price.

The market price of LURs in Shanghai can be viewed as an additive element of two parties' interests. The first one is the price for the land portion which is obtained by the local authority as the LURs owner, a reversionary freehold interest with encumbrances of an undefined and invisible leasehold interest in land. The second portion is the price for existing built structures (or the cost of resetting sitting tenants from this built structure) on which the sitting tenants have an invisible leasehold, in addition to the costs of physical and social infrastructure. These two together produce a production cost function that reflects the traditional socialist economic view of 'value'.

This in fact is no different from the normal appraisal of land with sitting tenants in an open-market economy which regards the sum of freehold reversionary interest and leasehold interest as land value. The table in Appendix 3, shows that, except in cases where resettlement is not needed, the 'invisible leasehold interest' of the land accounts for a high and constant proportion of about 80% in the total market land price. This is so even when plot ratio varies substantially within the same district for the same type of development, implying rather arbitrary determination of this important factor in real estate development. Determination of market land prices is quite independent from determination of plot ratio allowed on a site, ignoring its direct effect on property values to be realized from the development.

Since existing land users had unlimited rights of occupation on land in the pre-reform period, the discounted value of the reversionary interest to unencumbered freehold interest (held by the State) was theoretically very minimal.<sup>11</sup> Therefore, it is not unreasonable to have a leasehold interest accounting for as much as 80% of the total price of the land. When the leasehold interest has a term of lease approaching infinity, the value of the interest approaches that of a freehold interest with vacant possession.

Based on information from Appendix 3, it can be observed that there is a 50% probability of having a cost portion (or an undefined and invisible leasehold interest) of 85% or above; a 70% probability of a cost portion of 70% or above; and a 80% chance of a cost portion of 50% or above.

In the other words, the freehold reversionary interest on land is about 20% of the total price of the land use rights.

However, the summation of the invisible leasehold interest and the

reversionary freehold interest still does not make up a reasonable worth of land. This is because a combination of different legal interests on the same piece of land will always release an extra value known in the appraisal profession as the marriage value.<sup>12</sup> Marriage value can be observed by estimating the freehold unencumbered interest on land and comparing this value with the existing market price of land use rights in Shanghai.

From Appendix 3, it is observed that the residual land value (the freehold unencumbered interest on land) expressed as accommodation value (column 4) format exceeds market accommodation value (the summation of existing leasehold interest and reversionary freehold interest, in column 2) constantly over the 180 cases examined in the 1992-93 land sale programme in Shanghai. This surplus becomes the marriage value of land.

As developers only need to compensate for freehold reversionary interest and leasehold interest, they are in effect receiving the marriage value as a bonus. While overseas developers were complaining of possible over-supply of land in the Shanghai land market, they were actually asking the Shanghai authority to release more land to them, because they saw potential profits in buying LURs as soon as possible under the current pricing system.<sup>13</sup>

Hence, it is obvious that the deviation of market land price behaviour from the theoretical land value during the privatization of LURs has cost China dearly. This problem of mixed 'market/planned' operation has haunted the overall economic reforms in China for a long time, as Prybyla (1990) succinctly comments:

. . . the trouble is that after ten years of policy and structural changes the Chinese system is not a market system, nor is it any longer a coherent centrally planned system either . . . the economy is not a market economy but a dismantled planned economy with uncoordinated unlinked and imperfect markets here and there for individual . . . one can question the effectiveness of administrative levers to deal with problems that are partly administrative in origin, partly market-related, and partly due to the incompleteness of markets and administrative command and the uncomfortable coexistence of the two . . .<sup>14</sup>

We are therefore examining the performance of a privatization programme in a major sector of this transitional economy from a political-economic view. The focus of this view is the recognition that the government's political and ideological perceptions of the need for reform, and its ability to take the necessary measures, can influence the package of policy measures that are undertaken<sup>15</sup> far more critically than can market activities themselves.

In a transitional economy, especially one entering into a market socialism



instead of a completely open market system, political and ideological preferences always take priority over actual economic consequences. This phenomenon has been noted by Shirk (1993):

. . . as a consequence, the Chinese processed economic reforms through the old decision-making channels . . . A reform package that is politically logical is not necessarily economically logical . . .

