CHINESE REAL ESTATE LAW AND THE LAW AND DEVELOPMENT THEORY: COMPARING LAW AND PRACTICE

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ABSTRACT

China did not adopt a modern Property Rights Law until 2007, which means that most modern real estate development occurred before there was a comprehensive property law to govern it. Moreover, business conventions in China frequently diverge from published laws, and the rules that professionals follow do not always comply with legal requirements. This article addresses how real estate professionals in China contend with these legal inconsistencies and uncertainties. It also asks whether China is disproving the traditional law and development model, which holds that transparent property and contract laws are a prerequisite to robust economic development.

Part II introduces some of the common Western misconceptions about Chinese real estate law and business. Part III presents examples of how three specific Chinese business practices have come to differ in significant ways from Chinese real estate law. Part IV concludes by noting the ways in which China calls into question the widely accepted model of law and development.

I. INTRODUCTION

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I. INTRODUCTION

China’s real estate law is inherently paradoxical, as the nation strives to develop a modern economic and legal system against a

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backdrop of socialist doctrine. The nation actively encourages private investment and seeks integration into the world economic system but also remains officially wedded to Communist principles. For the past quarter century, China has mostly succeeded in walking this tightrope. Economic development during these years has been astonishing, particularly in the real estate sector, as China has raced to compensate for prior decades of little or no growth. At the same time, the Communist Party continues to maintain strict control over most aspects of economic and legal life. As a result, China’s real estate market displays many of the contradictions referred to as “socialism with Chinese characteristics.”

China did not adopt its first modern Property Rights Law until 2007. This means that much of China’s recent real estate development occurred before there was a comprehensive property law to govern it. Though other areas of business law filled some of the gaps, Chinese real estate professionals were operating during this time with only a limited grasp of what would happen if problems arose later. Many areas of ambiguity and uncertainty remain even after the adoption of the new Property Rights Law. This legal fuzziness does not seem to have impeded real estate investment in China either before or after 2007, and real estate professionals continue to make important decisions in a legally unclear environment.

For many years, real estate professionals have fashioned their business arrangements within this evolving legal landscape. In some cases, they relied on private contracts of questionable validity to address uncertainties in the law. As the law later developed, it either endorsed or contradicted these existing contracts. New rules sometimes were inconsistent with business practices that had emerged and become established before the laws were clarified. In other words, published Chinese real estate laws sometimes conflict with practices that have arisen in the Chinese real estate industry.

This article addresses how real estate professionals in China contend with these legal inconsistencies and uncertainties. I have interviewed dozens of real estate professionals in China during the past decade, learning how they operate when the legal environment is unclear and how they respond when legal rules contradict prevalent business practices. It turns out that business conventions in China frequently diverge from published laws, and the rules that professionals follow do not always comply with legal requirements. Government officials commonly ignore these discrepancies, either because they benefit personally from the status quo or because they do not wish to disrupt successful experiments, however questionable their legality. This article continues by asking whether China is
disproving the traditional law and development model, which holds that transparent property and contract laws are a prerequisite to robust economic development.

The article proceeds as follows. Part II introduces some of the common Western misconceptions about Chinese real estate law and business. Part III presents examples of how three specific Chinese business practices have come to differ in significant ways from Chinese real estate law. Part IV concludes by noting the ways in which China calls into question the widely accepted model of law and development.

II. WESTERN MISCONCEPTIONS ABOUT CHINESE REAL ESTATE LAW AND BUSINESS

Westerners who possess only a casual familiarity with the booming Chinese real estate market probably assume that modern China has already developed robust property and business laws. From our Western perspective, we imagine that no one would dare to commit to projects of the scale of those that China has attracted without a high level of security about the Chinese legal and business climates. These observers probably take it as a given that China must have strong contract and property laws, a well-established method of securing and perfecting rights in real and personal property, a predictable bankruptcy law, and a reliable judiciary.

But while China has generally been moving in this direction, it would be inaccurate to describe Chinese property laws as firmly established. In fact, China’s Property Rights Law – its first comprehensive law of real property since the 1949 establishment of the People’s Republic – did not take effect until 2007, well after the current real estate boom was underway. The Chinese Constitution and other substantive laws picked up some of this legal slack, but many of these related mandates were spotty and generalized, with little emphasis on property rights. In fact, it is this disjunction between practice and law, and between Western assumptions and Eastern realities, that first attracted me to the subject.\(^1\)

Westerners seeking to learn a new area of the law begin by looking for published statutes in that subject area.\(^2\) Once the Western lawyer identifies any applicable statutes, she will next look

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1. For a more detailed discussion of these Western misconceptions, see GREGORY M. STEIN, MODERN CHINESE REAL ESTATE LAW: PROPERTY DEVELOPMENT IN AN EVOLVING LEGAL SYSTEM 19-23 (2012).

2. To be fair, American lawyers seeking to understand real estate law may not actually begin in this way, since American property law tends to be common law rather than statutory, and the few statutes do little more than codify common law principles that have developed over the centuries. Thus, an American lawyer seeking to understand a topic within real property law may justifiably proceed directly to the cases.
for cases decided under these statutes, which may interpret imprecise terms and shed light on ambiguities in the statutes. After she has developed a clearer understanding of what the statute says and what the case law holds, she will then examine actual business practices, with the assumption that these practices have evolved to reflect what the law allows and prohibits. This is how Western lawyers are trained and how Western law professors train our students.

This approach does not work terribly well for the Westerner who aims to understand Chinese real estate law. China’s Property Rights Law is a new law, so it is still maturing and has only begun to be tested. Case law is far less important in China’s civil law system than it is under the common law. Conversely, personal relationships are far more significant and influential in China than in Western legal systems; in fact, these personal relationships (guanxi) form a critical component of social networking in China.³

If a Westerner seeks to learn Chinese real estate law from a Chinese expert, she will discover that there are few such experts, at least in academia. China’s law schools reopened only in the 1980s, and many schools do not even offer a separate course in property law. Moreover, those few who have become proficient in this area are less likely to be teaching real estate law than practicing it, or perhaps even working in the real estate business. The academic knowledge base is thin, a fact that is also reflected in the dearth of articles and treatises on the subject.

