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Visible Hand or Crippled Hand: Stimulation and Stabilization in China's Real Estate Markets, 2008-2010

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Visible Hand or Crippled Hand: Stimulation and Stabilization in China's Real Estate Markets, 2008-2010[1]

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1. Introduction

The burst of housing bubbles in 2008 triggered the worst economic crisis in the United States since the great depression. Financial globalization has exacerbated the contagion and a worldwide recession soon followed. As one major trading country, China depended heavily on export markets in the United States and Europe therefore its economy experienced serious setbacks. After the double digit growth in 2007, the Chinese real estate market started to take a nose dive. In the first quarter of 2008, the average house price in 70 major cities grew 11% but by the fourth quarter the growth rate slowed down to only 0.5%. The first quarter of 2009 even saw a growth rate of -1.1%. For the first time since 2000, house prices in China actually dropped. The parallel between these two countries, however, stopped there. While the American housing market continued to be sluggish after a steep decline, the housing market in China rebounded in a very dramatic fashion. After two consecutive quarters of negative growth, house prices began to rise again in the third quarter of 2009 and double digit growth reappeared by the first half of 2010. In April 2010, for example, the average house price grew by 12.8%, the fastest rise since 2000! The national average actually understated the extent of price hikes and some hottest real estate markets registered even more impressive figures, e.g. Shenzhen (18%), Hangzhou (17%), Wenzhou (22%), Haikou (53%), and Sanya (52%). Land was a mirror image of the housing sector. After the record high of 16.5% in the first quarter of 2008, the growth rate of land price plunged to only 1.5% in the first quarter of 2009 before climbing up to a new record of 21.2% one year later.

This "V" shaped recovery has certainly benefited from the stimulus package introduced in the fall of 2008. To avert a severe economic slowdown, the government pledged to increase fiscal spending by 4 trillion yuan in two years. In addition, the central bank also loosened credit policy and, as a result, about 10 trillion extra loans were issued in 2009 and another 4.6 trillion in the first half of 2010. With this extra fluidity, real estate prices should be expected to go up. While certainly valid, the power of this explanation should not be overrated. China's stock market, another sector that tends to rise with inflationary expectation, is still about a third of its peak in 2007. Something about the real estate sector must have attracted investors. Close examination of this recovery episode does raise some interesting questions. There is no doubt that the central government intended to raise real estate prices and believed that the stimulus should stabilize the market. By the fourth quarter of 2009, top officials acknowledged that the real estate market was apparently over-stimulated and price increases were on the verge of exceeding the pre-crisis levels, which were definitely not stable or sustainable. The central government quickly stepped the brake and reversed the course. Starting from December 2009, a series of tough measures were adopted to rein in the runaway prices, including no business tax exemption on house transactions within five years (instead of two previously) of purchase, 50% of land lease fees upfront and full payment within a year for developers, 40% down payment for second-home buyers, 70% of residential land supplies for affordable housing, and forced withdrawal of 78 large state companies from real estate businesses. House and land prices continued to climb in the first quarter of 2010. In desperation, the central government tightened the noose further by requiring 50% down payment for second-home buyers and stopping loans to third-home buyers all together in some cities. In addition, provincial governors were held personally responsible for price controls in their jurisdictions. In the following two months (May and June), house prices kept rising in double digits. Signs of slowing down finally emerged in the market but rumors about possible termination of price controls were already being spread in the media, which made the future direction of the market still uncertain.

Why did the central stimulus policy accomplish its goal almost immediately and even over-stimulate the market? Why, on the other hand, did its price stabilization policy fail to achieve the target several months after the initiation? This paper argues that, to understand this asymmetry in policy effectiveness, we need to analyze the incentive structure of the central and local governments in China. Massive industrialization and urbanization in the past few decades have turned real estate businesses into a major pillar of the Chinese economy. The Central government, local governments, banks, and real estate developers have forged a coalition and shared the common interest in keeping the sector growing. Local governments, in particular, are heavily indebted to this sector for GDP growth, job opportunities, and most importantly fiscal revenues to finance government functions. Land lease fees and taxes directly from real estate businesses have contributed handsomely to local coffers. The central government, on the other hand, does not collect a lot of revenues from this sector directly. Therefore local governments have stronger financial incentive than the center to engineer an ever-expanding real estate industry. When the center green-lighted economic stimulation, local governments rushed to implement the central policies to the fullest extent. Many regions even improvised local rules to provide further stimulation. The center's price control measures, on the other hand, went against local governments' financial incentive. Local officials dragged their feet drafting local implementation plans and some even actively sabotaged the central policies. As a result, local governments have become amplifiers or dampers of the center depending on their interest alignment with the latter.

This analysis has a few theoretical and policy implications. China's central-local relations have been the subject of intensive debates among political economists (Goodman and Segal, 1994; Huang, 1996; Yang and Naughton, 2004; Li, 1998; Wong, 2009). While some scholars believe that local governments have acquired enough power to bypass central control, others argue that the central government has adapted to new conditions and regained an upper hand. Our analysis of the real estate stimulus policy in 2008-2010 suggests that extreme views on both sides oversimplify the reality. Totally runaway local governments cannot be tolerated in an authoritarian state but local officials have indeed secured some autonomy. The central-local relation is like that of the wrist and fingers. The center may keep a tight wrist to control the general direction but, like fingers, local governments can still maintain certain wiggle room. In a large and centralized country, this equilibrium is hard to break because the central government must rely on its agents, i.e. local governments, to collect information and implement policies (Su, 2002). What kind of information is being passed upward and how policy is being selectively implemented will determine the content as well as the final impact of public policies. Instead of one side controlling the other, this mutual accommodation and negotiation are likely to persist in China's central-local relations.

Earlier scholarship has paid ample attention to the financial motivation of local governments in driving China's economic growth (Blanchard and Shleifer, 2001; Oi, 1993: Montinola, Qian, and Weingast, 1995; Jin, Qian, and Weingast, 2005). This paper amends this literature in two folds. First, these scholars have focused too narrowly on budgetary incomes of local governments. For the most part of 1980s, it was extra-budgetary revenues that gave local officials the incentive to promote growth. State and collective ownership provided institutional support for the expansion of the extra-budgetary account. Second, this narrow focus cannot explain local officials' strong urge for growth after the fiscal recentralization in 1994. We argue that changes in the central-local fiscal arrangement and the state-business relation in the early 1990s limited the ability of local governments to collect incomes. To keep up with their rising expenditures, local governments turned to land and real estate development for revenues. Taking advantage of the de facto monopoly of land supply in their jurisdictions, local governments leased land cheaply to manufacturers while demanded high prices from real estate developers. Through "managing" land and urban development, local governments have maximized not only land lease fees but also formal tax revenues. In short, our analysis of local governments' financial incentive transcends the narrow focus of the earlier literature and provides a logical explanation of local officials' behavior both before 1994 and in recent years.

These two theoretical angles have direct policy implications for the development of a healthy real estate sector in China. For obvious reasons, the Chinese government has frequently intervened in the land and housing markets. While scholars and policy makers have been debating the merit of the "visible hand", the biggest problem in China is that the "visible hand" constantly fights itself. The wrist and fingers are not always working in the same direction. This indecisiveness creates more uncertainty in the market and encourages speculation. To boost the market's long-term health, the government may need to refrain from too much and too eager intervention and let the "invisible hand" do its trick of stabilizing the market expectation. To make this possible, local governments' heavy dependence on revenues from real estate businesses must be adjusted. They should no longer be the only suppliers of land in the local markets. Collectives or individuals should be given the power to transact land on their own. As discussed fully in the conclusion, some financial instruments also need to be introduced so local governments' financial interest is guaranteed.