Shirk further comments that:

. . . the lesson of the Chinese case is that in some varieties of communism, it is possible to move from a command economy to market competition without changing the political rules of the game. Communist rule in and of itself is not an insuperable obstacle to economic transformation . . . The decision to create a two-track economy during a protracted period of transition may have been economically less optimal than a comprehensive package of reforms, but as a second-best approach it had positive economic consequences . . .<sup>16</sup>

A gradual approach to reform is also supported by other researchers on China's real estate market.<sup>17</sup> Uncontrolled rocketing market prices is always a major problem in the privatization of the socialist economies.<sup>18</sup> The Chinese approach of selective privatization of LURs has created a very active land market without pushing market price of LURs to an uncontrollably high level when there is an acute under-supply of land for uses such as office and high class residential housing. As explained in chapter 2, the primary land market is monopolized by the state and there are restrictions on the transfer of LURs among private developers.<sup>19</sup> Market land prices are therefore more or less under the control of the existing conveyance mechanism.

The Chinese approach pushes the market demand higher and thus speeds up market activities, as noticed by the growing number of LUR transactions in these few years, without creating an excessively high land price market but at the expense of losing the marriage value of the land to the developers. This is why most researchers observe that at the beginning of the LUR reforms, real estate developers gained substantial profit by not having to pay the full residual land value for the land use rights in China.<sup>20</sup> However, this was ideologically acceptable to the authority as land value had never been clearly defined before the land use rights reforms.

In addition, charging of rent-in-kind instead of full land price based on residual land value has also advantaged local authorities. In land-revenue-sharing negotiations the central government is in principle entitled to 40% of land sale revenue. Hence, the higher the conveyance price of LURs, the larger the share

to be taken by the State Treasury. Another example of this profit-sharing issue is that at the beginning of the reforms, local governments charged land users an annual land use fee as an experimental land rent. The central government subsequently changed the term 'land use fee' to 'land use tax' so that it could take a share.

There is no hurry for the privatization programme in China to be completely 'marketized' while ideologically the Chinese emphasize their 'market system with Chinese socialist characteristics'. Lichtenstein (1983) comments that:

... the best theory will ... rarely succeed in completely supplanting its competitors, largely because the criteria for a 'good' or 'bad' economic theory are rather vague ... many people often subscribe to theories not because they are 'scientifically' valid, but because theories somehow appeal to their personal feelings and sense of what is just. These feelings and senses are themselves rooted in popular ideologies ... a theory may continue to be accepted even if it can be proved false, for proving a theory incorrect may threaten people's loyalties ...<sup>21</sup>

If this is the case, residual land value can only be a goal at which the privatization programme of LURs should eventually aim when the overall economic environment is ready for genuine market prices to be realized not only for land but all kinds of commodities as well as factors of production.

For the privatization of LURs in China to completely match the nature of residual land value at the present stage, the political price would be very great. To allow such a total market mechanism to work in the property market, the housing market needs to be overhauled. However, wage and rent in socialist economies have always had a very special relationship due to their social implications which will have to be considered if housing rent is to be privatized.<sup>22</sup>

Without corresponding privatization in other sectors of the economy, the land market itself will continue to suffer incompleteness. The land privatization process in the transitional economy has always been taken as an isolated programme. The Chinese saying, 'heal the head when there is headache' is the common approach to the various price reforms in China. For instance, the Land Management Law was introduced early in 1990, while the draft of the real estate law was only finished by mid-1994. In addition, a multi-headed bureaucratic structure (i.e. State Land Administration and Ministry of Construction) concerned with the market mechanism of land and properties has made coherence between the land and property markets impossible.<sup>23</sup>

It is believed that land price behaviour as analysed in this book, although irrational according to western market standards, does not arise out of ignorance



of market phenomena but out of political compromise in the short term during the transition. Schumpeter (1950) comments that:

A system — any system, economic or other — that at every given point of time fully utilizes its possibilities to the best advantage may yet in the long run be inferior to a system that does so at no given point of time, because the latter's failure to do so may be a condition for the level or speed of long-run performance.<sup>24</sup>

China's experience in privatizing LURs is successful in the sense that a very active land market has been created, not only in Shanghai but also in most of the open and coastal cities. It is a market by normal standards as there is open transaction and entry is basically unlimited. The sale of LURs does not make the market any less comprehensible than land markets in the capitalist system where freehold interests are sold.