China’s emerging and impatient entrepreneurs were disinclined to wait for China to draft and implement all of the relevant laws. This means that Chinese business practices in the real estate sector began to mature before many real estate laws had been adopted and interpreted. If anything, the legal system has had to struggle to keep abreast of emerging business approaches, with laws seeming to respond to business practices rather than the reverse.⁴

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4. This phenomenon is not unique to high-end commercial real estate developers. Many rural migrants to China’s rapidly growing cities live in informal housing of questionable
In addition, the public sector is far more important in China than in most Western nations. This fact surprises some Western lawyers and business experts, who mistakenly view the current Chinese system as powerfully capitalist while often viewing Western government activities as “creeping socialism.” China owns or controls all of the land within its borders. Government-controlled or -affiliated businesses hold the right to use much of this land, and government-controlled banks make many of the lending decisions that determine in practice whether this land can be improved. In fact, there is a high degree of coordination between the political and business sectors in China, and certainly much higher than that seen in Western economies. In addition, the government has spent huge amounts of money on infrastructure during the past three decades, as China struggles to overcome many years of neglect.

The real estate sector is also far more important as a proportion of China’s economy than is the corresponding sector within Western economies. China’s stock markets are tiny compared to those in the United States and many other Western nations. China’s regulatory oversight of its securities markets is also less advanced, a fact that scares off many potential investors. Foreign opportunities are largely unavailable to domestic Chinese investors due to currency restrictions. Chinese citizens seeking investment avenues have flocked to real estate due to a lack of attractive alternatives. Real estate has thus become the default – and perhaps the only – option for many investors, causing lopsided growth in that sector.5

China’s adherence to the Western conception of rule-of-law has been spotty, much to the concern of many Western trading partners.6 The Chinese Communist Party is well aware of Western concerns about this issue. At the recent Third Plenary Session of the 18th Central Committee of the Communist Party of China, the Central Committee adopted a decision stating, “We should work harder to accelerate socialist democracy in a systematic way by

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adopting due standards and procedures. We should build a socialist country with the rule of law, and develop people’s democracy with wider, more adequate and sound participation.”

In addition, China is a far more communitarian nation than, say, the United States. China’s constitutional equivalent of the American Bill of Rights is quite expansive, but is limited by a provision that expressly subordinates individual freedoms to “the interests of the State, of society or of the collective.” Individual rights are left unprotected in China in other ways as well. There are few laws implementing these constitutional guarantees, and the judiciary is not independent. Moreover, a citizen’s right to sue the government is limited, and citizens may not invoke the Constitution in challenging government actions. China’s Property Rights Law appears to be atypical in this regard, in that it does further a constitutional guarantee.

Finally, while Western real estate markets – notwithstanding some huge shocks in recent years – are relatively established, the only constant in China’s modern real estate market is change. Western forecasters continue to predict a crash, but China’s real estate sector is surviving the blows that have struck it so far. Many of those with an appetite for risk and uncertainty have been able to profit in Chinese real estate, at least so far. And this process of legal and business evolution is not over, as the market and the legal system both continue to mature.

In short, any Westerner who believes on the basis of her own domestic experience that she knows what China’s future looks like is grounding that prediction on Western assumptions that probably do not hold true in a vastly different nation. To the extent that Westerner has made similar predictions in the past, she has probably been wrong much of the time, or just lucky.

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10. Id.
III. SOME EXAMPLES CONTRASTING CHINESE BUSINESS PRACTICES WITH CHINESE REAL ESTATE LAW

This part will offer three illustrations in which Chinese business and legal practice has diverged from official law. The first example addresses the legal requirement that the initial holder of a land use right develop the underlying land within two years. Article 26 of the Law on the Administration of Urban Real Estate provides, with some exceptions that are not pertinent here:

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

The intent of this Article seems to be to prevent the extended holding of undeveloped land. Investors who purchase land use rights with the goal of building promptly are allowed to use the land, while those who would hold the land are more limited in their capacity to do so. Without a provision such as Article 26, an initial purchaser of a land use right might theoretically hold the land vacant until the land use right expires seventy years later and might intend to do so from day one.

11. This divergence between published law and actual practice is not limited to real estate law, or even to business law more generally. For example, one scholar has documented how citizens are turning away from formal channels for redress of their administrative grievances in favor of public protest. Carl F. Minzner, China's Turn Against Law, 59 Am. J. Comp. L. 935, 962 (2013) (“Disgruntled parties (regardless of the underlying validity of their complaint) quite logically conclude that staging a coordinated internet protest or launching a mass petition of hundreds of disgruntled farmers to the provincial capital stands a better chance of getting what they want rather than actually using legal channels.”).


13. The understanding of the people I interviewed is that this provision is supposed to be enforced strictly, despite the use of the more discretionary “may” in the final clause.

14. Although the holder might hold land vacant for that long absent the limitations contained in Article 26, for practical reasons the holder would probably build far sooner than that. The holder has paid for the land use right and must also bear certain carrying costs, so there are considerable economic incentives to build promptly, in addition to the legal incentive that Article 26 provides.
Article 26 thus encourages rapid development by potentially imposing heavy penalties on those who allow urban land to remain dormant. While one might legitimately question the environmental and land use planning implications of such a law, it appears to advance the important goal of speedy construction of housing in a nation that needs to build tens of millions of urban residential units. Millions are flocking to China’s cities from the countryside, even as long-time urban residents seek to replace their outdated older housing with more modern dwellings. This legal provision dramatically increases the likelihood that those who acquire urban residential land use rights will use them quickly: If they buy a land use right, they must use it within two years or potentially suffer significant consequences. If they do not intend to use the land within the next two years, this provision will discourage them from purchasing the land use right in the first place, which will leave the land available for someone else who intends to use it promptly. The same incentives apply to commercial and industrial urban land.

