Abstract

Chinese Small Property: The Co-Evolution of Law and Social Norms

Shitong Qiao, 2015

This research investigates a market of informal real estate in China, referenced by the term “small property” (xiaochanquan), as their property rights are smaller/weaker than the big/formal property rights. In particular, I examine the formation and operation of this market, and how it interacts with the legal system and eventually leads to changes in the Chinese property law system.

Three decades of Chinese land reform has resulted in a liberalized urban real estate market and an unreformed rural real estate sector characterized by inalienability. Nevertheless, according to the Chinese Ministry of Land and Resources, by 2007, Chinese farmers had built over 6.6 billion square meters of houses in evasion of the legal prohibition on rural land development and transfer, resulting in a huge small-property market. By way of comparison, in 2007, the total floor space of housing sold on the legal housing market was 0.76 billion square meters.

In the city of Shenzhen, which experienced exponential population growth from 300,000 to over 10 million from 1978-2010 as the first experimental site of China's market reforms, almost half of the buildings are small-property constructions. These illegal buildings, without legal titles and concentrated in 320 intra-city villages, host most of the 8 million migrant workers in Shenzhen and are the main livelihood of the more than 300,000 local villagers. There has formed a huge impersonal small-property market that is supported by a network of institutional innovators, including local villagers and
their co-ops, local government officials, real estate developers and brokers, lawyers, etc. Both the risks of contract breach and of government demolition are greatly reduced because of the implicit consensus on rural land development and transfer.

However, as land available for development decreases, the Shenzhen city government has adopted various policies on small property, ranging from legal enforcement of the prohibition to legalization. These varying and changing policies, together with the tensions and conflicts within the Chinese legal system, have led to different interpretations and applications across time and in different villages, resulting in the diverging destinies of small property.

This case study endeavors to explore the co-evolution of property law and norms in the Chinese market transition. First, it finds that property norms changed more swiftly than property law and served as imperfect institutional infrastructure for a market economy at the beginning of the Chinese market transition. Property norms, as examined in this research, are norms of “intermediate-knit groups,” which consist of a core network of institutional and market entrepreneurs, and extends to millions of unacquainted and unrelated sellers and buyers.

Second, it discloses a more dynamic interaction between law and social norms in China. In particular, it explores how a layered and fragmented legal system leaves room for the growth of property norms, and how the ad hoc legal responses to the deviating property norms lead to changes in both the property norms and property law itself. What connects law and social norms are the institutional entrepreneurs who play different roles in different systems simultaneously in accordance with the identity they assume within each system. From the perspective of institutional actors, law and social norms are
endogenous to and integrated with each other, rather than exogenous to or separate from each other.

Overall it presents a story about the evolution of property rights with consideration of political, economic and communal factors combined, as opposed to the existing case studies that focus on only one of the above three aspects.

At the methodology level, this research endeavors to combine on-the-ground observations with insights from social sciences, in particular, law and economics. On one hand, this research is based on my eleven-month fieldwork in Shenzhen, during which I did interviews, observed small-property transactions, participated in policy-making of the local government, and collected case files, transaction documents, government reports, etc. On the other hand, it applies and tests interest group theory in explaining Chinese property law reform; coordination game models and focal point theory in explaining the formation and operation of the small-property market; optional law theory in examining the different legal approaches to the small-property market adopted by the Shenzhen city government, and a multiple-network evolution model in explaining the diverging destinies of small property resulting from the distinct reconstitution of law and social norms in different local settings.
Chinese Small Property:

The Co-Evolution of Law and Social Norms

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INTRODUCTION

I. A Market without Legal Titles?

Can a real estate market form in the absence of a supportive property law system? If so, how, and by what means does it operate? What would be the legal responses to such an extralegal market? How would the legal responses influence the evolution of the extralegal market and the underlying property arrangements?

The answer to the first question has conventionally been no. “Where do we record the relevant economic features of assets, if not in the records and titles that formal property systems provide? Where are the codes of conduct that govern the use and transfer of assets, if not in the framework of formal property systems?”

Hernando de Soto, by posing these rhetorical questions, implies that life in informal settlements, where formal property rights are absent, is nasty, brutish, and poor. For example, according to a study on informal settlements in Lima, Peru, one adult must occupy the house twenty-four hours a day in order to prevent others from taking possession of it. The presumption is that informal property rights must be uncertain and insecure, and, thus, transactions must be very limited. In De Soto’s seminal works on the relationship between informal property rights and a market economy, The Other Path and The Mystery of Capital, de Soto discussed real estate transactions in seven pages in the former and not at all in the latter. In the following years, most academic research has focused on calculating the

4 DE SOTO, supra note 2, at 25, 30–33, 35, 54 (discussing illegal real estate transactions).
value of legal titles—including topics such as how titling programs have increased tenure security, promoted investment, and increased the value of the property.\(^5\) In “Hernando de Soto and Property in a Market Economy,” a book consisting of essays by leading property law scholars, the editor writes in the introduction that,

“[I]t is important to distinguish between the two types of arguments that De Soto makes about property. De Soto’s arguments that formal property systems are **necessary** to the proper functioning of a market economy receive little, if any criticism. In contrast, de Soto’s apparent argument that property formalization is sufficient to bring the benefits of a market economy to the poor has received sustained criticism.”\(^6\) [emphasis added]

Real estate is the primary form of property and probably the most valuable asset to most individuals. Scholars assume that a real estate market cannot operate, nor even form, without property rights.\(^7\) As a result, development scholars have seldom studied exchanges of untitled real property. To my knowledge, one significant exception is Annette M. Kim, who examines the housing market in Ho Chi Minh City, Vietnam, where the vast majority of private titles in urban areas had still not been distributed by the state.\(^8\) Even this rare exception focuses on the value of a legal title, rather than the mechanism of property rights and market in the absence of a supportive legal system.

However, a well-functioning property law system should be the end – not

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the beginning - of discussions of property rights and economic development. Most
developing countries are struggling to build a well-functioning property law
system. Thus, it is crucial to explore how a market economy and the underlying
property arrangements work in the absence, rather than the presence, of a well-
functioning property law system.

