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The Evolution of Ground Rent Economy in China and Countermeasures Research

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Abstract: This paper examines the phenomenon of land rent economics, focusing on how landowners generate income from renting out land and how this affects economic development. The research is grounded in China's rapid urbanization and economic transformation, where land has become a key asset. The use of land resources by local governments to finance infrastructure and economic growth has fueled urban sprawl, highlighting the critical role of land in China's financial strategy. This study explores the dynamic characteristics of land as a scarce resource by applying the theory of absolute land rent and differential land rent proposed by Marx. The paper delves into the Chinese context of highly centralized land ownership and state monopoly, and how the dual-track land system with separate urban and rural land markets facilitates the conversion of rural collective land to urban operational land, affecting local government revenues and the urbanization process. Through a detailed examination of the land transfer process, the article reveals the systemic financial risks of land financing and local government financing platforms. In addition, the article identifies the potential systemic risks posed by shadow banking activities and implicit government guarantees and assesses the measures taken by the government to mitigate these risks, including regulatory reforms and fiscal policies aimed at improving transparency and controlling debt levels.

Keywords: Land rent economy, absolute land rent, rural collective land, local government financing platforms.

1. Introduction

The land rent economy is an economic phenomenon in which landowners earn rental income by leasing land to producers. In a land rent economy, land as a scarce resource is traded for the right to use it to form land rent [1]. The theory of land rent is mainly based on the natural and improved properties of land, which involve the natural fertility of the land and the added value obtained through human-made improvements [1]. Marx categorized land rent into absolute and differential land rent. Absolute land rent is the base rent available to all land, while differential land rent is the additional rent due to differences in land fertility and improvement [1]. Marx attributed the formation of absolute land rent to the lower organic composition of capital in agriculture, which implies a higher proportion of variable capital to total capital in agriculture [2]. The higher proportion of variable capital results in more surplus value being generated in agricultural production than in the non-agricultural sector, resulting in excess surplus value [2]. Under the monopoly of land ownership, this excess surplus value

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does not disappear in the equilibrium process of the average social rate of profit but is captured by landowners in the form of land rent [2]. The land rent economy has also had a profound impact on China's development. Due to the concentration and monopolization of land ownership in China, the uncertainty caused by the ambiguity of the system, the continuous change of land use, and the development of the rental market, land has been scarce in China. This has led to the monopolization of land by private landowners and the subsequent formation of absolute land rent in China.

In China, local governments exercise significant control over land ownership. The institutional framework for this control differs from that of Western countries. Firstly, there is a clear distinction between urban and rural land markets in China. Urban land is under state ownership, while rural land belongs to rural collectives [3]. Without the approval of the local government, it is not possible to trade or convert rural land for non-agricultural purposes. Secondly, local governments hold a monopoly on the supply of land [3]. They have exclusive rights to lease rural land to potential developers and can exert influence over the market by regulating quotas, prices, and leasing arrangements. With urbanization and industrialization, many collective lands have been converted to construction land [4]. During this transformation process, local governments and collective economic organizations have taken advantage of institutional ambiguities for land development and use, creating and developing land rental markets [4]. Despite evolving laws and policies to improve land use efficiency and economic incentives for farmers, the central government has maintained its principle of public land ownership, allowing the state and collective landowners to continue receiving absolute land rent from land use.

The formation of absolute land rents in China has had a complex impact on the economy, both in terms of its positive effects on promoting economic development and the challenges it poses. On the one hand, the revenues generated by the transfer and leasing of land use rights have significantly boosted local government revenues, which, in turn, has accelerated urbanization. On the other hand, local financing platforms derived from the development of the land rent economy have brought significant systemic financial risks. This paper will focus on describing how countries in the process of urbanization acquire rural collective land and transform it into commercial land in cities. Additionally, the paper will explain the specific process of land circulation to demonstrate its gradual financialization and highlight the systemic financial risks involved. Finally, the article will provide examples of how governments have controlled these risks.