The privatization of LURs on the other hand is not totally successful because a mixed 'market/planned' mechanism has been created in which the pricing model continues to follow the mainline ideology of the official view rather than the market view. In the transitional period, however, this may be a better option than realising a full market price since other pricing systems that have implications for the land market may not be ready to coordinate with such a development.

Having examined the land price behaviour of the transitional market in Shanghai, what are the lessons we can draw for other land markets in the open coastal cities in China? The first and most important implication noticed is the consequences of the distortion of the true nature of land value. In the short run, the production-cost-function of land price behaviour may have the advantage of being easy to follow, especially by local officials who have no experience in the property market. However, if the open door policy continues, it will be realized that private developers are obtaining high profits that should have been reaped by the landowner. One remedy is for more administrative controls in the market such as the levy of capital gains tax, but at the risk of more confusion in the market such as noted in the disagreement between central and local governments.

The problems created by misconception about the nature of land value are complicated by the traditional separate management of land and built-structure. The break in the linkage of the land and property markets must be bridged at the local level where implementation of land policies occurs by a much more integrated government structure. Future land sale programmes should be coordinated with local forecasts of demand for various types of properties, as this demand element determines to a great extent the residual land value affordable by the land users. This has further implications on the need for

more comprehensive local housing reform which has lagged behind land market reform substantially.

Finally, the analysis set out herein ironically provides real estate developers with a model for analysing the extent of marriage value they can reap from a transitional land market. As long as local governments price LURs on a cost function model, a developer can focus only on the property market, which determines the actual residual land value. A consequence of this is substantial land banking activities by developers. The earlier developers can enter the land market and the more they can purchase, the greater the marriage value they can realize in future. In Shanghai some major developers from Hong Kong are buying up street after street. This will eventually limit the degree of competition in the market, a direct contrast to the objective of the privatization programme. The sooner China closes this loophole, the healthier the land market will be; and hence the more effective the selective privatization of land in China can be.

From the analysis of the empirical results, it can therefore be concluded that economic reforms in China's transitional economy have to compromise with social and political constraints despite the fact that market land price behaviour could possibly behave theoretically similar to the nature of residual land value. This is especially true in a sector such as the land market which has strong relationships with other micro-economic sectors, and where changes in this sector have complicated ramifications in the others.

It is therefore impractical for the transitional economy to have a market mechanism superimposed on individual sectors of the economy without first sorting out the interrelationships between the sectors. It is also immature to judge the privatization programme in the transitional economy from a pure market view point without noting the inevitable influence of existing ideologies. The Chinese approach of a selective merging of the two mechanisms in the course of the privatization of land use rights provides an alternative allowing the compromises to be made while creating an active land market *in the short run*. In the long run, however, if this mixed 'market/planned' mechanism continues to exist without an objective goal to match the theoretical market land price behaviour, the privatization programme will suffer the same problem as other economic reforms in the last decade that would please neither market players nor political doctrinaires.

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<sup>1</sup> Walker, Anthony (1991) *Land, Property and Construction in the People's Republic of China*. Hong Kong: Hong Kong University Press.