A real estate market can form in the absence of a supportive property law system.
According to the Chinese Ministry of Land and Resources, by 2007, Chinese farmers had
built over 6.6 billion square meters of houses in evasion of the legal prohibition on
private rural land development and transfer, resulting in a huge market of illegal houses.
By way of comparison, in 2007, the total floor space of housing sold on the legal housing
market was 0.76 billion square meters.9 People in China call these illegal buildings
“small-property houses” (xiaochanquan in Chinese)10 because their property rights are
“smaller” (weaker) than those on the urban/formal housing market, which have “big”

9 房产存量 66 亿平米相当于十年房产成交量 [Small-Property Houses total 6.6 Billion Square Meters, almost the same amount of Legal Housing Transactions within a Decade]
10 There is no general consensus on the translation. Fennel uses “small title” to describe the phenomenon; Chen use “housing with a petit title” to describe the phenomenon; some others use “small property rights housing,” “minor property rights” or “limited property housing.” As this research shows, it is not a simple “title” problem, but a phenomenon we need to understand from the perspective of the evolution of the Chinese property system. “Property” is a more precise word than “title” because of its more encompassing meaning. People might worry about the conflation of physical property and property rights when I use “small property” as the translation. Here I refer to Alchian and Demsetz: “In its original meaning, property referred solely to a right, title, or interest, and resources could not be identified as property any more than they could be identified as right, title, or interest.” Armen A. Alchian and Harold Demsetz. The Property Right Paradigm, 33 J. ECON. HIST. 16, 17 (1973). Under this understanding of the term “property”, the word “rights” becomes superfluous. Accordingly, I use “small property” to depict the general phenomenon, and “small-property buildings,” “small-property houses,” or “small-property constructions” to refer to the physical constructions built under the general phenomenon. Also, “small” is more direct and neutral than “minor” or “limited.” See Wang Lanlan, Tieshan Sun & Sheng Li, Legal title, tenure security, and investment—An empirical study in Beijing, HOUSING STUD.1 (2014); Li Lixing, Land titling in China: Chengdu experiment and its consequences, 5 CHINA ECON. J. 47 (2012); Wang Qianyi, Miao Zhang & Kee-Cheok Cheong, Stakeholder perspectives of China's land consolidation program: A case study of Dongnan Village, Shandong Province, 43 HABITAT INT'L 172 (2014); Lee Anne Fennell, Options for Owners and Outlaws, 1 BRIGHAM-KANNER PROP. RTS. CONF. J. 239 (2012); Ruoying Chen, Informal Sales of Rural Housing in China: Property, Privatization and Local Public Finance (2010) (unpublished Ph.D. dissertation, University of Chicago) (on Proquest).
property rights protected by the government. Shenzhen is the city with the highest ratio of small-property houses, which make up 47.57% of the city’s total floor space, compared to 30% in Xi’An and 20% in Beijing. 11 These illegal buildings, lacking legal titles and concentrated in 320 intra-city villages, host most of the eight million migrant workers in Shenzhen and are the main livelihoods of the more than 300,000 local villagers. The market has developed in step with China’s continuing struggle for a formal property regime, an effort that is still unfinished. According to an official at the Shenzhen Real Estate Ownership Registration Center, “Nobody cares whether they have legal titles or not. You say they are illegal, dare you void the contracts? You say they are legal, are you to grant them legal titles? The contracts are there—to void them, could you do that? It is a huge number of transactions—you say farmers cannot sell, it is illegal, but they do it privately with little ado. Are you to tell them whether it is legal or illegal?” 12

The object of my study is the co-evolution of property law and norms in the formation, operation and institutionalization of the small-property market in Shenzhen. This dissertation is based on my eleven-month fieldwork in Shenzhen, during which I observed small-property transactions firsthand; interviewed real estate brokers, lawyers, buyers, sellers and government officials and judges whose work was related to small-property houses; and participated in the formation of government policies addressing small-property houses. I collected government investigation reports, court files, village maps and records, transaction documents, and news reports that addressed small-property houses to further my research.

12 Interview with a city government official, in Futian District of Shenzhen City (June 7, 2012).
II. The Market: A Bird’s Eye View

A. Chinese Property Law Reform and Small Property Nationwide

In the early 1980s, the communist prohibition on land alienation proved to be inadaptable to a market-oriented economy with the experimentation and implementation of the “reform and opening-up” policy under the leadership of Deng Xiaoping. This inadaptability was most acute in the urban area, where both urban construction and cooperation with foreign investors could benefit greatly from land development and transfer. As a result, in 1988, China amended both the Constitution and Land Administration Law (“LAL”), stating that use rights to both state-owned and collective-owned land could be transferred “according to law.” On May 19, 1990, the State Council promulgated detailed rules governing the sales of urban land use rights from the government and the transfer among land users.\(^\text{13}\)

This urban land use reform not only built the legal basis for China’s urban real estate market but also made land the most important source of revenue for Chinese local governments, which can requisition rural land at compensation equal to its agricultural value and sell the same land on the urban land market at 50 times or more of that value.\(^\text{14}\) As a result, the more the urban real estate market develops, the more unlikely it is that the

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\(^{13}\) For the history of Chinese property law, see Chapter One.
\(^{14}\) Compensation for the requisitioned rural land is mainly based on its agricultural output, but the government transfers it at urban land market prices. Chinese laws do say that land requisition should be “for the need of public interest.” See art. 10 of the Chinese Constitution and art. 42 of the Chinese Property Law. However, as rural land requisition is the main legal way to satisfy the vast need for construction land in China’s urbanization process, the above public interest requirement has been essentially moot. See Chapter One for a more comprehensive explanation.
central and local governments would liberalize rural land development and transfer, since this would jeopardize their monopoly over land.15

Unsurprisingly, the corresponding legal authorization for the transfer of rural land use rights has never been promulgated. Instead, the Chinese government made a comprehensive revision to LAL that excluded the possibility of the transfer of rural land use rights in 1998. The 1998 revision also made it clear that rural-urban land conversion could only be legally achieved through requisition by the state.16

However, the rural land has not been insulated from the booming urban real estate market. The boom in China’s urban real estate market began in 1998, when the central government decided to replace its housing allocation system with a housing market.17 According to official statistics, from 1998 to 2007 the annual nationwide sales of residential houses grew tenfold.18 Under such circumstances, rural land, especially land located near urban areas, has become attractive. Therefore, local governments have great incentives to seize rural land. The general mechanism is that the government requisitions rural land, converts it to urban land (thereby qualifying it for various construction purposes), and then sells it to commercial land developers. Millions of acres of rural land

15 See Chapter One.
16 Id.
have been urbanized in this way in China since the 1980s, creating more than 40 million landless farmers.\textsuperscript{19}

One way Chinese farmers have responded to this unjust law is by evading legal prohibitions on rural land development and transfer. Farmers living in the periurban\textsuperscript{20} areas of big cities often face large incentives to transfer their houses to urban residents who cannot afford a house in the urban area. While they cannot sell houses at prices comparable to those on the formal market due to the illegality of the transfer, they can still get much more profit than they could from using the land for agricultural purposes. Their illegal transfers of land for non-agricultural uses have created a huge informal real estate market in China.