The rest of the paper proceeds as follows. In section 2, we explain the root of local governments' financial interest in land and housing development. To do so, we critically survey one popular literature about local developmentalism and propose our alternative perspective. The following section focuses on land and real estate development and traces their different impacts on central and local finances. Then, we illustrate this central-local divergence logic with a case study of the stimulus policy between 2008 and 2010. The final part concludes with some discussions about possible reforms in the future.

2. Central-local Fiscal Relations and Land Developmentalism: an alternative view

Before discussing local governments' financial ties to the real estate sector, it is useful to revisit the 1980s and 1990s and examine how local governments' financial incentive has evolved. In this regard, the popular fiscal federalism argument should be a good starting point because its analysis is based on an assumption about local financial interests. According to these scholars, local governments promoted economic growth for two reasons. Fiscal contracts regulating central-local budgetary incomes incentivized local officials. Collecting more revenues enabled them to save more for local spending. In addition, factor mobility forced local governments into fierce competition and better protection of property rights. Neither argument, however, accurately describes Chinese political economy in the 1980s (Tsui and Wang, 2004; Yang, 2006; Cai and Treisman, 2007). We echo these observations but contend that the Chinese economy since the second half of the 1990s does bear the factor mobility argument out. To illustrate this point, we interpret China's local developmentalism from a broader institutional framework. Many scholars have emphasized the central-local fiscal dimension. While important, state-business relations must be examined as well to explain local officials' behavior. Combining these two angles, we can break down regional economics into two stages.

2.1. Protectionist local development

The first stage started in the early 1980s and gradually ended with the introduction of the tax-sharing system in 1994. During this period local governments actively promoted economic development. In the wake of the Cultural Revolution disaster, the Party elevated economic construction to the top of its agenda. It was well understood that economic revival hinged on local initiatives. Local officials were entrusted with more economic decision-making power, including the control over local public finance. With intimate knowledge about local conditions, they could make better decisions and invest public money wisely. This economic and fiscal decentralization created powerful incentives among local governments to develop economies. An "eating in separate kitchens" system was introduced, whereby local governments gained certain rights over the surplus revenues (Oi, 1992; Bahl, 2000). But this fiscal contract was unlikely to be one major factor behind local developmentalism. The contract lacked credibility and the central government had the power to revise the clauses afterwards. Between 1980 and 1994, the central government made several major adjustments (Wong *et al.*, 1995)[2]. In each case, the central government was alarmed by the increasing share of local governments and tried to grab a large piece of the growing revenues. This significantly undermined the effectiveness of the contract.

The existence of extra-budgetary accounts had larger impacts on local governments' incentive for growth. Since the formal budgetary contracts could not be trusted, local officials used extra-budgetary accounts to hide revenues from the center (Tsai, 2004). Government-business relations facilitated this diversion. Despite the dramatic success of private farming in the rural area, China's industrial success in the 1980s was really engineered by local states. For example, State Owned Enterprises (SOEs) controlled by provincial and municipal governments alone accounted for eighty percent of the total industrial outputs at or above the township level by 1985 (Qian and Xu, 1993). Even eight years later, private enterprises contributed to less than fifteen percent of the national industrial outputs (Qian, 1999). The status of Township and Village Enterprises (TVEs) was somewhat ambiguous, but they were mostly funded and operated by township governments and village collectives (Naughton, 1996). Local officials at various levels invested government resources into these public enterprises. They also utilized their power and pressured local bank branches to grant loans (Park and Shen, 2002;).[3] This symbiosis, from a revenue perspective, allowed local officials to avoid central predation. Local control of all taxation bureaus provided further convenience. As owners, local governments collaborated with "their" enterprises to inflate production costs and deductions. As enterprise profits dropped, local governments had less to share with the center. These hidden resources stayed in the local enterprises or went to local extra-budgetary accounts (Ma, 1995; Tsui and Wang, 2004).

[2] There were at least three major changes in 1982-83, 1985, and 1988. For example, in the 1982-83 adjustment, local governments enjoyed a larger marginal share of the industrial and commercial tax, but the center was able to significantly raise the central fixed income. In the 1985 and 1988 reforms, the central fixed revenues were further raised.

[3] In the case of TVEs, some local governments went even further to explicitly guaranteed loans in lieu of collaterals for local enterprises, so that enterprises owned by the same local government (or collective) became jointly liable for loans to individual enterprises.

Being owners of public enterprises also shaped local governments' attitude toward private as well as non-local businesses. Given the pent up demand for consumer goods and cheap labor, industrial investments offered relatively guaranteed returns in the 1980s (Lin *et al*., 1999). Public enterprises under active state sponsorship preempted local private businesses. The latter faced high entry barriers and uncertainty (Qian,1999). At the same time, local governments intentionally closed local markets off to commodities from other areas by disconnecting inter-regional roads or ordering local businesses to buy local products only. Foreign direct investments, one major source of mobile capital, did not make much inroad into Chinese economies then. They were heavily concentrated in special economic zones. For example, between 1983 and 1992, Guangdong, Fujian, Beijing, Shanghai, and Tianjin hosted more than seventy percent of all FDIs in the country.[4]

2.2. Marketization and the new developmentalism

This protectionist development led to its own demise in the early 1990s. As local governments rushed to build their own enterprises, duplications created serious industrial over-capacity and the pressure for re-structuring mounted (Naughton, 1999; Young, 2000; Poncet, 2003). Local officials first reacted by erecting more local protections. This led to a vicious cycle and many public enterprises turned red. Gradual commercialization of banks further weakened local governments' ability to extend cheap credits and provide subsidies. The hemorrhage prompted a gradual but determined shift toward privatization and liberalization (Li *et al.*, 2000). By the end of 1996, seventy percent of small SOEs had been privatized or gone bankrupt in pioneering provinces and about half in other provinces (Cao *et al.*, 1999). In the second half of the 1990s, privatization gained momentum and about twenty-five million workers lost their jobs in SOEs and TVEs. This process was largely complete by the end of the decade (Qian, 2000). As a result, local governments transformed themselves from owners of public enterprises to tax collecting authorities.

The tax-sharing reform in 1994 further facilitated the demise of local state's pro-public enterprise bias. The reform was designed to arrest local governments' growing capacity to divert

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[4] Our calculation based on data from National Bureau of Statistics, various years. In the early 1980s, FDIs in Guangdong alone accounted for seventy percent of the total inflow.

and hide revenues. Universal taxes replaced ownership-defined profit or tax submissions. Regardless of their ownership, all enterprises had to pay similar taxes. The introduction of Value-added Tax (VAT), in particular, further undermined local governments' ownership preference. As a tax on exchanges, VAT was effective in preventing cheating and fraudulent accounting practices, something quite common between local governments and their enterprises in the past. The central government built a parallel taxation agency across the country, which answered directly to the central government. VAT was collected by the central taxation agency, further limiting the room for government-business collusion in local areas (Bahl, 1998; Wong and Bird, 2005; World Bank, 2002).

The tax sharing reform had fundamentally altered central-local fiscal relations. Before 1994, local share in total government revenues gradually increased. The new system assigned some major taxes to the central government, such as the consumption tax and customs duties. Among three major taxes (VAT, business tax, and enterprise income tax), VAT was classified as a shared tax but seventy-five percent went to the central government. Enterprise income tax was initially a local tax. As it ballooned, the center reclaimed fifty percent of it in 2002 and further increased its share to sixty percent in 2003.[5] Overall, the 1994 tax reform raised the central share in government revenues (World Bank, 2002). Local governments, on the other hand, found their share shrinking in the late 1990s and early 2000s. In addition to budgetary revenues, it became more difficult for local officials to divert revenues to extra-budgetary accounts. Their total resources could not keep up with the increasing financial obligations, including supporting retirees and laid-off workers from former SOEs and fulfilling various unfunded mandates from the center (Tsui and Wang, 2004).[6]

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[5] Business tax was assigned as a local tax. Other than this, tax bases for sub-national governments are mostly minor ones, such as urban maintenance and construction tax, vehicle purchasing tax, land use tax, , et al.