Thus, Article 26 appears to promote a particular type of stewardship of a limited resource. For better and for worse, Chinese policy plainly favors rapid real estate development over speculative investment in raw urban land, and this provision may have been included to address a perceived buy-and-hold problem that existed before the law became effective. In response to this problem, Article 26 proclaims, “Use it or you may lose it!”

In numerous interviews with real estate developers and other professionals, however, I learned that government enforcement of this provision is flexible, if not a bit erratic. Some holders of land use rights have been permitted to purchase extensions: they pay an additional fee and, in exchange, the government agrees that the right will last for more than the statutory two years even in the absence of construction by the owner. Others simply ask for extensions and receive them free of charge. Neither of these options appears to be encouraged by Article 26. But under these

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15. Note, though, that the Law on the Administration of Urban Real Estate dates back to 1995, twelve years before the adoption of the Property Rights Law, a time when the current system of land use rights was just beginning to blossom. So the drafters may actually have been anticipating a potential problem rather than confronting an existing one.

16. The non-mandatory language of Article 26 (“as agreed upon in the granting contract”) might allow the government to grant a land use right with a deferred construction date. Chengshi Fangdichan Guanli Fa [Law on the Administration of Urban Real Estate] (promulgated by the Standing Comm. Nat’l People’s Cong., July 5, 1994, revised Aug. 30, 2007, effective Aug. 30, 2007), art. 26. However, local government policy favors rapid real estate development and generally discourages such delays, and none of my interviewees suggested that governments were granting these types of built-in deferrals.
applications of the law, the motto of this Article becomes the more flexible and less predictable, “You should use it now, but you may also be able to use it a little later if you prefer and we consent.”

Still other holders of land use rights initiate minimal construction in an effort to meet the letter of the law, though plainly not its spirit. Article 26’s requirement that the land be “developed” within the applicable time period is most plausibly read to mean fully developed, which suggests that minimal construction does not meet the requirements of Article 26. Thus, a small amount of construction probably is not enough to preclude imposition of the statutory penalties and is almost certainly not what the drafters intended. Nonetheless, my interviewees told me that some developers had taken this approach successfully.

Some of the parties I interviewed did verify that the government may insist on strict compliance with Article 26. In at least some of these cases, the initial holder of the land use right forfeited the right and did not receive a refund of the purchase price. However, the law’s strong encouragement of prompt construction appears to be treated more flexibly in most cases. Prevailing business practices and government enforcement do not always comport with the apparent intent of this Article.

There are numerous reasons why a government body might treat this mandate so flexibly. The government might believe that flexibility is warranted as a matter of good policy, perhaps because the retention of vacant land sometimes serves a useful purpose and ought not to be discouraged quite as strongly as the statutory language indicates. If government officials view the legislation as bad policy, they may elect to interpret it in a way that seems wiser to them. Officials might be doing favors (or worse) for their friends or might own interests in the projects themselves. They may believe that it would be unfair to surprise purchasers of land use rights by beginning to enforce this construction requirement strictly after years of failing to do so.

In fact, some of the people I interviewed noted that the Shanghai government has begun to hint that it might soon enforce this provision more strictly, perhaps providing in practice the warning that the statute ostensibly delivered already. This might be an example of the government finally acknowledging what the law has actually said all along and enforcing it as written. Or it might simply reflect a desire to cool down a market that some see as having

17. Practically speaking, two years will not always be sufficient time to develop a large parcel fully, even if the holder of the land use right commences construction promptly and pursues it diligently. Keep in mind, though, that construction in China frequently proceeds at a breakneck pace that is unfamiliar to those in the West who interact regularly with building contractors.
become too overheated. If this latter view is correct, then the government has opted to vary the rigor of its enforcement in response to changing market conditions. Stricter enforcement will presumably lead holders of land use rights to reduce the extent to which they warehouse buildable land, thereby reducing demand for and prices of land use rights and quieting the market.

This more nuanced approach might constitute wise land use policy, even if it is not authorized by the law itself. The selective-enforcement tactic many local governments in China have adopted with respect to Article 26 may represent a flexible response to constantly changing market conditions. But it seems that government bodies and purchasers of land use rights have been following business practices that conflict with the restrictions contained in the law itself.

A second example of the divergence between practice and law, somewhat linked to the first example, appears in Article 39 of the Law on the Administration of Urban Real Estate. This provision places limits on the power of the initial non-governmental holder of a residential land use right to transfer that right to another. While land use rights are generally transferable, the initial holder of a residential right may not re-transfer that right until the initial holder has completed at least 25 percent of the proposed structure. Specifically, Article 39 states: “Where the land-use right has been obtained by means of granting, transfer of the real estate shall meet the following conditions: . . . (2) Having . . . fulfilled twenty-five percent or more of the total investment for development in the case of housing projects . . . .”18

The prohibition set forth in Article 39 appears to serve a purpose similar to the limitation described in Article 26. While Article 26 encourages the prompt use of scarce urban residential land, Article 39 discourages speculation in vacant land by restraining those who seek to profit from buying raw land and then selling it rather than developing it. This latter Article both advances public policy goals and accords with Communist doctrine. Those investors who will use land rapidly and productively, thereby benefiting the broader public as well as themselves, may do so. By contrast, detested land speculators will be thwarted in their efforts.

Once again, this provision is frequently ignored, or at least finessed, as several of the Chinese real estate experts I interviewed

confirmed. To begin with, it is not always easy or desirable to clarify exactly when a developer has “fulfilled twenty-five percent or more of the total investment for development,” and developers are apparently able to persuade government officials that “a good start” is equal to at least 25 percent. Perhaps there is uncertainty as to what the denominator of this development fraction is, and real estate professionals may be able to convince officials that even a small amount of construction is equal to 25 percent of something. Or perhaps developers are very persuasive and government officials are easily persuaded, or merely indifferent.