The prices of small-property apartments are significantly lower than those of legal apartments, ranging from 20\% to 60\% of the price.\textsuperscript{21} For better or worse, small-property houses have become a serious option for many Chinese residents. According to an investigation in 2011, 60.3\% of the respondents viewed small-property apartments as an option for buying a house.\textsuperscript{22}

B. Small-Property Market in Shenzhen

Shenzhen, a city in the southern part of southern China’s Guangdong

\textsuperscript{19} 新华网：《委员称失地农民超 4000 万人 过半人生活困难》，2011 年 3 月 9 日 \textit{[A CPPCC Member Revealed that there were over 40 Million Landless Farmers, Over Half of Them Live in Hard Times, XINHUA NET (March 9, 2011)], http://news.qq.com/a/20110309/001085.htm (last visited Feb. 18, 2013).}

\textsuperscript{20} “Periurban” is defined as areas where the dynamic, interactive and transformative urbanization is happening and mixed features of the rural-urban spectrum are present in the background of developing countries. See e.g., David L. Iaquinta & Axel W. Drescher, \textit{Defining Periurban: Understanding Rural-Urban Linkages and Their Connection to Institutional Contexts} (Paper presented at the Tenth World Congress of the International Rural Sociology Association, Rio de Janeiro, Aug. 1, 2000).

\textsuperscript{21} REICO 工作室：《我国小产权房问题研究：现状与出路》\textit{[INVESTIGATION REPORT OF SMALL-PROPERTY CONSTRUCTIONS 12-13, REICO (2012)]} (on file with author).

\textsuperscript{22} 袁业飞：《禁？放？小产权房路在何方？——聚焦走到十字路口的小产权房》，《中华建设》，2011 年第 5 期，6-15 页\textit{[Yefei Yuan, Whither Is Small Property?, CHINA CONSTRUCTION, 2011(5): 6-15.]}

7
Province and situated immediately north of Hong Kong, has been the literal and symbolic heart of the Chinese economic miracle. In many ways, Shenzhen epitomizes China’s recent economic development: it is the starting point of China’s transition to a market economy, the birthplace of China’s urban land-use reform and modern real estate industry, and the city with the highest ratio of small-property houses in China. It is the ideal case study of the relationship between property rights and the market economy in China.

In 1980, Deng Xiaoping, the then-supreme leader of China, designated Shenzhen—then named Bao’An and a small agriculture county—as a “special economic zone” (SEZ) for piloting market-oriented reforms. Within this special economic zone, investment from overseas Chinese, Hong Kong, Macau, and foreign companies would be permitted and used for urban construction.

Since the establishment of the SEZ, Shenzhen has experienced miraculous economic growth and urbanization. In 1979, the urban population in Shenzhen was no more than 30,000, and all of the remaining population of 284,100 was rural. Agriculture was the county’s main and nearly only industry in 1979. There was no decent public infrastructure—not even a sewage system. From 1979 to 2010, the annual average growth rate of gross domestic product (“GDP”) in Shenzhen was 25.3%. The population of Shenzhen has grown from 314,100, of whom 312,600 have local hukou (household

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24 See, e.g., 江潭瑜主编：《深圳改革开放史》，人民出版社 2010 年版 [The History of Reform and Opening-Up in Shenzhen (Jiang Tanyu, ed., 2010)].


26 Id. at 5.
registration) in 1979 to 10,372,000 in 2010, of whom only 2,510,300 have local hukou.\textsuperscript{27} Shenzhen ranked fourth in GDP and first in GDP per capita among mainland Chinese cities in 2009.\textsuperscript{28} In 2010, the GDP of Shenzhen was over 958 billion RMB (1 RMB = 0.16 USD).\textsuperscript{29} Shenzhen has ranked first since 1993 in the total value of exports among all mainland Chinese cities.\textsuperscript{30} Moreover, the economies of Shenzhen and Hong Kong are closely interconnected; an integration plan has even been officially proposed.\textsuperscript{31} More than half of the foreign direct investment in Shenzhen has been from Hong Kong.\textsuperscript{32}

Three decades ago, most of the land in Shenzhen was rural and collectively-owned by the farmers of the respective villages. Urban (state-owned) land made up a bit more than three square kilometers in Shenzhen in 1980. The Shenzhen government has since converted most of the rural land to urban land under its jurisdiction. Villages that used to be located on the outskirts of the city are now surrounded by urban buildings, many of which are skyscrapers. In the urbanization process, the Shenzhen government requisitioned most of the rural land (mostly farmland) and converted it to urban land, preserving only the rural land on which residential homes and village factories had been built because of the higher social and economic costs of requisitioning those plots. These remaining villages are called “intra-city villages” (chengzhongcun in Chinese). Though located in the midst of the urban area, land in intra-city villages is still rural, which makes it subject to the legal prohibition on rural land development and transfer. Among the total

\begin{flushleft}
\textsuperscript{27} Id. at 4.
\textsuperscript{28} 乐正主编: 《深圳之路》，人民出版社 2010 年版，第 16 页[ZHENG LE, THE ROAD OF SHENZHEN 16(2010)]
\textsuperscript{29} SHENZHEN STATISTICAL Y.B. 2011, supra note 25, at 5.
\textsuperscript{30} Le, supra note 28, at 121.
\textsuperscript{32} In 1986, 78.86% of foreign investment in Shenzhen came from Hong Kong; 63.47% in 1988; 64.49% in 1992; 71.69% in 1998; 53.91% in 2001; 53.05% in 2005; 63.75% in 2008. SHENZHEN STATISTICAL Y.B. 2011, supra note 25, at 284.
\end{flushleft}
1,993 square kilometers of land in Shenzhen, the government failed to convert over 300 square kilometers of rural land to urban land, on which there have been 356,852 illegally-built buildings, totaling 392 million square meters and making up 47.57% of the total floor space of Shenzhen.\textsuperscript{33}

<table>
<thead>
<tr>
<th></th>
<th>Number of Buildings</th>
<th>Total Floor Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illegal Buildings</td>
<td>356,852</td>
<td>392 million</td>
</tr>
<tr>
<td>Total Buildings</td>
<td>620,800</td>
<td>824 million</td>
</tr>
<tr>
<td>Illegal Buildings (%) of Total Buildings</td>
<td>57.49</td>
<td>47.57</td>
</tr>
</tbody>
</table>