<sup>2</sup> For instance, Yeates, Maurice, H. (1965) 'Some Factors Affecting the Spatial Distribution of Chicago Land Values, 1910–1960,' *Economic Geography* 1965 Vol. 41

- pp. 57–70, and Hong, Ki-Yong (1990) *The Changes in the Price of Urban Residential Land in Korea: 1973–1987*, paper prepared for the Pacific Rim Council Development Conference, 1990, Hong Kong.
- <sup>3</sup> Walker, Anthony and Li, Ling-Hin (1994) 'Land Use Rights and the Real Estate Market in China,' *Journal of Real Estate Literature* pp. 199–214, Vol. 2, Number 2, 1994.
  - <sup>4</sup> Tolley, George S. (1991) *Urban Housing Reform in China: An Economic Analysis*. Washington, D.C.: The World Bank.
  - <sup>5</sup> Yeung, Yue-Man (1993) *Urban and Regional Development in China: Recent Transformation and Future Prospect*, Occasional Paper No. 22, Hong Kong Institute of Asia-Pacific of Hong Kong, The Chinese University of Hong Kong.
  - <sup>6</sup> 'Capital to China', *Hong Kong Research*, May 1993, Credit Lyonnais Securities.
  - <sup>7</sup> Tappan, W.T. (1993) *Handbook for the Financial Analysis of Real Estate Investments*, Chapter 4. New York: McGraw-Hill Inc.
  - <sup>8</sup> Shih, X.K. (1991) 'The Problem of Value Price in China's Urban Land' *Real Estate Appraisal* June, 1991 (in Chinese).
  - <sup>9</sup> Zhou, X.C. (1992) 'The Theoretical & Psychological Obstacles to Market-oriented Reform in China,' in Kovacs, J.M. & Marton, T. (eds) (1992) *Reform & Transformation in Eastern Europe*, page 207, London: Routledge.
  - <sup>10</sup> Ishihara, Ko, Chang, Q., Ho, L.S. and Kao, Charng (eds.) (1993) *The Long Term Prospects of the Chinese Economies*. Tokyo: Institute of Developing Economies.
  - <sup>11</sup> Reversionary interest in valuation terminology means the value of the freehold interest when the landlord gets back the land with vacant possession so that he can either lease the land at open market rent or sell it for a price reflecting the vacant possession.
  - <sup>12</sup> For instance, see Baum, Andrew and Mackimn, David (1989) *The Income Approach to Property Valuation*. London: Routledge.
  - <sup>13</sup> Zhang, Chong-Guang (1993) 'Forecast of Shanghai's Real Estate Market,' *Shanghai Land*, pp. 9–13, Issue 4, 1993. Shanghai: Shanghai State Land Administration Bureau (in Chinese).
  - <sup>14</sup> Prybyla, Jan S. (1990) *Reform in China and Other Socialist Economies*, page 184. Washington, D.C.: The AEI Press.
  - <sup>15</sup> Krueger, Anne O. (1993) *Political Economy of Policy Reform in Developing Countries*. Cambridge, MA.: MIT Press.
  - <sup>16</sup> Shirk, Susan L. (1993) *The Political Logic of Economic Reform in China*, Chapter 14. Berkeley: University of California Press.
  - <sup>17</sup> For instance, Dowall, David E. (1993) 'Establishing Urban Land Markets in the People's Republic of China,' *Journal of the American Planning Association*, Vol. 59, No. 2 Spring 1993.
  - <sup>18</sup> Corbo, Vittorio; Coricelli, Fabrizio and Bossak, Jan (1991) (eds.) *Reforming Central and Eastern European Economies: Initial Results and Challenges*. Washington, D.C.: The World Bank.
  - <sup>19</sup> One of the major restrictions is that 25% of the total investment must have been spent on the development before transfer is allowed.

- <sup>20</sup> Yeung, Yue-Man (1993) *Urban and Regional Development: Recent Transformation and Future Prospect*, *ibid*.
- <sup>21</sup> Lichtenstein, Peter M. (1983) *An Introduction to Post-Keynesian and Marxian Theories of Value and Price*, page 3. New York: Sharpe.
- <sup>22</sup> Tolley, George S. (1991) *Urban Housing Reform in China: An Economic Analysis*. Washington D.C.: The World Bank.
- <sup>23</sup> For instance, a recent and unusual political dispute arises as the local people's congress in Guangdong Province accuses the Guangdong State Land Administration Bureau of failure to implement a single registration system of property rights.
- <sup>24</sup> Schumpeter, Joseph A. (1950) *Capitalism, Socialism and Democracy*, page 83. New York: Harper & Row.

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