In addition, initial holders of land use rights to undeveloped land and the parties who wish to buy these rights from them can readily avoid the strictures of Article 39 by structuring their land transfers as stock sales rather than asset sales, which government officials do not appear to view as “transfers” within the meaning of Article 39. Thus, a would-be buyer who appears barred by the Article from buying a current owner’s land use right can instead purchase all of the shares of the current owner, thereby becoming the indirect holder of the land use right. There appears to be nothing improper about behaving in this manner, though the statute might have been drafted with more precision to prevent – or endorse – this work-around. In fact, it seems unlikely that this provision was adopted with the recognition that it could be so readily circumvented.19

It is also possible that despite the negative connotations surrounding speculation in land – connotations that are probably even more severe in China than in the United States – government officials charged with enforcing Article 39 recognize the valid and useful economic purpose that speculators serve. Speculators reduce price risk for some sellers (including, here, the government) by committing to a set price immediately and reducing future uncertainty. In effect, they provide a form of price insurance: The seller pays an insurance premium now in the form of a possibly reduced price in exchange for the comfort of knowing that the land has been sold for a fixed price that will not drop even more in the future. The seller thereby conveys the risk of price volatility to the speculator. Speculators take the risk that the land will never prove to be worth what they paid for it, a price that includes the carrying costs of the land during the intervening fallow years, and are rewarded with the possibility that the price they paid will seem inexpensive in retrospect.

19. American real estate professionals often behave in a similar manner – legally – whether it is to avoid the imposition of transfer taxes and recording fees or to circumvent landlord restrictions on assignment and subletting.
In China, where the initial seller of a land use right is always a government entity and is usually hungry for cash, waiver of strict compliance with this Article also allows the government to accelerate its receipt of the proceeds of the sale of the land use right. This allows the government to obtain immediately funds it may need for current government operations, even before developers are ready to proceed. China might have important historical and cultural reasons for trying to limit land speculation. But a prohibition on land speculation is not cost-free, and government officials that waive strict enforcement of Article 39 seem to recognize this fact.

The initial buyers of land use rights have their reasons for wanting to convey these rights before the land is sufficiently built out, and their would-be transferees have their own reasons for wanting to buy these rights. Government officials seem to have decided that they will allow this conduct, or at least look the other way. The government benefits both by obtaining cash earlier than it otherwise might and by reducing price risk. The initial purchaser benefits by obtaining a land use right before it is ready to build. It locks in its ownership of the right and may receive a lower price. The subsequent purchaser benefits by acquiring a land use right when it chooses rather than having to wait for its seller to reach a certain stage of construction.

The only losers are the opponents of the much-despised activity of speculation in land. This restriction, presumably adopted for historical reasons, makes little economic sense and counters the generalized trend toward freer markets in China. Once again, actual business practice in China appears to contradict intended legal restrictions. And here, this incongruity illustrates a case where the practice probably makes more economic sense than the legal prohibition does.

My third illustration is somewhat different. This next illustration is a demonstration of intentional reality distortion rather than intentional disregard of the law or the law's intent, but it bears many similarities to the first two examples. In order to qualify for a loan, real estate developers must make certain submissions to potential lenders, just as borrowers have to do in the West. For example, prospective borrowers are required to submit a feasibility study that demonstrates the need for the project. Lenders want to be repaid, and this study is designed to give them comfort that there is a market for the developer's product. If the developer plans to sell the project, as with a residential building, then these sales will generate the proceeds the developer needs to repay the lender when the project is completed. If the developer plans instead
to hold the project for rental income, as with some retail buildings, then the net cash flow will allow the developer to make monthly loan repayments. Either way, the lender wants some confirmation that the project is needed and realistic and that there are enough potential buyers or tenants out there that the borrower’s proposal will actually pan out.

Developers do submit feasibility studies to lenders, but, as my interviewees confirmed, these studies are entirely unrealistic and overoptimistic. They make projections that are not justified, solely to persuade the lender to extend a loan that it otherwise would be reluctant to make. Surprisingly, the lenders know from day one that these feasibility studies are largely fabricated and make the loans anyway. Why would a lender that claims to need comfort rely on reassurances it knows to be false?

It turns out that China’s banks have dual goals, and these goals often conflict. On the one hand, they are lenders that need to turn a profit. On the other hand, they are owned or controlled by a government that may have political goals that conflict with this profit orientation. When government-controlled lenders approve loans that they know are unlikely to be repaid, they are probably favoring political goals over the desire to make money. Stated differently, they choose to lose money in order to advance particular important political aims. When they knowingly overlook the fact that a developer’s feasibility study is unrealistic, they are, in fact, choosing to lose money for reasons that may be entirely rational.

For example, suppose an old, government-controlled factory wishes to expand. By expanding, it can continue to provide jobs, housing, education, health care, and retirement benefits to its employees and their families. However, the factory is obsolete and the product it makes could probably be produced more efficiently and less expensively by a newer, privately owned factory. In short, this old factory should probably be permitted to die a natural death. The lender the old factory approaches for funding has two choices: it can turn down the loan, knowing that the loan is high-risk and unlikely to be repaid, or it can take the risk anyway and advance the funds.

A profit-oriented lender would choose the first option. The factory would not receive its loan and would not be able to expand, and some of its workers would lose their jobs, their homes, and their benefits. The government would either have to let these workers suffer on their own – an unlikely outcome in a nation that seeks to avoid social unrest – or it would have to step in and make up for these lost benefits one way or another. Even if the government does intervene to protect the displaced workers, these workers would
experience significant displacement during this transition and might become restless for change. The bank would have made a wise economic decision, and the government would pay the financial and political price.