Table I.1: Illegal Buildings in Shenzhen\textsuperscript{34}

In the periurban area, the actual problem is not to find a small property, but to find a legal property. Small-property building were intended for a variety of residential and industrial uses, as well for use as shopping malls, offices, and public facilities such as primary schools, hospitals and even government buildings. This differs from the conventional view of informal settlements presented by de Soto and many others. In a report on small property in Shenzhen, a journalist found that even an official building of a sub-district government had no legal titles.\textsuperscript{35} Following is a table on the different uses of small-property buildings. The total number is 348,400 because information on 8,440 small-property buildings was not reported to the government.\textsuperscript{36}

\textsuperscript{34} Id. at 11.
\textsuperscript{36} Shenzhen City Gov., supra note 33, at 13.
Many of these small-property buildings are of decent quality and are not “small” at all. According to an official from the Bureau of Construction of the Shenzhen city government, “The illegal buildings built after 2000 were designed and built under professional supervision; they also used high-quality steels; the qualities of these buildings are above the median.”\(^\text{38}\) As shown in the following table, many small-property buildings are typically five to ten floors high. The tallest may reach fifteen floors or higher.

\(^{38}\) Interview with a city government official, in Bao’An District of Shenzhen City (June 29, 2012).
Table I.3: Number of Floors of Small-Property Buildings in Shenzhen

<table>
<thead>
<tr>
<th>Number of Floors</th>
<th>Number of Buildings</th>
<th>Ratio (%)</th>
<th>Total Floor Space (millions of square meters)</th>
<th>Ratio (%)</th>
<th>Land Area (millions of square meters)</th>
<th>Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 or unknown</td>
<td>94100</td>
<td>27.02</td>
<td>21</td>
<td>5.51</td>
<td>29</td>
<td>22.65</td>
</tr>
<tr>
<td>2-4</td>
<td>118600</td>
<td>34.03</td>
<td>121</td>
<td>31.35</td>
<td>53</td>
<td>41.35</td>
</tr>
<tr>
<td>5-6</td>
<td>69500</td>
<td>19.95</td>
<td>104</td>
<td>27.04</td>
<td>25</td>
<td>19.05</td>
</tr>
<tr>
<td>7-10</td>
<td>58500</td>
<td>16.77</td>
<td>94</td>
<td>24.54</td>
<td>15</td>
<td>11.73</td>
</tr>
<tr>
<td>11-14</td>
<td>5800</td>
<td>1.67</td>
<td>23</td>
<td>5.95</td>
<td>5</td>
<td>3.47</td>
</tr>
<tr>
<td>15 or more</td>
<td>1900</td>
<td>0.56</td>
<td>22</td>
<td>5.61</td>
<td>2</td>
<td>1.74</td>
</tr>
<tr>
<td>Total</td>
<td>348400</td>
<td>100.00</td>
<td>385</td>
<td>100.00</td>
<td>129</td>
<td>100.00</td>
</tr>
</tbody>
</table>

De Soto suggests, with no empirical backup, that both the selling and the renting of the illegal buildings would be limited because of the lack of legal titles. Below, I present some statistics from the Shenzhen government to discuss the scale of the market, which is not limited to exchanges between villagers and their acquaintances.

For residential buildings, about 34% of the current owners were not original villagers, the only category of legal owners. For non-residential buildings, 60.75% of the

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39 Shenzhen City Government, supra note 33, at 70.
40 De Soto, supra note 2, at 25.
current owners were not village co-ops, the only category of legal owners.\textsuperscript{41} Regarding
the land used for small-property buildings, for residential buildings, over 43% of the land
had been transferred to non-villagers. For non-residential buildings, over 30% of the land
had been transferred to non-villagers.\textsuperscript{42}

\begin{table}[h]
\centering
\begin{tabular}{|l|l|l|}
\hline
 & Owner & Land \\
\hline
Residential Buildings & 34\% were not original villagers & 43.53\% had been transferred to non-villagers \\
Non-Residential Buildings & 60.75\% were not original village co-ops & 30.2\% had been transferred to non-villagers \\
\hline
\end{tabular}
\caption{Illegal Transactions of Land and Buildings\textsuperscript{43}}
\end{table}

The Shenzhen government also investigated small-property high-rises, buildings of
fifteen floors or more that were mostly built after 2000 in response to the high demand
for residential housing in Shenzhen. The total floor area of these buildings totaled
21,598,800 square meters,\textsuperscript{44} about one-third of the total area of legally developed
residential houses for sale built in Shenzhen from 2000 to 2009.\textsuperscript{45} The Shenzhen Urban
Planning and Design Institute conducted a questionnaire survey of small-property
apartments in these high-rises. Among 334 buyers, 278 used their apartments for self-
living; 56 used their apartments for renting or investment.\textsuperscript{46} Regarding the size of their
apartments, 36 were less than 70 square meters; 96 were between 70 and 90 square

\textsuperscript{41} Shenzhen City Gov., \textit{supra} note 33, at 66–67.
\textsuperscript{42} Id.
\textsuperscript{43} Id. at 49, 65. Some sold land directly; some sold buildings and the land was not sold.
\textsuperscript{44} Id. at 77.
\textsuperscript{45} From 2000 to 2009, the official market of residential houses supplied 59,220,000 square meters of
housing in total. 黄珽主编：《深圳房地产年鉴（2011）》，海天出版社，第 151 页[SHENZHEN REAL
ESTATE YEAR BOOK 2011 151 (Huang Ting, ed. 2011)].
\textsuperscript{46} SHENZHEN URBAN PLANNING & DESIGN INSTIT., SURVEY ON UNIFIED-CONSTRUCTED BUILDINGS (2012),
on file with the author.
meters; 172 were between 91 and 140 square meters, and 30 were more than 140 square meters.\textsuperscript{47}

There is no comprehensive data available on the total number of small-property transactions, but according to a government official in Bao’An, one district of Shenzhen, the number of illegal sales of small-property apartments was about half that of sales of legal/big-property apartments (there were about 1,400,000 sales of legal apartments in 2011 in that district).\textsuperscript{48} These transactions are not limited to villagers and their personal contacts; rather they happen daily between strangers. Village co-ops, real estate brokers, land developers, and other stakeholders have formed a network to support this small-property market.\textsuperscript{49} Small-property apartments can be used and rented freely, sold and mortgaged subject to some constraints, and compensated according to the same standard of big-property apartments when requisitioned by the government.\textsuperscript{50}