2. Rural Land System Ambiguity and Urbanization Development

Rural and urban land markets are independent of each other, but there are strong links between them. Although a large amount of literature discusses the relationship between rural and urban land markets separately, there is a strong connection between them. This is because most of the land for urban development originates from the expropriation of rural land. Since the establishment of the dual-track land system in China in the 1980s, urban land has been owned by the state, while rural land has been owned by collectives [5]. This system has dramatically exacerbated the gap between the "plan" and the "market," and between rural and urban areas. Within this framework, although urban land is owned by the state, its use can be marketized through concessions or leases to commercial users [5]. Specifically, state entities that acquire land use rights through the "planned channel" of administrative allocation pay a very low nominal fee. The government has the right to transfer the land use rights acquired through administrative allocation or state concession from the "planned channel" to the "market channel," transferring them to commercial users at a high price and thus obtaining high profits [5]. In addition, the government to expropriate collective land by paying compensation to rural collectives that are far below the market price, and then transfer the land to commercial users at a much higher price, a process that generates significant financial revenue for local governments [5].

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Under China's legal framework, rural land is collectively owned. However, collectively owned land is not legally defined as to which collective level (e.g., natural village, administrative village, or township) owns the land [4]. Historically, ownership of land used to be held by production teams (now natural villages or village groups). However, after the economic reforms, this ownership structure was not clearly defined, leading to the fact that, in practice, the administrative village or township government usually manages and distributes the land on behalf of the village or township. In some cases, the land ownership may be seized by a higher level of government or unit to facilitate town planning and economic development [4]. The state sometimes maintains a degree of ambiguity in its law-making, aiming to reserve room for flexibility in policy adjustments to dynamic changes in the social and economic environment so that it can respond to these changes quickly and effectively if necessary [4]. This ambiguity has helped the state avoid potentially large-scale social conflicts and facilitated urbanization. However, this uncertainty has made collective ownership difficult to achieve in practice, and thus farmers have struggled to truly enjoy the rights and benefits of land.

The Law of the People's Republic of China on the Organization of Rural Collective Economy, introduced in September 2024, clarifies the rules of membership within rural collectives and protects women's land ownership rights [6]. It ensures that women retain their land rights regardless of their marital status. It also authorizes the Procuratorate to make recommendations or file public interest lawsuits against collectives that violate land rights. However, there is still no clarity on the right to own land.

3. Land Financialization

After acquiring rural collective land and converting it for urban development use, the land is incorporated into a system of land reserve centers managed by local governments. These centers serve as a centralized management and development platform for land resources and are responsible for reserving, organizing, and preparing land for future market demand. By using the reserved land as collateral, the land reserve centers utilize local financing platforms to apply for loans from banks, which are used to pay for initial development costs such as demolition and infrastructure construction. In this context, a local financing platform (LFP), also known as a local government financing vehicle, is generally a company established by a commercial entity for financing development projects in cities and the construction of urban infrastructure (e.g., highways, water treatment).

Local governments utilize LFP companies, which they own and operate, as a means to access market capital since they are prohibited from borrowing directly. The government assets serve as a guarantee for the liabilities of these LFP companies, which are then repaid using government revenues primarily derived from land-related sources [7]. Apart from bank loans, the LFP also generates funds in the capital market by issuing corporate bonds such as municipal investment bonds to support additional urban development projects [3]. Out of the land premiums and off-budget taxes collected, local governments inject capital into LFPs to ensure a continuous cash flow to meet repayment obligations [3]. In some cases, the Land Reserve Center makes a certain amount of land available to local government financing companies to secure bank loans to finance infrastructure projects and support the interest on the bonds [3]. Upon completion of the infrastructure development, the land is put on the primary land market for auction or transfer [3]. By controlling the supply of land and the pace of market placement, local governments can influence the price of land to maximize its market value. The income from land sales is used to repay loans and support further infrastructure projects [3]. In this way, local governments not only support local economic development and urbanization but also create an important source of fiscal revenue.

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4. Systemic Risks of Local Government Financing Vehicle

Local Government Financing Vehicles (LGFVs) raise funds through two main channels: bank loans and the issuance of Chengtou Bonds (City Investment Bonds), which provide financial support for urban development and infrastructure construction [7]. Although Chengtou Bonds, a type of corporate bond dedicated to supporting urban construction, are not legally guaranteed by the government, these debts are usually implicitly guaranteed by local governments in practice,the government's implicit guarantee distorts the normal financing process and increases financial instability [8]. Additionally, to cope with debt pressure, local governments engage in financial innovations through the shadow banking system, such as issuing wealth management products (WMPs), which provide short-term funding but also distort the normal market financing process, exacerbate the complexity of the financial system, and may trigger potential risks of financial instability [8].