[6] In the late 1990s and early 2000s, sub-national governments accounted for more than seventy percent of total public expenditure, while collecting less than fifty percent of total government revenues. Social service spending was decentralized further down to the county level with the sub-provincial tiers financing seventy percent of social services, provincial and central governments making up the other twenty and ten percents, respectively (World Bank, 2002).

3. Land-based Developmentalism and Central-Local Interest Alignment

Because of the changes in central-local fiscal arrangement and in government-business relations, local governments could no longer profit from protecting local state enterprises and must welcome all sorts of businesses (state, private, local, and outside) and collect both budgetary and extra-budgetary incomes to make up for their financial shortfalls. Therefore, by the second half of the 1990s, the stage was set for a new kind of local developmentalism based on land.[7]

3.1. Local Financial Interest and Growth Coalition

Land becomes the basis for this new mode of growth because any development, such as a factory, an investment firm, a shopping mall, a restaurant, or an apartment building, must stand on a piece of land physically. But a more fundamental reason lies in China's unique land regulatory regime. After the communist revolution, the state nationalized land and in theory all land in China belongs to the abstract public. In reality, land ownership is highly fragmented and two groups of players exercise this right. Local governments are de facto owners of all urban land in their jurisdictions.[8] They can determine how land is used and collect revenues from leasing out land use rights on the market. Land in rural areas, on the other hand, is owned by collectives (mostly villages). Therefore, in each local jurisdiction, there are two parallel land ownership regimes. More important for our analysis, only local governments have the power of crossing this line and convert rural land for urban use. It is illegal and strictly forbidden for village collectives to directly lease land to urban users (Tao et al, 2010; Lin 2005).

For the planned period and most part of the 1980s, this duality land regime did not attract much of local governments' attention. Having this power was fine but, after requisitioning farmland from peasants, local governments could not do much but appropriate land to state land users with minimal fees. This changed in the early 1990s. Fiscal recentralization forced local governments to find every means to secure revenues. After state-owned enterprises were sold or declared

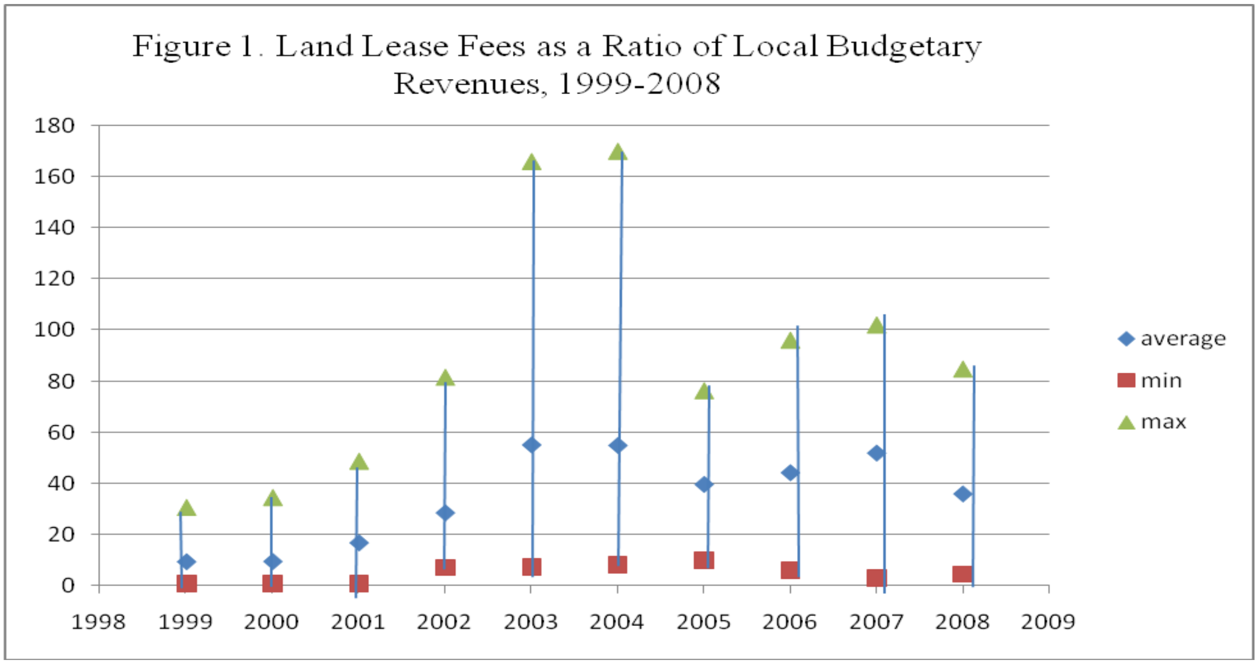
[7] In recent years, some scholars argue that local officials' career incentive has played a crucial role in regional development (Li and Zhou, 2005). More empirical testing is needed to verify this argument. We believe that political evaluation is endogenous to revenue adjustments. This analysis is developed further in a separate paper.
[8] Strictly speaking, the Land Administrative Law states that the State Council represents the state and should be the owner of all urban land. It did try to claim part of land lease revenues from local governments but failed.

bankruptcy, they must find other valuable assets. Moreover, in order to attract Hong Kong and Taiwanese investors to Shenzhen, China started to separate use right from ownership in 1987 and allowed local governments to lease land for fees. This essentially created a land use market and opened up tremendous opportunities for revenue-hungry local officials. As the de facto owners of urban land, local governments could sell land use rights to industrial investors for 50 years, businesses for 40 years, and residential housing for 70 years. What is more, when urban land was used up, they, and only these local officials, had the legal authority to convert farmland. Therefore, local revenues would grow with urbanization. Since then, requisitioning farmland, leasing land, and managing urban expansion have become the main business of China's local governments.

The land monopoly has enabled local governments to extract maximum amount of revenues by adopting different leasing strategies to industrial land users and business/residential land users. Partly because of the restructuring in the global economy and partly in response to China's further opening up policies, billions of foreign direct investments rushed ashore, mostly manufacturers. Regions started to compete for these investments. These manufacturers can bring job opportunities and GDP to their areas. For government revenues, these enterprises can pay a lot of value-added tax (VAT). In addition to this direct contribution, manufacturing usually spawns related services tending to the needs of workers, such as restaurants, shopping malls, and apartments, which contribute business tax to local governments. Therefore, from a revenue perspective, industrial capital is very desirable. But it is inherently footloose and manufacturers do not need to be in one particular location. To win this regional competition, local governments leased land at very low prices, even under-cost or zero prices in some areas. In the long run, VAT and business taxes should well compensate for the low land lease fees.

Business and residential land users, on the other hand, are location-specific and must be close to their customers to sell their products. Local governments used this leverage and their local monopoly to exact maximum rents from land leases. Given the limited land supply in a locality, business and residential land developers could easily pass the costs to local customers. In terms of revenues, regional governments reaped a large sum of land lease fees, which allowed them to subsidize land requisition and development for industrial land users. Cheap land attracted manufacturers, which provided a stable income of VAT. Factories boosted service businesses and housing markets, which paid business taxes and high land lease fees. Utilizing prefecture-level data, Tao et al. (2010) have shown that land leases and taxes did go hand in hand as predicted by this analysis. Of course, the key to this "virtuous" cycle was local governments' monopolistic control over land. Many cities have set up "land storage centers" to manage land supplies in their areas. Backed by the handsome land lease fees, local governments rushed to build more and more industrial parks and development zones. By the end of 2003, the total number of industrial zones had reached 3,837. By three years later, the figure jumped further to 6,015, averaging three industrial parks per county! (Zhai and Xiang, 2007).