III. Piercing the Market: Structure of the Dissertation

Chapter One investigates the history of land use reform in China and proves that the so-called rural land problem is the consequence of China’s partial land use reform. In 1988, the Chinese government chose to conduct land use reform sequentially: first urban and then rural. It was a pragmatic move because it would focus the reform and would provoke much less resistance. A consequence was that local governments in China became the biggest beneficiary and supporter of the partial reform. However, as a beneficiary of partial reform, local governments do not necessarily support further reform because of the excessive

\textsuperscript{47} Id.
\textsuperscript{48} Interview with a city government official, in Bao’An District of Shenzhen City (June 26, 2012).
\textsuperscript{49} See Chapter Two for more details.
\textsuperscript{50} Id.
rents available between the market of urban real estate and the government-controlled rural land system. The central government, in particular its agency in charge of land administration (the former Bureau of Land Administration, which has been elevated to the Ministry of Land and Resources), also has interests embedded in this regime. In contrast, Chinese farmers and other relevant groups, have no voice or power in the political process of the reform, which makes it difficult for the central government to achieve an agenda that balances the interests of all parties.

However, this is not to say that a country, even without a democratic political structure, would necessarily be trapped in the partial reform equilibrium. In the China case, Chinese farmers challenged the existing system by forming a huge small-property market, around which social groups disadvantaged by the partial reform, mainly Chinese farmers and the middle-and-low income urban population, present their interests and their capacity to counteract the goals the central and local governments hope to achieve through the existing system. This has led to adaptive policy changes. Recent news demonstrates that Chinese land reform is moving in a direction that would address Chinese farmers’ concerns, though much work is still needed to unify the small-property market and the legal real estate sector.

Based on my fieldwork in Shenzhen, Chapter Two presents the factual situations and mechanisms of the small-property market in Shenzhen. The main

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51 Under the current dual land system, which is the result of this partial reform, the government can requisition rural land at compensation equal to its agricultural value (because rural land sector is not liberalized for construction or commercial uses) and sell the same land on the urban land market (which is monopolized by the government) at prices according to its construction or commercial value, which is often 50 times or higher of the agricultural value. See Chapter One for a comprehensive discussion.
participants in the market are legitimate and include village co-ops, real estate brokers, lawyers, a local bank, and even the local government branches and agencies, which from time to time choose to acquiesce to the development of the small-property market. Although they are legitimate actors, they are not constrained by legalities. They have developed a network to support the operation of the small-property market. The formal property law has been ambiguous and subject to change and inconsistent enforcement, and, thus, it has had limited prohibitive force.

Chapter Three models the formation and operation of the small-property market as coordination games and demonstrates that a focal point of rural land development and transfer coordinates players’ expectations to converge on the same equilibrium. It investigates the historical, political and other contextual factors that not only structure the interactions of relevant parties but also influence their expectations.

Chapter Four focuses on the Shenzhen government’s policies addressing small-property houses. To demolish them has proven an impossible mission. To legalize them would encourage more illegal buildings. I frame this small-property conundrum as an adverse possession question and resolve it by utilizing the optional law framework developed by Ayres. I find that in an effort to grandfather in existing small-property constructions and deter further development of small property, the Shenzhen government has spent the last three decades adopting land use policies that can be neatly categorized into the five rules of legal entitlements under the optional law framework. The only missing rule, Rule 5, also provides a
solution to a certain type of cases. Evidence from my fieldwork shows that Rule 2, the liability rule in which entitlement is assigned to the government, subject to taking by residents willing to pay the government, is most successful. I make a general argument in this Chapter that the allocation of initial options matters as much as the allocation of initial entitlements and that options should be granted to parties with the best information to make decisions, which in the small-property case, are the individual owners rather than the government.

Chapter Five explores two distinct outcomes for small-property villages. Some villages successfully gain government recognition of their real estate business by making use of various government policies created in response to the widespread small-property constructions. In contrast, other villages have given up any legal dialogue with the official system and resorted mainly to bribes and even violence to maintain their small-property business. One reason for these vastly different outcomes is the layering and fragmentation of the legal system, which makes the choice of different social control systems more difficult than the existing theories portray. Built on a multiple-network evolution model, I investigate the three identities of village co-ops in the triple-system of social control (market, community and law) and how the three identities influence each other and the systems in which they are embedded and ultimately lead to each village’s outcome.

Chapter Six concludes with a critique of the residual legal centralism embedded in the existing research on law and social norms and argues that property norms can precede property law in the context of market transition and
serve as catalyst for legal change, which would be achieved through a reconstitution of law and social norms. It also clarifies that the focus of my research is the co-evolution and interaction mechanism of property law and norms, different from de Soto’s focus on the formalization of informal property systems.

IV. Property Law and Norms in Temporality

A well-functioning property law regime, albeit beneficial to the development of a market economy, may be a long time in coming for many transitional countries. Through this original case study, I propose a theory that provides an option for transitional countries during their long march toward rule of law:

- Stage I: Property law reform trapped in partial reform equilibrium;
- Stage II: A network of institutional innovators invented a market under the focal point of market transition;
- Stage III: Pragmatic/ad hoc legal responses;
- Stage IV: Reconstitution of layered and fragmented law in local communities, which in turn can be catalyst for legal change.

This unique case study can shed some light on the evolution of property rights. In his 1967 path-breaking work *Toward a Theory of Property Rights*, Demsetz offered before-and-after snapshots of the evolution of property rights, but left the actual process that leads from one state to another as a black box. The Demsetz thesis is very concise: “[P]roperty rights develop to internalize externalities when the gains of internalization

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become larger than the cost of internalization.” This portrays the evolution of property rights as happening automatically in response to new cost-benefit possibilities, regardless of the social and political processes. This is, of course, oversimplified. Comparing to Demsetz’s solo emphasis on economic constraints, Ostrom focused on the communal settings in which resources are governed.\(^5^3\) In recent years, there has been increasing interest in the political process of property rights. Levmore argues that “the prevailing arrangement of property rights may be the product of politics and interest-group activity.”\(^5^4\) According to him, interest groups, including coordinators and beneficiaries of emerging property rights, such as entrepreneurs, play a key role in the evolutionary process of property rights. Anderson and Hill, Epstein, and Banner arrive at similar conclusions through their separate case studies.\(^5^5\) Wyman emphasizes the political character of property rights by studying the case of New York taxicab medallions\(^5^6\) and the evolution of individual tradable rights in U.S. coastal fisheries.\(^5^7\) China’s market transition provides an opportunity to observe the co-evolution of property law and norms, which are shaped by economic constraints, communal settings and interest group politics, calling for an integrated theory about the evolution of property rights.