Alternatively, a government-controlled Chinese lender might elect the second option, extending credit with full awareness that the borrower is unlikely ever to repay its loan. The factory will be able to expand, however inefficiently, and the “iron rice bowl” will survive a bit longer. These workers will continue to enjoy their jobs and benefits, will not suffer tremendous social displacement, and are less likely to become restive. Meanwhile, the factory will probably remain uncompetitive and thus will be unable to repay the loan. The bank will lose money but will continue to enjoy government support despite its economically poor decision to make this loan.

Either way, the government probably ends up paying the costs of keeping these workers housed, educated, and healthy. In the first case, it pays these costs directly, transferring money to newly unemployed workers, educating their children, and providing them with the health and retirement benefits their former employers can no longer offer. If this is what happens, the workers may be dissatisfied, as unemployed workers anywhere would be. In the second case, the government pays these costs indirectly, in the form of a disguised jobs program, and the workers may never notice that their wages and benefits are being subsidized by the taxpayers.

A Western lender, which must answer to individual shareholders, would prefer the first option. The loan is unlikely to be repaid, and the political concerns are someone else’s problem. A government-controlled Chinese lender is more likely to prefer the second option, which achieves approximately the same ends but with less upheaval. This lender is not responsive to individual shareholders who must be satisfied. Rather, its goal is to meet the political objectives of the government that controls it. The factory will eventually die, but its workers will have more time to adapt to this inevitable reality. The pain will be spread out over a longer time as the workers adjust their expectations more gradually. From the government’s perspective, this may be the preferable alternative. The government-affiliated lender, in short, has a greater incentive than a private lender to internalize the social externalities that the closing of the business would trigger.

Chinese bank policies also advance these political goals in other ways. Bank officials in China must meet annual lending quotas, and their compensation is tied to the amount of money they lend. These loans need not be wise ones. Rather, the point is to get the funds
they are holding from China’s many thrifty depositors back into the economy to support economic development. Thus, the vice president of a Chinese bank might be rewarded for making a loan that would get the vice president of an American bank fired. The goals of the two lenders differ dramatically, and the system of rewarding employees reflects these significant differences.

The Chinese developer, of course, is far more likely than the lender to want the project to be economically successful. Granted, real estate developers in China, like lenders, often enjoy close government ties. A government entity might be a partner in a developer. For example, an entrepreneurial private party with real estate expertise and a government entity that has the power to decide who receives a desirable land use right might become partners, with the private party contributing money and know-how and the government partner contributing the land use right. Thus, a Chinese developer may be motivated in part by the same political goals as a lender. However, the Chinese developer is still far more likely than the Chinese lender to want to turn a profit and far less likely to care about satisfying some long-time workers in a dying industry.

For this reason, many real estate developers actually produce two feasibility studies. The more realistic one is intended for internal review only. It predicts for the company’s principals whether the transaction will be profitable and facilitates the company decision as to whether it will proceed. The less realistic study is designed for the lender. It provides the lender’s loan review staff with the cover it needs to approve the loan and goes into the files in case the lending decision is ever reviewed by regulatory officials. The lender may know that this second feasibility study is unrealistic, but that is not the point. Rather, the goal is for the developer and the lender to appear to have done everything properly.

In the end, these high-risk loans often will not be repaid. The lender will lose money, as it foresaw was likely. The loss suffered by this government-controlled lender will be subsidized by the government, which is to say by the taxpayers of China. A political goal that the government deems beneficial will be advanced and will be paid for by China’s citizens. The fact that these banks served as a conduit for this money is simply a means of accomplishing a political end that the government deemed desirable.

This last illustration is not, strictly speaking, an example of business practices developing that conflict with published laws, although it is quite likely that the deliberate submission of a fictitious or misleading feasibility study is legally improper. Rather,
this is an example of a case in which a large number of people involved in the decision whether to extend a loan to a real estate developer knowingly participate in a dog-and-pony show. Instead of ignoring a law overtly, the developer is giving the appearance of complying with it.

There is nothing inherently wrong with a government-controlled lender and a developer that may also be affiliated with the government working together to accomplish goals that the government, on behalf of China’s citizens, deems to be worthy. Given China’s recent history, with its many rocky conflicts between those who wish to join the international economy more closely and those who would adhere more strictly to Communist principles, this may be a workable compromise. The government subsidizes its workers indirectly while giving the appearance of fostering a market economy. As long as everyone involved in the system knows how it works in practice, there is probably little damage done economically and perhaps much to be gained politically. But no observer should believe that she is receiving an accurate picture of China’s real estate market by reviewing feasibility studies that prospective borrowers submit to lenders. The charade may succeed reasonably well, but it is still a charade.20

IV. CHINA AND THE LAW AND DEVELOPMENT MODEL

This part concludes by noting some of the ways China calls the widely accepted law and development model into question. The previous part explored several settings in which Chinese real estate law and Chinese business practice have become disconnected. In two of these examples, a business practice that developed for sensible reasons appears to contradict the letter or the spirit of the law. China seems content to let these divergences persist for the time being: There are good reasons for the law and other good reasons for the actual practice, and the inconsistency seems to create no great harm in the short run. In the third example, all the parties in a particular sector of the real estate industry pretend that something is true while knowing it to be false. Once again, this may make good sense in context.