While it is obvious that local governments have benefited tremendously from land and real estate development, a full assessment of their financial ties to this sector is difficult. Nevertheless, we present two types of evidence to illustrate the connection. Figure 1 calculates the ratio of land lease fees and local budgetary revenues. Land lease fees are part of local extra-budgetary therefore this ratio does not have any substantial meaning. But government budgetary revenues are generally a good benchmark for comparison. The basic unit is province. For each year, an average, the minimum, and the maximum are reported. There are a few interesting patterns. In the late 1990s, the ratio stays about 10% but climbs to the all time high of 55% in just four years. It then stabilizes in the 40-50% range. For revenue-starved local governments, these incomes are indeed quite substantial. Since the provincial budgetary revenues used for this calculation include both provincial-level and sub-provincial-level incomes and provincial-level governments usually do not lease land, even these high figures are understating the importance of land lease fees. As the maximum and minimum ticks show, there are also extremely wide variations. In 2003, land lease fees in Zhejiang exceeded its budgetary income by 65% and Tianjin in 2004 set the new record of 70% increase! Some provinces are constantly ranked high in terms of land dependency, including Zhejiang, Jiangsu, Anhui, Fujian, Sichuan, and Chongqing. Some regions, such as Qinghai, Gansu, and Inner Mongolia, do not derive much from land development. If we break down to city and county levels, the variation may be even larger. But it is fair to say that in China's most economically vibrant areas, land lease fees have provided an important source of revenue to local governments.



Source: China Statistical Yearbook (www.stats.gov.cn) and China Land and Resources Statistical Yearbook, various years.

As discussed earlier, local governments also derive revenues directly from various taxes on land and housing transactions. House asset tax and contract tax are levied specifically on houses and the transactions. Urban land use tax, land value added tax, and farmland occupation tax are based on land use and transfers. Table 1 tabulates these taxes for all local governments and the last column calculates the ratio in the total tax revenues collected by local governments (excluding shared revenues with the central government). As expected, all categories of taxes have increased quite substantially, especially land value added tax and contract tax. As a result, the share of taxes directly related to land and houses has doubled in a decade. In comparison, VAT, a tax levied on all manufacturing businesses, constitute only about 20% of local tax revenues. Like land lease fees above, these percentages have certainly underestimated the importance of the sector. Real estate developers are usually large contributors of business taxes in cities. House sellers also need to pay a 5% business tax if they sell houses within 5 years (sometimes 2 years) of purchase. Since business tax is the largest item on local governments' income list (about 30% of total taxes), financial contributions by the real estate sector should be much larger.

Table 1. Local Government Taxes Directly Related to Land and Real Estate, 2000-2008

Year	House Asset Tax	Urban Land Use Tax	Land Value Added Tax	Farmland Occupation Tax	Contract Tax	Share in total tax revenues
2000	2,093,819	647,648	83,936	353,160	1,310,811	8%
2001	2,284,249	661,542	103,296	383,340	1,570,772	7.25%
2002	2,823,827	768,328	205,104	573,390	2,390,709	9.26%
2003	3,238,610	915,681	372,812	898,968	3,580,454	10.9%
2004	3,663,167	1,062,260	750,391	1,200,850	5,401,041	11.8%
2005	4,359,577	1,373,444	1,403,140	1,418,490	7,351,400	13.0%
2006	5,148,467	1,768,092	2,314,724	1,711,174	8,676,745	13.4%
2007	5,754,590	3,854,863	4,030,975	1,850,376	12,062,460	14.3%
2008	6,803,359	8,168,960	5,374,329	3,144,075	13,075.394	15.7%

Source: China Statistical Yearbook (www.stats.gov.cn).

This financial tie has forged a strong growth coalition in China's local landscape. Local governments, real estate developers, and banks share the common goal of expanding cities: lure more enterprises to settle in industrial parks, lay down cleaner and faster transportation networks, build bigger and luxurious apartments, erect ever grandeur shopping centers, and so on. Local governments reaped in handsome land lease fees as well as bloating taxes. Officials basked in the praises of their "achievements" showered from media and their superiors. Real estate developers paid higher fees to the government, but with limited land supply, they could rest assured to pass the cost to consumers and rake in huge profits. Finally, banks provided the crucial capital to turn the wheels around. Real estate developers needed loans to purchase land and develop properties and consumers depended on banks for financing their homes. Local governments also sponsored many city development and investment corporations for infrastructure constructions. With government guarantee and cheap land, these companies were darlings of local banks and massive loans further fueled the development craze. These three players worked in sync and turned this into a major urbanization movement. In many cities, local officials were found to rob peasants of their farmland with dirt cheap compensations, grab farmers' residential land, demolish urban houses to make way for subways or luxurious condos, and even beat up or arrest people who protest or refuse to accept these changes under the excuse of "disrupting social order". Once the site was clear, developers and banks stepped in to make the transformation. Real estate developers and local officials have developed such cozy relations that almost all major corruption cases in recent years had the specter of real estate.

3.2. The Central Government: Growth and Equity

In many ways, the central government belongs to this growth coalition as well and oversees tens of thousands of local coalitions across the country. When China abandoned the revolutionary path spearheaded by Mao, the regime legitimacy really hinged on the state's ability to fulfill its promise of a better life for the citizens. Since the economic reform in 1978, high economic growth has improved peoples' living standards and boosted the state's popularity. One key engine behind this miracle was exports to the United States and other developed countries. While the Chinese leaders were fully committed to this development strategy and actively pursued WTO membership, they were fully aware of the vulnerability of too much dependence on the world market. The top leadership tried hard to stimulate domestic consumption and oil another engine to sustain China's growth. During the 1997-98 Asian financial crisis, real estate provided strong stimulus and cushioned the Chinese economy from the downward pressure from outside markets. This convinced the leaders to further liberalize the housing market in 1998 in hope of releasing tremendous demand for housing.[9] Since then, real estate has experienced rapid development and was formally recognized as a national pillar industry by the State Council in 2003.[10] It became a common phenomenon in recent years that central leaders praised the real estate sector for driving growth in about 100 other industries, such as steel, cement, glass, machinery, home electronics, furniture, transportation, etc.

Among many central bureaucracies, the Ministry of Land and Resources (MLR) and the Ministry of Housing and Urban-Rural Development (MOHURD) bear the most direct responsibility of overseeing the development of real estate. MLR is in charge of planning land use and enforcing the regulations. Since 1997, it introduced micro management and specified quantitative land use

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[9] 1998 年国务院颁布《关于进一步深化城镇住房制度改革，加快住房建设的通知》

[10] 2003 国务院关于促进房地产市场持续健康发展的通知 国发〔２００３〕１８号

quotas for each locality. MOHURD on the other hand regulates building standards and overall urban planning. In recent years, it got more actively involved in securing affordable housing to middle and low income family through regulations and public financing instruments. Both ministries have strong incentive to steer a booming real estate sector. Higher growth expands their regulatory power and enhances their standing among the peers in the central government. Not surprisingly, the officials frequently consult real estate developers, many of which are state-owned, on policy matters and present these views to the top policy-makers. While MLR and MOHURD enjoy certain degree of freedom and have certain bias favoring the developers, as administrative arms of the State Council, MLR and MOHURD should also implement policies made by the top leadership.