Moreover, by revealing the dynamic process of the evolution of property rights in China, in particular considering the bottom-up institutional exploration, this research can

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contribute to resolving the so-called “China problem”—why China has enjoyed three decades of rapid economic growth with a weak legal system.\textsuperscript{58}

Lastly, this research also has broad implications for research on law and economic development. It treats an informal (bottom-up) market economy as a positive change towards a modern market economy, not simply as an anomaly. Therefore, rather than focusing on the lack of or need for legal property rights, a focus on the mechanics of informal markets could shed light on the way forward for transitional market economies. Scholars have referred to exchanges of untitled real property in their studies of Chinese Rural Land Reform,\textsuperscript{59} property reform in Vietnam,\textsuperscript{60} squatters in Hong Kong,\textsuperscript{61} the Brazilian Amazon\textsuperscript{62} and the U.S. frontier history.\textsuperscript{63} Systematic case studies of informal real estate markets around China and the world would greatly enrich our understandings of law and economic development.


\textsuperscript{59} Chen, \textit{supra} note 10.

\textsuperscript{60} Kim, \textit{supra} note 8.


CHAPTER THREE. SMALL PROPERTY, BIG MARKET: A FOCAL POINT

EXPLANATION

The formation and operation of this market is mysterious: how did this market form despite the legal prohibition? How does this market operate without legal titles? I kept asking various persons in the field the following questions: since it is illegal to transfer rural real estate, how dare you buy/sell it? Aren’t you worried that the government might demolish your illegal buildings? Aren’t you worried that the contract might be voided by the other party? According to the conventional view, informal transactions are either limited to people who have continuing business relations\(^1\) or those who are supported by systematic institutions.\(^2\) However, in Shenzhen there existed no centralized institution to enforce contracts of small-property transactions. A common response I received is that: “I did it when other people were doing the same thing. A lot of people are doing the same thing, why should I worry?”

This common response indicates a situation of coordination, in which one would take some action only if others are expected to also act correspondingly. The underlying question is how to coordinate people’s behaviors in the absence of a centralized law—a question that has been addressed by both economists and legal scholars. Nobel Laureate Thomas Schelling first observed that, in situations requiring coordination, anything that

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makes salient one behavioral means of coordinating tends to produce self-fulfilling expectations that then lead to the occurrence of that result. Schelling calls the salient solution the “focal point.”

Weingast models the policing of rights as a coordination problem among citizens, and suggests that self-enforcing limits on the state could result from a focal solution constructed in a constitution or a galvanizing event such as a major riot, or by a charismatic leader. Sugden explains that self-enforcing conventions about coordination, reciprocity, and property rights that resolve rival claimants disputes arise from focal point equilibria. Myerson argues that Schelling’s focal point is among the most important ideas in social theory and that one can understand the foundations of political institutions in terms of focal equilibrium selection in a more fundamental game. Dixit considers multiple settings in which coordination can be achieved by extra-legal conventions, including focal point settings. Several legal scholars argue that law can serve as a focal institution to help parties deliberately select an equilibrium from multiple possible self-enforcing coordination equilibria. Both McAdams and Myerson observe that a rule recognizing possession as the basis of property rights can avoid wasteful contests over property by coordinating rival claimants’ strategies: the concept of “rightful” ownership is expected to be applied and thus the “rightful” owner will rationally claim

and the other will rationally recede. Most recently, Hadfield and Weingast develop an account of legal order that relies on “a common logic,” rather than a third-party centralized enforcement mechanism, to coordinate people’s behaviors.

However, the above insights have rarely figured in the study of market institutions. A significant exception is Avner Greif’s analysis of the community responsibility system that supported impersonal exchanges in the context of pre-modern Europe. Set against the backdrop and context of China’s market transition, this paper hopes to enrich our understanding of market institutions by applying the updated insights from coordination games and focal points to an examination of a contemporary example of a market without formal property rights. It also contributes a significant real world example to the theories of coordination games and focal points, most of which are based on laboratory experiments.

This chapter is organized as follows. Part I introduces the focal point theory and applies it to the Shenzhen case. Part II models the formation of the small-property market as an assurance game among social entrepreneurs in Shenzhen, models the demolition risk as a hawk-dove game between the Shenzhen government and farmers, and models contract risk as a hawk-dove game between a buyer and a seller. Part III summarizes the

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9 For a critique of viewing property as hawk-dove games, see Carol M. Rose, *Psychologies of Property (and Why Property is Not a Hawk-Dove Game)*, in *The Philosophical Foundations of Property Law* (J. E. Penner and H. E. Smith, eds. 2013).


broad implications of the focal point theory and coordination game models to law and
development.

I. Focal Point

A. Theory

As Schelling says,
most situations—perhaps every situation for people who are practiced at this kind of
game—provide some clue for coordinating behavior, some focal point for each person’s
expectation of what the other expects him to expect to be expected to do. Finding the key,
or rather finding a key—any key that is mutually recognized as the key becomes the
key—may depend on imagination more than on logic, it may depend on analogy,
precedent, accidental arrangement, symmetry, aesthetic or geometric configuration,
casuistic reasoning, and who the parties are and what they know about each other.\(^\text{13}\)

In his classic *The Strategy of Conflict*, Schelling began his analysis with the study
of tacit bargaining—bargaining in which communication is incomplete or impossible.

Specifically, Schelling began with the special, simplified case in which two or more
parties have identical interests and face the problem not of reconciling interests, but only
of coordinating their actions for their mutual benefit.\(^\text{14}\) In the Grand Central example, the
sample began in New Haven, Connecticut, so Grand Central Station was their first stop in
New York City. This makes Grand Central a more salient choice of where to meet than
other famous places in New York City, such as the Empire State building.\(^\text{15}\) People were
thus able to meet each other at the same place in the absence of prior arrangements.

Schelling then proceeds to consider tacit bargaining of divergent interests. The outcome
of his experiments suggests that among all the available options, one particular option
usually seems to be the focal point for coordinated choice, and the party to whom it is a
relatively unfavorable choice quite often accepts it simply because he knows that the

\(^\text{13}\) Schelling, *supra* note 3, at 57.