20. In fact, it is not always clear how to distinguish between privately owned and state-owned enterprises. See generally Curtis J. Milhaupt & Wentong Zheng, Beyond Ownership: State Capitalism and the Chinese Firm, 103 GEO. L. J. 665, 688-700 (2015) (suggesting that the focus should be not on the ownership of the firm, but rather on the extent to which the industry in question has been captured).
While these examples, individually, seem relatively minor, they are all indications that real estate professionals have grown comfortable ignoring or circumventing official rules. The government seems to be suggesting that this is acceptable behavior, or at least appears to be condoning it.\textsuperscript{21} In at least two of these instances, government officials evidently do not mind that real estate professionals are contravening the laws these officials are charged with enforcing. More broadly, this habit of looking the other way encourages similar disregard in the future and suggests that rule-of-law standards are not fully imbedded among Chinese real estate professionals. It also hints at more widespread government corruption, a fact of which the Chinese Communist Party is keenly aware.\textsuperscript{22}

This is not meant to imply that similar violations of the rules are uncommon in Western jurisdictions.\textsuperscript{23} However, the frequency of this type of behavior in China and the large stakes involved in some of these examples suggest that the problem is far more widespread in China than in Western nations, where adherence to rule-of-law standards is more firmly established. It appears that Chinese professionals, at least in these settings, see less of a need to follow published laws.

All of this discussion raises the more general question of the degree to which China follows the traditional law and development model. That model holds that contract and property law must be firmly established, predictable, and reliable before investors are comfortable investing heavily in an economy.\textsuperscript{24} If those laws are not well-established and are not well-supported by an independent judiciary, potential stakeholders will view this legal uncertainty as

\textsuperscript{21} Chinese entering into real estate transactions may also have a difficult time shedding their old habits relating to real estate. Two commentators, for example, have described the “mental inertia” that some condominium owners may experience when first undertaking condominium self-governance. See Lei Chen & Mark D. Kielsgard, Evolving Property Rights in China: Patterns and Dynamics of Condominium Governance, 2013 Chinese J. Comp. L. 1, 16 (“The general popular appeal and vitality of the private ownership of real property is subject to varying opinions since traditional communal or collective practice is ingrained in Chinese society, and many unit owners may experience difficulty in overcoming this mental inertia.”).

\textsuperscript{22} See, e.g., Third Plenum, supra note 7, at X.36 (“We will strengthen the Party’s unified leadership over the work of improving Party conduct, upholding integrity and fighting corruption. We will reform the Party’s discipline-inspection system, improve the leadership system and working mechanism to combat corruption, and reform and improve the function of anti-corruption coordination groups at all levels.”).

\textsuperscript{23} See, e.g., Margaret F. Brinig & Nicole Stelle Garnett, A Room of One’s Own? Accessory Dwelling Unit Reform and Local Parochialism, 45 Urb. Law. 519, 521 (2013) (noting that accessory dwelling units are common in residential neighborhoods despite the fact that many local land use regulations prohibit them).

\textsuperscript{24} For a more comprehensive exploration of this topic, see STEIN, supra note 1, at 147-98.
an additional speculative risk that detracts from their potential return, and they will be correspondingly less willing to commit their funds to acquiring assets that are governed by that legal system.\textsuperscript{25} This is not to say that investors will be unwilling to invest under this type of regulatory uncertainty. These participants should, however, demand higher returns that reflect the increased risk this legal ambiguity generates. This type of uncertainty functions as a drag on the economy, with investors demanding a greater return than they would if the legal risk were lower.\textsuperscript{26}

The law and development model, then, suggests that markets with firmly established property and contract laws will have an advantage in the competition for investment dollars. China, however, has exhibited considerable uncertainty and unpredictability in these areas of the law while still attracting huge amounts of capital.\textsuperscript{27} The question then becomes how to explain this inconsistency. I have already described elsewhere several ways in which to account for China’s unexpectedly strong performance.\textsuperscript{28} I will summarize that subject here very briefly and will also discuss the ways in which informal norms seem to have served as a substitute for formal legal rules in China.

The first explanation for this apparent inconsistency is that the law and development theory is simply wrong. As Frank Upham notes in his criticism of the theory as applied to China, “For those interested in the relationship between law and economic development, . . . it is almost as if those thirty years of growth [1978-}

\textsuperscript{25} See, e.g., Cheryl Xiaoning Long, Does the Rights Hypothesis Apply to China?, 53 J. L. & ECON. 629, 646-47 (2010) (“A higher proportion of business disputes settled through the court system . . . is correlated with a higher investment rate, a higher propensity to adopt automated technology, a higher probability of developing new products, and more long-distance sales for Chinese firms.”); Stefan Voigt & Jerg Gutmann, Turning Cheap Talk into Economic Growth: On the Relationship Between Property Rights and Judicial Independence, 41 J. COMP. ECON. 66, 72 (2013) (concluding that legal promises to protect property rights have little effect on economic development on their own; rather, these legal promises must be buttressed by an independent judiciary); see generally Third Plenum, supra note 7, at IX (“We will deepen reform of the judicial system, accelerate the building of a just, efficient and authoritative socialist judicial system to safeguard the people’s rights and interests, and ensure that the people are satisfied with the equality and justice in every court verdict.”).

\textsuperscript{26} See, e.g., HERNANDO DE SOTO, THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD 152-58 (1989) (discussing the costs of working around an inadequate legal system in Peru).

\textsuperscript{27} The Chinese Communist Party seems to be aware of this potential problem. See Third Plenum, supra note 7, at II.5 (“Property rights are the core of ownership. We need to improve the modern property rights system with clear ownership, clear-cut rights and obligations, strict protection and smooth flow. The property rights of the public sector are inviolable, as are those of the non-public sector.”).

\textsuperscript{28} See generally STEIN, supra note 1, at 170-98 (reviewing and assessing several possible explanations).
2008] have not taken place.”

Carried to its extreme, this argument could even be stretched to suggest that law and development theory is exactly backwards in China, where there is evidence that economic growth is a precondition to legal development.

A second and related possible explanation is that law and development theory, while not completely inaccurate, needs to be refined considerably. Perhaps it overstates the case. Perhaps it is correct as far as it goes while overlooking other causes that have contributed to Chinese economic growth. Perhaps it is more accurate in some contexts and settings than in others. Or perhaps informal systems have filled in many of the gaps in the formal legal system, a point I will return to momentarily. For example, one pair of commentators argues that China’s formal legal institutions provide adequate security for shorter-term investments, but that investors with longer time horizons rely more on close connections with powerful government officials. And Cheryl Xiaoning Long summarizes the literature suggesting that personal relationships are more useful in establishing a less complex economy but that as the economy matures, governance by legal rule becomes more important.