For the central government as a whole, even though developing real estate has positive impact on the economy, its direct financial contribution to the central budget is really slim. A quick glimpse of the itemized tax incomes of both central and local governments makes this apparent. In 2008, about 90% of central taxes come from VAT, sales tax, enterprise income tax, personal income tax, and tariffs.[11] Under the current fiscal regime, all major taxes directly related to real estate, like housing asset tax, contract tax, land value-added tax, are assigned to local governments. More important, in designing policies, the central government must transcend narrow financial returns and factor in political considerations. In a modern society, housing has become a basic human right and governments shoulder the responsibility of providing all citizens with decent and affordable living space. No matter how fast the real estate markets grow, if the result is highly unequal and a large number of people are left out, it may jeopardize the social harmony and trigger a legitimacy crisis. The Chinese leaders must tread the water carefully and do not alienate large segments of its population, especially the middle class. Local officials, on the other hand, derive their legitimacy from central appointment and are less concerned about public opinion. There is another sort of political risk associated with real estate. If housing development gets out of control, speculation will bid up asset prices, which drive more construction. At some point, the bubble will burst and a systematic crisis occurs. Economic crisis tends to spawn political one. The central leadership is more cautious about the long-term health of the sector.

[11] China Statistical Yearbook (available online at www.stats.gov.cn).

Local governments, like players trapped in a prisoners' dilemma situation, keep building up and expanding credits in the local markets, hoping to externalize the risk.

In sum, both the central and local governments have forged ties with the real estate sector. But local governments' tie is deepened by hundreds of billions of revenues directly drawn from this sector. The central government's bias is mitigated by its concern about equity and a systematic crisis.

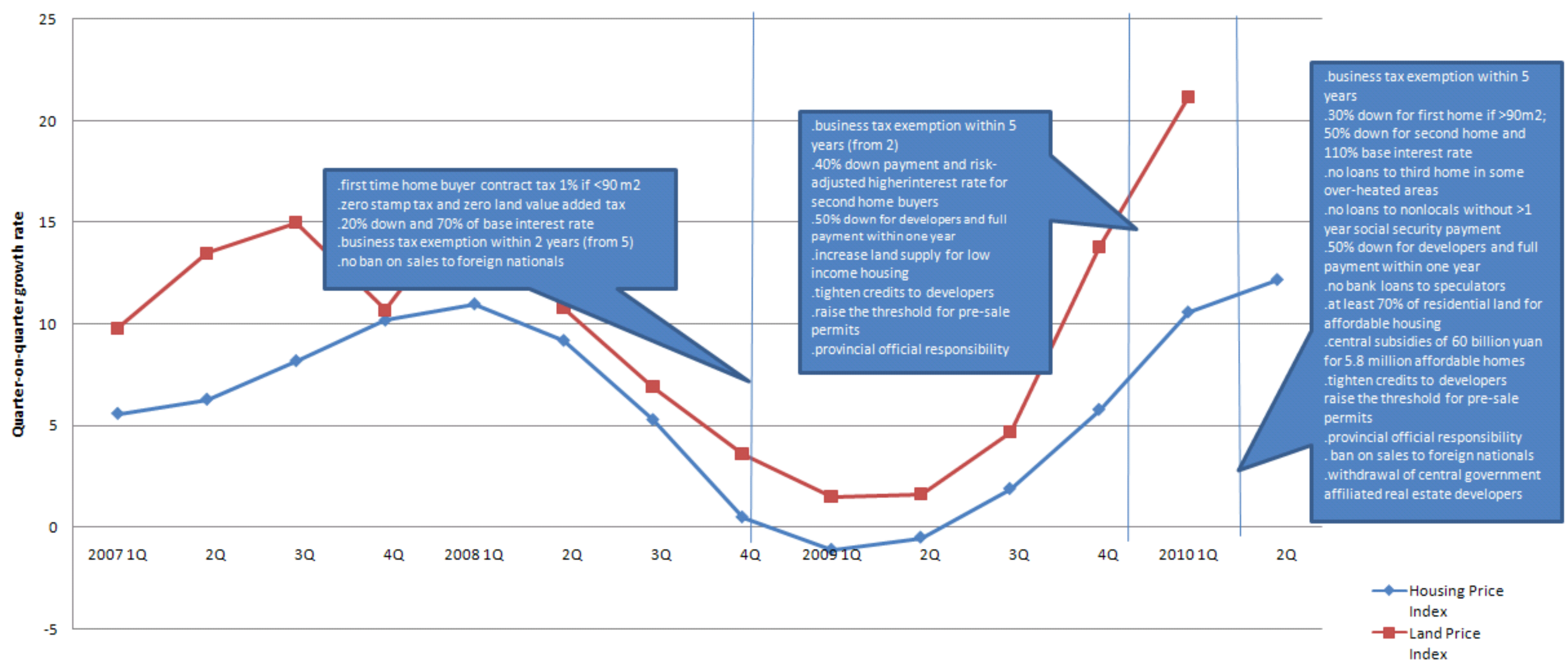
4. Crippled Hand in Action: Government Intervention during the Financial Crisis 2008-2010

This growth coalition has supported the spectacular growth of China's real estate sector in the past decade. Since 2003, the government had been battling the constant pressure for double-digit growth and introduced some tough measures in 2006 and 2007. In the second quarter of 2008, it seemed that growth rate was being brought down again. Then the worldwide recession triggered by the American housing bubbles sent a chill to the Chinese market and, for the time since the housing reform, prices actually stopped growing! It unleashed the largest government intervention in recent years. The implementation of the stimulus and the adjustment afterwards provides an excellent case to illustrate the analysis developed above.

4.1. Interest alignment and over-stimulation, fall 2008-December 2009

While the recession impacted Chinese economy as a whole, its shock to China's real estate markets was particularly severe. The burst of the American housing bubbles triggered the near meltdown of its financial system. For a long time, many Chinese consumers and investors believed that house prices would never go down and it was the safest investment tool. The American crisis reminded people that bubbles could develop if investors are misguided and, like any market, real estate was full of risk as well. This hesitation contributed to the ten percentage drop in growth rate from the first quarter to the fourth quarter in 2008. The central government was under pressure to come up with some policy responses. Real estate developers and local government started to lobby MLR and MOHURT to remove various restrictions imposed in

Figure 2. Land and Housing Price Indexes under Stimulus and Adjustment, 2008-2010



2006 and 2007. For the top leaders, the biggest challenge was to maintain reasonably high growth rate. The most important engine, i.e. exports, seemed to be in deep trouble. After 19.2% growth in the first ten months, Chinese exports dropped by 2.2% in November.[12] All signs indicated that a quick rebound in the export market was not very likely. In reality, Chinese exports dropped by 21% in the first half of 2009.[13] If domestic consumption did not pick up the slack, the growth target set by the central government would be in jeopardy. The central government did not have much option but to help the industry. As an indication of the leadership's eagerness, even before the announcement of the 4 trillion fiscal stimuli in November, a large stimulus package was rolled out.

In October 2008, the Ministry of Finance, State Taxation Bureau, and People's Bank of China issued notices that offered tax and interest rate incentives specifically to the real estate sector on the same day.[14] As hoped by the developers, it scrapped restraining policies adopted in the previous two years and lowered the costs for home buyers. For first time home buyers, if the house was smaller than 90 m2, the contract tax would be 1% instead of the normal rate of 3%. House sellers were exempt from stamp tax and land value added tax. In terms of mortgages, the differential policy, i.e. 30% down for houses larger than 90m2 and 40% for second home and 110% base interest rate, was unified to 20% down payment with 70% base interest rate. For applicants for the more restrictive Housing Public Cumulative Fund (HPCF) loans, the interest rate was dropped by 0.27 percentage point on top of the already low rate (usually 2 percentage point lower than the commercial bank rate). Finally, if home owners chose to sell their houses after two years of their purchase, they were exempt from the business tax. To qualify in the past, home owners must wait for five years.