\(^\text{14}\) *Id.* at 54-8.

\(^\text{15}\) See also McAdams, *supra* note 8.
other participants will expect him to.\textsuperscript{16} In the end Schelling investigates explicit bargaining in which communication is possible and there is no apparent need for intuitive rapport.\textsuperscript{17} There is abundant evidence that the influence of the focal point is powerfully present even in explicit bargaining.

The essential idea of the focal point is that “the intrinsic magnetism of particular outcomes, especially those that enjoy prominence, uniqueness, simplicity, precedent, or some rationale makes them qualitatively differentiable from the continuum of possible alternatives.”\textsuperscript{18} These particular outcomes are what Schelling calls focal points. Schelling presents the focal point theory as generally applicable to situations involving coordination, such as the formation of interest groups, spontaneous revolt, and bargaining.\textsuperscript{19} In the past decades, a number of researchers have observed high coordination rates in games with a focal point and symmetric payoffs; though the influence of focal points can become weaker with the increasing divergence of interests.\textsuperscript{20} Though most laboratory experiments are limited to the study of focal points in tacit bargaining situations, a recent study by Anders Poulsen and Robert Sugden, two of the foremost researchers of focal points, have proved that focal points also play an important role in explicit bargaining situations.\textsuperscript{21}

\textsuperscript{16} SCHELLING, supra note 3, at 60.
\textsuperscript{17} Id. at 67.
\textsuperscript{18} Id. at 70.
\textsuperscript{19} Id. at 70-74.
B. Focal Point in Shenzhen

In the context of Shenzhen, three elements made private rural land development and transfer a more focal choice than the legal prohibition. First, the Shenzhen government’s urban land use reform successfully challenged the old Constitution and sent out a signal to people in Shenzhen that land-use rights can be sold for money. Second, Shenzhen was designated to pilot market-oriented reforms and by doing so “blaze a bloody trail,” i.e., break the old rules, which encouraged people in Shenzhen to innovate new institutions. Third, the Shenzhen farmers saw how the Shenzhen government made money from land requisitioning and saw no justification for depriving themselves of the same profit opportunities. Overall, Shenzhen people strongly believed that farmers should have the right to develop and transfer rural land.

When the Shenzhen SEZ was founded in 1980, the biggest barrier to becoming an attractive destination for foreign investment was a lack of financing for urban infrastructure. The central government could provide very limited support to the Shenzhen government’s infrastructure construction projects.\(^{22}\) A Hong Kong lawyer provided Shenzhen government with the solution: “Isn’t the land money? Even your ancestor Marx admitted that land was wealth.”\(^{23}\) The Shenzhen government leaders got the message. They knew that land could generate the money they urgently needed for urban construction, but two barriers existed: (i) land was inalienable in the orthodox

\(^{23}\) Id.
ideology of a country that had abolished private ownership of land; (ii) the Constitution stated very clearly at that time that commercial land alienation was illegal.²⁴

But Shenzhen is the city of reform. As Deng Xiaoping said, “The central government has no money, but can give you policies. You should try by yourself. Blaze a bloody trail (of reform)!”²⁵ “To attract foreign investment, it would adopt different administration and policies, mainly market-oriented”.²⁶ These words represented the main support the Shenzhen government received from the central government. Under such a reform spirit, the Shenzhen government decided to challenge the old Constitution. Shenzhen started with what was explicitly allowed by the central government: the charging of land-use fees to foreign investors in the SEZ.²⁷ The “land-use fees” filled a pressing financing gap, but they were far from enough. Public land ownership and the inalienability of land still remained the norm across the country; the Shenzhen practice of charging land-use fees to foreign investors who did not believe in Marx ideology was viewed as a trivial exception.

As the need for money became more acute, the Shenzhen government eventually broke with the old norm of land inalienability. Bearing in mind the illegality of land alienation, it proceeded in a measured and strategic fashion. In September 1987, for the first time, the Shenzhen government sold a 50-year right to use a plot of land of 8,500

²⁴ Id.
²⁵ Id. at 33.
²⁶ See 《广东省经济特区条例》（第五届全国人大常委会 1980 年 8 月 26 日颁布）[Guangdong Regulation of Special Economic Zones in Guangdong Province (promulgated by the Standing Comm. of the Fifth Nat’l People’s Cong., Aug. 26, 1980), art. 12]; 《中外合资经营企业法》(1979 年 7 月 1 日第五届全国人民代表大会第二次会议通过)[Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures] (promulgated by the Standing Comm. of the Nat’l People’s Cong., July 1, 1979, art. 5).
square meters to a Chinese company for the price of RMB 5,250,000.28 In October 1987, the Shenzhen government invited celebrated theorists from all over the country to attend a conference on urban land administration reform. The question posed to them was whether land could be a commodity. Delegates of the Shenzhen government spurred debate by asking: “We have collected a lot of money from alienating land. Isn’t land a commodity?”29 The highlight came on December 1, 1987, when the Shenzhen government held the first public auction of land. The Shenzhen government was fully aware that the auction would be in public conflict with the Constitution. As a result, it invited a member of the CCP political bureau, a deputy head of the State Bureau of Land Administration (SBLA), 17 mayors from the country, 28 Hong Kong entrepreneurs and economists, and more than 60 journalists to observe the auction. It was a public attack on the old norm. The auctioned plot of land was eventually won by the government’s own land company after 44 other companies submitted bids.30

Five months later, the National People’s Congress (“NPC”) passed a constitutional amendment stating that land-use rights can be transferred according to law. At the end of 1988, the Standing Committee of the NPC made a corresponding revision to the LAL to allow the transfer of land-use rights. The State Council made a law according to which urban land use rights can be transferred in 1990; however, a corresponding legal authorization for rural land use rights has never materialized.31

Though unconstitutional, the first public auction of land use rights in Shenzhen became a landmark event in the city’s history and was widely praised as one of

28 Feng, supra note 22.
29 Id.
30 Id.
31 See Chapter One for more details.
Shenzhen’s most important contributions to China’s economic reform. During my interviews, SEZ citizens of various backgrounds, including government officials, indigenous farmers, and real estate developers were eager to share this story, proudly declaring that their people facilitated the constitutional amendment through the first public auction and that Shenzhen was the city of reform.