A third alternative is that China is following the law and development theory to a greater extent than many of the commentators have acknowledged and is gradually improving its adherence to rule-of-law standards. My field research in China largely supports this view. In the first days of the modern Chinese real estate market, there was no official law governing property rights, but other early laws were able to fill this gap. China adopted the General Principles of the Civil Law (GPCL) all the way back in 1986, and this early law served as a basic business law blueprint during the ensuing years. Once the GPCL was in place, investors had a higher degree of comfort that their investments were being encouraged and safeguarded by official government policy and that greater protections would follow in time. During the 1990s and early 2000s, China adopted other laws governing business relationships. The Property Rights Law, effective in 2007, was actually one of the final steps in that process. That law may have been adopted fairly

31. Long, supra note 25, at 630, 647.
late, but other related laws already were serving to regulate business dealings and provide investors with the confidence they needed that their stakes were adequately protected.  

If this third alternative is correct – and I believe that it is – then China actually has had sufficient legal protections in place for about thirty years. China’s government was not in a position to draft comprehensive business laws in the early 1980s. It did not yet know what topics it needed to address and in what sequence, it did not have the time to undertake such a massive project quickly enough, and it lacked familiarity with both business and law-making. Meanwhile, the business community was beginning to expand without waiting for the legal system to ratify its actions. The government’s response since that time has been to draft laws as quickly as it feasibly could. Along the way, it observed what the business community was doing and what was working and what was not, and endorsed some of these experiments in its ever-expanding body of formal law. Legislators learned from the business community, which then responded to the new legislation. Thus, legal and business developments proceeded hand in hand, with each side prodding the other to act. During this interim period, informal norms and guanxi also served to fill in some of the gaps in the legal system.

This point serves as a reminder that China’s development of an effective legal system has involved considerable transmission of information in both directions. It is not simply the case that business people begin by doing the best they can under considerable legal uncertainty and then the government, acting in isolation, adopts a legal structure unrelated to these new practices. Rather, the government observes what is happening in practice and is influenced by it, even as business people lobby for particular reforms. By following this approach, the Chinese government has been able to adhere to a development strategy that fosters economic progress. Once a legal structure is adopted, the business and legal communities adjust to it while also pressing for additional changes.


33. See David Kennedy, Law and Development Economics: Toward a New Alliance, in LAW AND ECONOMICS WITH CHINESE CHARACTERISTICS: INSTITUTIONS FOR PROMOTING DEVELOPMENT IN THE TWENTY-FIRST CENTURY 19, 55 (David Kennedy & Joseph E. Stiglitz eds. 2013) (“The focus on legal formalization downplays the role in economic life of the informal sector – the sector governed by norms other than those enforced by the state or that emerges in the gaps among official institutions”); Li and Li, supra note 3, at 25-27 (noting how guanxi has served as an informal enforcement system in China but suggesting that it needs to be supplanted by rule-of-law principles as the Chinese economy becomes more complex and China’s citizens become more mobile).
There is an ongoing conversation among business professionals, lawyers, legislators, and judges, with every action leading to a response and the system evolving over time. In theory, real estate practice should become more efficient and predictable as it matures, as appears to be happening in China. So while the law and development model in its purest form holds that legal developments must precede business investment, in fact, the two are more likely to progress in tandem, with developments in each sphere influencing the other in a type of feedback loop. Moreover, these developments reflect China’s unique history and culture.

Every step of the way, the business community had enough comfort to act, with each subsequent legal development providing more certainty and thereby reducing investment risk. The 2007 Property Rights Law was important, but earlier legislation had already done much of the necessary labor. If lawmakers had had a decade to sit down and draft a comprehensive law before the business community acted, they might have come up with a more coherent and systematized legal approach. But the system that actually developed may be superior to the one that process might have produced, in that it reflects actual experience and encourages further experimentation. China has managed to develop a sophisticated system of business law in little more than a quarter of a century, while it took the West about two centuries to reach this

34. See van Gelder, supra note 4, at 497 (“[S]ettlements often actively attempt to establish their ‘legality’ through strategies of noncompliance with, and adaptation to, the official legal system in order to ultimately enforce formal recognition by the latter, which gives rise to a dynamic and evolving relationship between the two.”); see also id. at 510 (discussing the effects of “presenting the authorities with a fait accompli that is difficult to return to its original form and residents in these settlements also progressively attempt[ing] to convert the informal tenure into legal tenure through processes of negotiation, contestation and adaptation.”).


36. See David Kennedy, Some Caution about Property Rights as a Recipe for Economic Development, in Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century 187, 192 (David Kennedy and Joseph E. Stiglitz eds. 2013) (“Consequently, property rights are less a legal ‘system’ than a historical record of winners, losers, and social accommodation in economic and political struggles over a nation’s direction. . . . The ongoing allocation and definition of property entitlements is part of the social and political history of any market economy.”).

37. For a valuable discussion of the sequencing of Chinese legal and economic development, see Alice Xie, Revising the Law-Growth Hypothesis: A Case Study of Reform-Era China, 6 NW. INTERDISC. L. REV. 155, 178 (2013) (“Not only can economic activity flourish in the absence of law, but it may actually stimulate and inspire the development of the legal system.”); id. at 157 (“China is a case in point of how alternative mechanisms to the rule of law, and indeed wholly alternative systems, can sustain such conditions to yield spectacular economic growth.”).
same level of legal development. Of course, the Chinese process has been far more harried and frenetic.