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[12] Data from the official website of the General Administration of Customs (www.customs.gov.cn).

[13] Ibid.

[14] The full texts are available at http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/caizhengbuwengao2008/caizhengwengao2008dishiqi/200901/t20090116_108793.html.

Clearly this stimulus was popular among developers.[15] Investors and home owners may also like the sense of stability injected into the market. Many potential home buyers who were deterred by high prices in the past and actually hoped for a drastic price reduction to improve their living conditions, did not welcome this. According to an online survey conducted by the official Xinhua news agency, 90% who responded did not want government support and 78% believed that real estate developers were the ultimate beneficiaries.[16] While this was certainly true, local governments were also strong instigators for and beneficiaries of the stimulus policy. Even before the central policy, some local officials had taken matters into their hands and introduced local stimuli. Not surprisingly, when the center took the first step, local governments rolled out even stronger incentives on the excuse that real estate in their areas was particularly hard hit.

Table 2. Extra Stimulus Policies in Some Cities

Cities	Stimulus Policies
Hangzhou	Home buyers awarded Hukou in the old city district; tax subsidies; extension of land development period for developers.
Shanghai	Increasing the Housing Public Cumulative Fund (HPCF)loan limit to 600,000 for families with two incomes.
Nanjing	Housing subsidies: 1% for <90 m2 and 0.5% for > 90 m2.
Suqian	Government subsidies between 0.5% and 7% for purchases between Nov 2008 and end of 2010.
Shijianzhuang	1.5% contract tax for general housing; Housing Public Cumulative Fund (HPCF) upper limit raised to 400,000.
Shenyang	HPCF loan green path for speedy approval; HPCF maturity 30 years and 20% down payment; 1.5% contract tax.
Xi'an	Housing subsidies 1.5%, 1%, and 0.5%; city infrastructure fee lowered by 35 per m2.
Changsha	Cash subsidies; 1.1% contract tax for old houses; real estate fees exempted; HPCF 20% down and 30 years.
Xiamen	Home buyers of 70-80 m2 apartments awarded Hukou; loan interests lowered, 20% down, 20 years for <90 m2
Chengdu	Contract tax exemption and fiscal subsidies; HPCF 20% down, upper limit 300,000, 30 years maturity; HPCF loans accepted in different localities.
Chongqing	Contract tax exemption for <90 m2; old house transaction tax 1.1%; tax exemption for some old homes.

Source: news and reports from major online media, including www.eastmoney.com, house.focus.cn,

[15] Two real estate developers, Ren Zhiqiang, CEO of Huayuan Group, and Pan Shiyi, Chairman of SOHO China, were quite vocal in the policy debate and called for government bailout. Ren said explicitly that the government had to extend a helping hand for its own revenues. Instead of bailing out the housing market, the government was actually bailing out itself. Pan requested the government to remove restraining policies imposed in 2006 and 2007 (http://news.xinhuanet.com/house/2008-09/11/content_9913118.htm).

[16] The questions and results are available online at http://www.xinhuanet.com/house/dc20080911.htm.

www.china.com, house.sina.com.cn, www.xinhuanet.com.

Table 2 summarizes some extra incentives in a few cities. While local practices varied, there were certain common strategies. Both Hangzhou and Xiamen awarded home buyers local Hukou. Since Hukou was tied to public services and opportunities, such as the access to good hospitals, the chance of going to superior high schools, and increased likelihood of going to top universities. Many parents wanted to settle in urban areas and buying houses was a shortcut therefore a powerful incentive to boost house sales. Nanjing, Suqian, Xi'an, and Changsha all paid home buyers cash out of the local government budgets. Shijiazhuang, Chengdu, and Chongqing extended the central preferential policy of low contract tax from first time home buyer with small apartments to other types of houses or simply exempted it all together. Finally, many localities have loosened credit control for HPCF loans and made it cheaper and more convenient to finance home purchases. There must be other extra incentives in other regions, but the general spirit was the same: local real estate markets were weak and needed stronger stimuli. The market responded to these policies and the signals very promptly. House and land prices stopped sliding the next quarter and reverted to the positive territory by the third quarter of 2009. By then, signs were indicating that the real estate sector was probably over-stimulated and price increases were rapidly approaching or even surpassing the pre-crisis high levels.

4.2. Interest divergence and under-stabilization, December 2009-June 2010

The central government became seriously concerned about the social and political implications of a runaway housing market. In the past, when housing prices grew more than 10% or even only in the 5-10% range, a lot of people felt being left out and that sense of hopelessness has contributed to the social instability. Even the government-owned media was filled with criticisms of the policy and called for more equitable distribution of housing in the society. If double-digit increase reappeared on the already high prices, its political legitimacy might be reduced. In addition, the central government was also worried about the systematic impact of a real estate bubble on the economy. By the end of 2009, the top leaders decided that some policy changes were needed to bring down the growth rate of prices and make it stable. Note that the central government never said that house prices should drop but only slow down the growth rate. This reflected the central leadership's attempt to balance growth and equity.

The first round of price adjustment was launched in mid-December and early January. Business tax exemption was tightened to five years again. If home owners sold their houses within five years of the purchase, they must pay a business tax. This should discourage wild speculation. For second home buyers, the down payment was raised to 40% and a higher interest rate applied.[17] There were also measures targeting real estate developers. After winning land from the auction, developers must deposit 50% down payment and pay up the rest within a year.[18] This policy was designed to deter speculators who were not interested in real development but used land for quick sales and profits. Banks were ordered to tighten credit approval to developers so they would not bid up land prices too much. The government also increased pre-sales permit regulation so that real estate developers must sell houses at the published prices. Local governments, in particular, were asked to increase more affordable housing in their areas so the lives of low and middle income families would not be affected by the high prices too much. Provincial leaders were held responsible for bringing down the price hike.

Compared with price stabilization measures in the past few years, these policies were indeed quite substantial. The market, however, basically brushed them aside. In the first quarter of 2010, land prices rose by a neck breaking 21% and house prices by 10.6%! As a symbol of active defiance, land lease prices for residential housing made records on a daily basis just days after the premier called for price readjustment in the annual NPC and CPPCC meetings. This enraged the general public and even Xinhua news agency and People's Daily issued strong criticisms on the greedy developers and failed government policies.[19] In desperation, the central government rolled out another set of harsher measures in mid-April. The title of the State Council notice, *Resolutely Suppress Too Fast Housing Price Increase in Some Cities*, demonstrated the urgency

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[17] 国务院办公厅关于促进房地产市场平稳健康发展的通知国办发〔2010〕4 号（http://202.123.110.3/zwgk/2010-01/10/content_1507058.htm).

[18] Full text is available here (http://www.law-lib.com/law/law_view.asp?id=304450).

[19] 三问北京"地王"：现行土地招拍挂制度催生？2010 年 03 月 18 日 08:58　来源：经济参考报　孙晓胜 岳瑞芳 王涛

of the central government.[20] Its opening statement was also quite revealing: “housing concerns people’s livelihood. Therefore, it is an economic problem. But it is also an important livelihood issue that impacts social stability. High and fast growing house prices have made it difficult residents to meet their housing needs through the market and increased financial risks. These undermine the harmonious development of the society and economy.”[21] In the top leaders’ mind, this was a serious political issue. But even then, the government was not willing to bring down house prices but only to stop the price from rising too fast.