Firstly, because of the prevalence of implicit government guarantees on municipal bonds, the market generally believes that local and even central governments will intervene to prevent defaults [8]. This perception is rooted in the government's past bailout actions and the strategic position of infrastructure projects as indispensable to economic growth[8]. This implicit policy support has led investors to view these bonds as low-risk products, even though their underlying economic fundamentals may not be solid [8]. This cognitive bias leads to a distortion in risk pricing as the market demands a lower risk premium for these bonds. As a result, investors may engage in aggressive lending behavior by providing capital to LGFVs at rates lower than their risk profile should require. Belief in government bailouts also creates moral hazard, whereby LGFVs may overextend themselves financially in anticipation of government support in difficult times. This behavior may lead to excessive borrowing and commitment to risky investment projects that are not economically viable.

Secondly, the association of municipal bonds with shadow banking entities such as trust companies and wealth management products (WMPs) increases systemic risk [5]. Trust companies, a core component of the shadow banking system, invest heavily in municipal investment bonds and frequently package these bonds as financial products that are widely sold to retail and institutional investors. This interconnectedness means that any financial distress within local governments or in the real estate market could affect the value of these bonds, impact the returns on financial products, and potentially lead to broader financial instability [5]. The lack of transparency in shadow banking activities complicates risk assessment and leaves the system vulnerable to sudden market adjustments once potential problems are exposed [5]. Due to the complexity and rapid growth of the shadow banking industry, the Chinese government faces challenges in its regulatory efforts to manage shadow banking. Stricter regulation could create liquidity shortages for local government financing platforms, affecting their ability to issue new bonds or refinance existing debt. As a result, problems in the municipal bond market could have a contagion effect, with significant vulnerabilities in local government debt that is being financed by shadow banking.

5. Government Control Measures

To effectively control the financial risks posed by local financing platforms, the Chinese government has introduced a series of bills and policies aimed at strengthening the regulation of municipal bonds and shadow banking. Since 2015, the Ministry of Finance has launched a local government debt replacement program, under which high-risk municipal investment bonds are replaced with lower interest rates and safer local government bonds to reduce the cost and risk of debt, according to the ‘Circular on Local Government Debt Replacement Program’ [9]. In addition, the government issued the ‘Measures for the Administration of Issuance of Local Government Bonds’ in 2016 to limit the scale of issuance of local government bonds and require them to be in line with national macro-control

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policies, thus preventing over-reliance on debt financing and reducing potential debt risks [10]. China's Audit Office and Ministry of Finance have also announced that they will strengthen the supervision and risk assessment of local government debt through joint actions to ensure that debt levels are within control [11].

In terms of shadow banking control, 'the Guidance Opinions on Regulating the Asset Management Business of Financial Institutions', issued by the central government, requires banks to bring off-balance-sheet businesses into on-balance-sheet accounting to improve transparency and prevent financial institutions from circumventing regulation through shadow banking channels [12]. At the same time, the government has increased the capital adequacy ratio requirements for banks by enhancing their ability to withstand financial shocks to ensure the robustness of the financial system [13]. Most importantly, the People's Bank of China (PBOC) and the China Banking and Insurance Regulatory Commission (CBIRC) have stepped up their efforts to monitor shadow banking, and the PBOC and CBIRC have jointly set up a comprehensive financial risk monitoring system to identify and respond to potential risks promptly by monitoring shadow banking activities and maintaining the stability of the financial market [14].

6. Conclusion

This paper explores the complex dynamics of the land rent economy and its significant impact on China's economic development. By examining the absolute and differential land rent theories in the Chinese context, it is clear that land plays a crucial role as a scarce resource and a major source of income for landowners and the government. In China, the dual-track land system and centralized government control have facilitated rapid urbanization and economic growth. However, these developments have also brought inherent challenges, including systemic financial risks associated with local government financing platforms (LGFVs) and the shadow banking system. Implicit government guarantees of municipal bonds distort risk perceptions and can lead to moral hazard and financial instability. Managing these risks through regulatory reforms and policy measures is critical to maintaining financial stability. By increasing transparency, controlling debt levels, and imposing stricter regulations on shadow banking activities, the Chinese government aims to reduce potential systemic risks while supporting economic development. Overall, this study highlights the intricate interplay between the land-rent economy and China's financial system, emphasizing the need for sustained reforms and close supervision to ensure that the benefits of land-driven economic growth do not come at the expense of financial stability and social equity. As China continues to urbanize and modernize, a balanced approach to land management and economic policy is critical to sustainable development.

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