These three possible explanations are not the only ways in which China’s recent growth can be harmonized with the traditional model of law and development. A fourth possibility is that the law and development model cannot be transplanted to China because of the huge historical, cultural, and social differences between China and the West. The nation is too big and too different, and is developing too rapidly, for anyone in the West to expect a supposedly universal model to apply to China.

Mo Zhang notes, for example, that “China does not regard the rule of law as having universal application. Instead it insists that the rule of law in a country is determined by and conforms to its national conditions and social system.”38 Similarly, in commenting on the large amount of control China’s government continues to exercise over its economy, another pair of commentators notes a growing consensus that China’s “state-investment-led, export-oriented variants work well during the catch-up phase under favorable global conditions but do not work at higher stages of development.”39 In fact, one pair of commentators even argues that culture serves as a partial determinant of economic development.40 And Mary Szto describes the importance of various Chinese rituals to the practice of law, a fact that a Western observer less familiar with China might easily overlook.41

A fifth and related alternative is that it is foolhardy to attempt to apply the law and development model to a nation that is still Communist. Under this view, China’s economic system has not changed sufficiently since the death of Mao to be a suitable subject for examination under a Western economic model. No one disputes that China’s economy has undergone remarkable change in recent decades. Even so, this criticism still might apply to certain portions of China’s real estate sector. For example, it is fair to ask whether China’s rural land system has changed to the point where it makes

39. Randall Peerenboom & Bojan Bugarić, Development After the Global Financial Crisis: The Emerging Post Washington, Post Beijing Consensus, 19 UCLA J. INT’L L. & FOREIGN AFF. 89, 99 (2015). The authors proceed to ask whether the problem with the Washington consensus is “an invisible hand and too little government intervention,” while the problem in China today is “too visible a hand and too much government intervention.” Id. at 100.
sense to attempt to apply the law and development model to it.\textsuperscript{42} One might reasonably make the same inquiry about China’s state-controlled lending industry, discussed above.\textsuperscript{43}

A sixth possibility is that each nation is unique, and no one can expect a generalized model to apply terribly well to any specific nation. One-size-fits-all garments do not actually fit most people terribly well, and “developing countries cannot just imitate international best practices.”\textsuperscript{44} This sixth possibility unifies the previous five in many ways: China does not seem to be following the law and development model in full but it has adopted it to some extent, and the areas of nonconformity reflect China’s exceptionality. Of course, this type of rationalization both confirms and discredits the law and development model, or just about any other model for that matter: The model fits where it fits, and no one can expect any model to fit perfectly.\textsuperscript{45}

Thus, there seem to be at least six ways to explain the apparent disconnect between China’s recent economic growth and the traditional model of law and development. As this part demonstrates, that lack of conformity may be inherent in any model. A model is not a perfect predictor of actual behavior, and China’s departures from the model may just be what one should expect.

It does appear, though, that China has followed the law and development model reasonably well. This statement is particularly true once one recognizes that even before China adopted its Property Rights Law, it had implemented other business laws that did a fairly good job of providing the market with the requisite predictability. China’s system was only partially developed at that point, but it did exhibit enough of the elements of a formal legal system to give comfort to real estate investors. They were not simply investing and hoping for the best. Rather, they knew what these other laws said, they had a good sense of how these rules were being applied.

\textsuperscript{42} Note, for example, that many of the buildings in formerly rural Shenzhen are built on land to which the purported owners have only questionable legal title. See Shitong Qiao, \textit{Planting Houses in Shenzhen: A Real Estate Market Without Legal Titles}, 29 CAN. J.L. & SOC. 253, 258 (2014) (noting that “the need for economic development in Shenzhen could not wait for definitive legal authorization of rural land development and transactions from the Chinese central government”).

\textsuperscript{43} Benjamin Liebman suggests that China has pulled back from its move toward the rule of law in response to social protest. Benjamin L. Liebman, \textit{Legal Reform: China’s Law-Stability Paradox}, 143 DAEDALUS 96, 97 (2014) (suggesting that recent events demonstrate “a retreat not only from legal reform but also from the rule-based model of authoritarian governance that has contributed much to the resilience of the Chinese system”).

\textsuperscript{44} Peerbooms & Bugaric, \textit{supra} note 39, at 101.

\textsuperscript{45} See, e.g., David Kennedy & Joseph E. Stiglitz, \textit{Introduction, in Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century} 1, 9 (David Kennedy & Joseph E. Stiglitz eds. 2013) (“In every market economy, each [property law and contract law] is a complex legal regime reflecting a history of social, political, and economic conflict and debate.”).
enforced, and they knew what existing social norms and customs permitted and prohibited. The Property Rights Law may have solidified this system still further, but the structure was largely in place well before 2007. This means that, to a considerable degree, China has been following the law and development model fairly well since the mid-1980s.

V. CONCLUSION

Real estate professionals in China continue to face many of the same uncertainties they have confronted for years. But these professionals seem confident that the Chinese legal system provides adequate legal assurances to protect their assets, a fact which encourages further investment in this rapidly growing market. China now has a comprehensive Property Rights Law, but investors felt a high degree of comfort under pre-existing business laws even before China adopted that law in 2007. In fact, the legal and business systems in China have developed in tandem, with each one examining, reflecting, and learning from the other. The government views the burgeoning real estate market as a series of experiments, and it observes the successful efforts and drafts new laws accordingly. Investors adapt to those laws even as they seek to influence future legal developments. Moreover, given the high level of government involvement in the so-called private market, it would be naïve to treat the government and the investment community as two distinct groups. The government may be adopting laws that protect the very investments that the government itself or individual government officials have made in the real estate market.

Recent Chinese business practices may have developed in ways that appear to contradict business laws, or may have arisen in the absence of those laws. But real estate professionals have astutely experimented, learned from their mistakes, and influenced future legal growth. The Chinese system appears to provide a high – and continually increasing – level of predictability and comfort to investors. As a result, China truly does appear to be following the traditional model of law and economic development.