In addition to earlier measures, more instruments were adopted. For first home buyers of large apartments (>90 m2), the down payment was raised to 30%. For second home buyers, the down payment was 50% and the interest rate was 110% of the base rate. For third home buyers, down pay and interest rate should be much higher and some hot markets should stop this type of loans altogether. If buyers were not local residents, they must have proof of at least one year of tax or social security payment to get loans from banks. All these were designed to further discourage investors and control speculations on the real estate market. 78 state-owned enterprises with central affiliation were also ordered to withdraw from the market. This excluded 16 SOEs under the central government whose main business was real estate. The purpose of this move was to appease the public and clear its tarnished image of backing greedy developers. This might also weaken price competition in auctions and lower land and house prices.

Despite these unprecedented measures, the market response was mixed at best. House prices continued to climb in the second quarter even though the rate of increase was not as high as in the previous three quarters.[22] More important, there seemed to be a lot of uncertainty in the

[20] Full text is available here (http://202.123.110.3/zwgk/2010-01/10/content_1507058.htm).

[21] Ibid.

[22] According to one recent survey, house prices in ten major cities (Beijing, Hangzhou, Shenzhen, Guangzhou, Nanjing, Shanghai, Tianjin, Chongqing, Chengdu, and Wuhan) rose 61.7% month-on-month in June 2010. Beijing took the lead with an 80% increase (http://house.focus.cn/news/2010-07-20/991487.html). The methodology is not reported so it is hard to compare this data with those from the State Statistics Bureau. We use SSB data in our analysis only even though there are criticisms about its methodology as well.

market and developers and investors were anxiously waiting for something to happen. The central government was partly responsible for this uncertainty. As discussed earlier, the central government also has interest in maintaining stable growth in real estate even though it does need to balance growth with political concerns. As the world economy was facing another possible downturn in recent weeks, some central government officials started to talk about revising the adjustment policies. This will surely affect the policy outcome in the next few months. But local growth coalitions were mainly responsible for the lack of market response to central government policies in the past six months.

Local governments, banks, and real estate developers were all afraid that the central adjustment measures might be too strong and could cause the sector to drop too steeply. If that happened, developers would surely lose their fat profits and local governments would face revenue shortfalls and worry about providing basic services. Banks on the other hands would be sitting on piles of non-performing debts. Land owned by city investment and development corporations affiliated with local governments would depreciate and, as a result, these corporations and local governments find themselves unable to raise capital to carry out large scale projects in the cities. Motivated by the same goal, these players worked together to mitigate the impact of the central policy.

Most local governments chose to water down the central policies in its local implementations. After the State Council's urgent notice on April 17, all levels of local governments started to draft their own versions of the adjustment policy. Even three months later, only a handful of local governments have published their detailed rules for implementation. Close reading shows interesting contrasts with the implementation of the stimulus package. As discussed above, local government adopted policies far beyond the central explicit authorization and improvised rules that could be interpreted in the spirit of the central policy, i.e. supporting the real estate sector. In this case, almost all local governments simply repeated the central policy and promised to carry them out locally. The only exception was Beijing. It required that each family could purchase one home in Beijing.[23] This was much stricter than the central policy of limiting loans to third homes. It might reflect the fact that Beijing was under the central government's close monitoring and the center might want Beijing to send a good signal to the rest of the country. If this was indeed the central intention, it certainly failed. No other regions followed. In fact, some areas with the hottest real estate markets, like Guangzhou, Hainan, Chongqing, did not even mention stopping loans to third home buyers.[24] On the other hand, almost all localities stressed the importance of increasing supplies of affordable housing. It was indeed part of the central policy but only one of many. Because it matched local governments' desire for growth and expansion, this aspect of the central adjustment was amplified.

Some daring local officials actively sabotaged the central policy. Governor of Liaoning, Chen Zhenggao, likes to say, "if other people catch a cold, we do not need to take medicine."[25] His rationale is that every place is unique and different policies may be necessary. This makes perfect sense but it can also be used as an excuse for noncompliance. Under this mentality, Liaoning issued a new policy regarding fees associated with home sales in June. It abolished a 200 yuan processing fee and lowered house assessment fees. The alleged goal was to regularize the market and protect home buyers' rights.[26] And Liaoning did not have over-heating problem. Under the similar excuse, Chongqing officials insisted that, unlike Beijing and Shanghai, real estate in Chongqing was healthy and stable. Therefore no "hard medicine" was needed. In fact, the central policy has already damaged local housing market. The government decided to offer fiscal subsidies to first time home buyers. Local officials argued that the demand in the housing market must be strong to give real estate developers confidence. The latter was the basis for

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[23] 北京市人民政府贯彻落实国务院关于坚决遏制部分城市房价过快上涨文件的通知(http://www.law-lib.com/fzdt/newshtml/gddt/20100430211012.htm).

[24] Guangzhou issued its implementation rules one month after the State Council notice and it is available here (http://gz.focus.cn/news/2010-05-21/940470.html).

[25] "辽宁省长称沈阳楼市全国最好 别人感冒咱不要吃药" 2010 年 06 月 26 日 00:13 经济观察报

[26] Ibid.

healthy and stable development. Therefore, their policy was in fact in the spirit of the central policy.[27]

Banks and developers did not sit idle either. Some banks skirted the central regulation and interpret second or third homes liberally so that buyers of multiple houses could still get loans. Because many local governments did not admit that they "got cold", i.e. real estate was over-heated, many banks in Shanghai, Hangzhou, and Shenzhen, continued to give out loans to buyers of third homes.[28] Even in the hot spot of Beijing, some banks were reported to finance home loans to non-Beijing residents who could not provide tax or social security payments. Real estate developers were often found in close consultation with local government officials. For example, after the April 17 State Council notice, Chongqing officials called on local real estate developers to interpret the central policy. Not surprisingly, they walked out of the room believing that the central government just wanted to crack down price hikes in some regions and Chongqing should increase affordable housing to stabilize local markets.[29] Some developers also used their connections to influence central policy directly. Ren Zhiqiang, CEO of Huayuan Corp, a real estate developer in Beijing, is well known as someone who is close to policy makers. He claimed that one senior official who was attending a State Council work meeting called him and a few other real estate developers for consultation. In their meeting, he and others warned the government not to take tougher measures for the sake of larger economy.[30]

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[27] http://www.he.xinhuanet.com/fangchan/2010-05/31/content_19932297.htm.

[28] "上海部分银行开闸三套房贷:贷款还清就算首套房" 中国证券报 2010 年 07 月 12 日 01:07 (http://business.sohu.com/20100713/n273482567.shtml). "南京多家银行重新开闸第三套房贷 市场悄然松动"环球网 2010 年 07 月 10 日 (http://news.sohu.com/20100710/n273403663.shtml).

[29] http://www.he.xinhuanet.com/fangchan/2010-05/31/content_19932297.htm.

[30] "任志强:房价会涨 勿调现有政策让开发商背黑锅" http://news.hexun.com/2010-07-16/124274987.html.

In short, during the two rounds of price adjustment between December 2009 and June 2010, local governments, banks, and real estate developers worked in sync and shirked or even sabotaged the central policy.

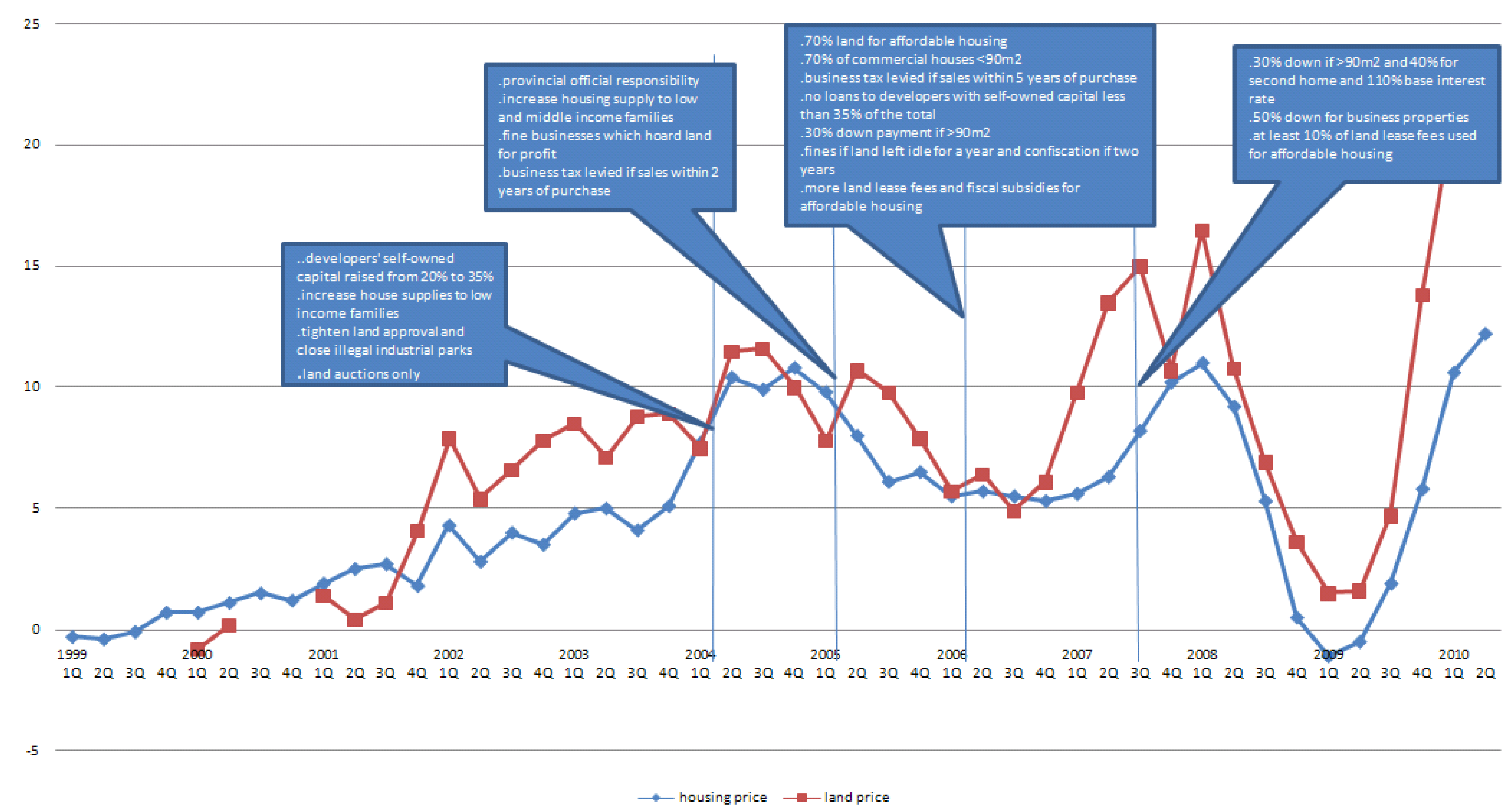
4.3.Earlier interventions, 2004-2008

Some skeptics may argue that it is still too early to tell if the central adjustment policy will work. The market uncertainty three months after the unprecedented policy intervention speaks loudly the inability of the central government to dissuade consumers and investors. The need to launch the second round of adjustment with much stronger measures further proves the point. In this section, we briefly go over similar attempts of price adjustment in the past few years. It should give us some insight as to what to expect in the future.

While the stimulus package in fall 2008 is unprecedented, price control and adjustment are by no means the first. In fact, between 2004 and the onset of the stimulus, the central government had tried to bring down fast price rises at least four times. For the most time before 2004, China's real estate markets remained stable with the growth rate of house prices below 5%. But the first quarter of 2004 saw a big spike and house prices seemed to rise rapidly and were approaching double digits. To stabilize the market, the central government started to introduce some policies. Unlike the recent attempts at managing housing demand, the policy then mostly aimed at land supplies because it was generally believed that there was too much corruption in land market, which fueled speculation and price hikes. Regularizing the land market did not solve the problem, however, house prices finally hit double digit. In May 2005, another price adjustment was introduced. In addition to requiring more land supply to low and middle income families and levying fines on land speculators, business tax was used to manage house demand. Price growth slowed down afterwards but still remained above 5%. Apparently not satisfied with this, the central government rolled out the toughest policy, mandating the ratio of residential use in land supply as well as the ratio and size of commercial houses on the market. Both tax and interest instruments were used.

Despite this intervention, price increase remained in the high gear and, by the second quarter of 2007, the price was running away again. In September 2007, the central government raised down payment and interest rate for second homes, only to find that price growth hit double digits afterwards. It finally fell below 5% in 2008 mainly because of the financial crisis. Speaking of government's inability to stabilize growth, some policy analysts like the metaphor of "French fries", i.e. crisp and hard right out of the pot, but soft and chewy after a while. The local governments were the softeners.

Figure 3. Land and House Price Growth Rate, 1999-2010



Conclusion

When China's real estate markets plummeted after the American housing bubble, the government introduced the biggest stimulus package in recent memory. One year after the policy, the land and house markets made a V-shaped recovery. Beyond this simple story of successful government intervention, we observe some interesting dynamics. While the stimulus achieved its goal of averting a possible collapse, it clearly over-stimulated the market. One year after the rescue package, the government had to step in again to control price and cool down the market. After the first batch of measures failed to wrestle the rapid price rise, the central leadership rolled out the second batch of stronger policies. Despite this commitment, the market did not respond promptly and remained deeply unsettled. We argue that the key to the asymmetry in policy effectiveness of over-stimulation and under-stabilization lies in local governments' financial incentives. As a result of central-local fiscal changes, local governments became heavily dependent on revenues from land-related incomes. Land lease fees and taxes directly from the real estate sector constitute a large and growing portion of local budgets. Driven by this economic interest, local officials stretched the central stimulus policy while resisted the stabilization. This pattern has in fact characterized China's real estate markets since 1998.

Instead of being the faithful arms of the central government, local officials have behaved like amplifier or dampers depending on their interest alignment with the center. As discussed in the beginning of this paper, this finding can shed some light on the debate about central-local relations and on the literature on fiscal federalism. In this conclusion, we would like to discuss how our argument might contribute to the healthy development of the real estate sector in China. We have shown that the biggest threat to market stabilization is the distorted incentive by local officials. While government intervention, especially in correcting market failures such as under provision of low income housing, can be helpful in a society, the "visible hand" should be capable and consistent. Unfortunately for China, the hand is crippled. As the de facto owners of urban land and the only players that can convert farmland for urban use, local governments have every incentive to limit land supplies to extract high profits. Seeing this logic, investors bet that land and house prices will never go down. Therefore, instead of calming down the market, the current regime actually causes more uncertainty.

To get local governments' incentive right, their addiction to land-based revenues must end. Two reforms can help to steer the course in this direction. First, local governments should no longer be the only legitimate arbiter between urban and rural land. Rural collectives should be allowed to lease their land on the open market. Rural construction land is about 63% of all construction land in the country. This would instill a sense of calm to the market and defeat wild speculations. More affordable houses will also speed up urbanization process and unleash new sources for growth. Second, this should make a big dent in local budgets and it should be addressed seriously. Even though local governments are portrayed as "bad guys" in some literature, they are really "innocent". After all, it is the central government that takes resources away and forces local officials to accomplish policy goals. Local governments should have stable sources of revenues. In place of land lease fees, local governments should be given the authority to levy property tax. Compared with the high variable lump sum land lease fees, property tax is more stable. These reforms should restore local governments' role as neutral market regulators, not money grabbers or market spoilers.

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