The urban real estate industry began to prosper after the establishment of a legal system that permitted and facilitated the transfer of urban land use rights. As a result of the first public auction of land use rights, Shenzhen became the birthplace of China’s modern real estate industry. Among the top ten national real estate companies, four are based in Shenzhen. The real estate industry contributed greatly to both government revenue and GDP growth in Shenzhen. Even in 2010, the year when real estate industry tax revenues were at their lowest in two decades, the real estate industry still accounted for 4.82% of the GDP growth in Shenzhen and 11.1% of tax revenues. In 1999, real estate industry tax revenues reached their highest levels of 14.49%. Overall, from 1988 to 2010, the Shenzhen government made at least 170 billion RMB from the direct sales of land.

Participants in the small-property market are well aware of the astronomical profits the Shenzhen government has earned from land sales and development. Ordinary Shenzhen citizens, in particular the farmers, have seen how the Shenzhen government

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32 This group of statistics was provided in 2011 by Wang Fan, the then Director of the Urban Planning, Land and Resources Commission of Shenzhen City. See 王芃:去年深圳房地产企业税收贡献率达到 11.1%, 网易房产 2011 年 7 月 11 日 [Wang Fan, Real Estate Enterprises Contributed 11.1% of Shenzhen’s Revenue Last Year, WANG YI REAL ESTATE, July 11, 2011], http://sz.house.163.com/11/0711/23/78NG7MB400074KDB.html (last visited Oct. 25, 2014).

seizes their land through requisition, paying them a low price but selling the land at prices many times higher. They mock the legal prohibition on rural land development and transfer with an old Chinese saying: “The magistrates are free to burn down houses, while the common people are forbidden even to light lamps.”

II. Coordination Games and the Market

The role of a focal point is to enable coordination. Therefore, it is necessary to determine at the outset whether a coordination problem exists before applying focal point theory. The problem of coordination is “where two or more individuals can reach some mutually desired outcome—or avoid some mutually undesired outcome—only by combining their actions in a certain way, but where more than one possible combination will suffice. The presence of multiple ways to combine actions requires that individuals coordinate on the same combination.”

Coordination games have multiple equilibria, and, therefore, the payoffs alone do not determine the behavioral outcome. Instead, the final outcome depends on the specific social settings and individual participants involved, leaving room for less concrete variables, such as history and politics, to impact oversimplified economic models. Moreover, coordination games often require the participants to make choices between the conflicting preferences of different individuals, since it is often impossible to

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35 An equilibrium refers to a “Nash equilibrium,” which is the central solution concept in game theory. It is based on the principle that the combination of strategies that players are likely to choose is one in which no player could do better by choosing a different strategy, given the strategies the other players choose. A pair of strategies will form a Nash equilibrium if each strategy is one that cannot be improved upon given the other player’s strategy. We establish whether a particular strategy combination forms a Nash equilibrium by asking if either player has an incentive to deviate from it. DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, GAME THEORY AND THE LAW 310 (1998).
36 McAdams, supra note 34, at 212.
find a solution that makes everyone better off. As a result of the above factors, coordination game models are closer to reality than the prisoners’ dilemma model, which has long dominated the application of game theory in legal studies.\footnote{Id.}

Classic coordination games include the Assurance, or Stag Hunt Game and the Hawk-Dove Game. The name “Stag Hunt” comes from Rousseau’s illustration of the choice between hunting stag and hunting hare, where one succeeds in hunting stag only if the other hunter also hunts stag. Sharing a stag with the other hunter is the best outcome, but hunting hare is safer because one can succeed without the other hunter.\footnote{JEAN-JACQUES Rousseau, A Discourse on Inequality 111 (Maurice Cranston trans., 1984) (1755), cited in McAdams, supra note 34, at 219.} The formation of the small-property market in Shenzhen is a revolt against the formal law that can be likened to hunting stag in the Stag Hunt Game, since people need to coordinate amongst themselves in order to “hunt.”

The Hawk-Dove Game is used to describe a situation between two players who desire the same thing that they cannot both enjoy.\footnote{ROBERT SUDGEN, THE ECONOMICS OF RIGHTS, COOPERATION AND WELFARE 61 (2005).} This game is also well known as the Chicken Game, in which teenagers drive their cars directly at each other. The one who swerves first loses face, but the failure of either to swerve is catastrophic.\footnote{McAdams, supra note 34, at 224.} There are two strategies for players in these Hawk-Dove Games. The dove strategy is submissive—doves are not prepared to fight in support of their claims. If their opponents show any inclination towards fighting, doves immediately concede.\footnote{SUDGEN, supra note 39, at 62.} In contrast, the hawk strategy is to try to win the whole of the resource by fighting. If a hawk meets a dove, the hawk lays claim to the whole of the resource. By signaling his readiness to fight, the hawk
causes the dove to back down, allowing the hawk to take the resource without having to fight for it. However, if a hawk meets another hawk, they fight it out, often with severe consequences for both parties. These types of Hawk-Dove Games are present in the operation of the small-property market, particularly in the tensions between the Shenzhen government and the farmers in determining whether to demolish the illegal buildings and the tensions between contract parties deciding whether to void a legally ineffective contract. In these examples, neither party wants to “swerve” first, nor do they want to directly clash with each other.

In the following sections, I will apply the Assurance and Hawk-Dove Game models to analyze the formation and operation of the small-property market in Shenzhen.

A. An Assurance Game of Market Formation

1. An Assurance Game of Social Entrepreneurs

The formation of the small-property market can be viewed as a change in social norms from an acceptance of the inalienability of real estate in the communist era to an adoption of the idea of the alienability of real estate in the post-communist era. Many scholars have emphasized the role of social entrepreneurs in the evolution of social norms like these. They claim that when an exogenous change creates new cost-benefit conditions that favor a switch to a new norm, social entrepreneurs tend to serve as catalysts for the switch. Scholars refer to this category of social entrepreneurs as “norm

42 Id.
entrepreneurs.” It is often true that there exist entrepreneurial people more likely to initiate changes in society. However, it would be an oversimplification to assume that whenever there is an exogenous change, entrepreneurs will always succeed in accordingly changing the norm. As North would agree, inefficient institutions often persist. There is always room for improvement, but improvement often does not occur.

If room for improvement always exists and potential social entrepreneurs are always present, why do social entrepreneurs initiate change at certain times and in certain places? The answer is often because these social entrepreneurs must bide their time. Therefore, the term “exogenous change” must be further qualified. Exogenous change is not simply a change resulting in new cost-benefit conditions, like the rise of the fur trade with Europeans among North American Indian tribes, for instance. Instead, an exogenous change, for the purposes of this article, also requires a change in society’s broader understanding, such as a new focal point to shed light on a new choice.

A potential social entrepreneur would step forward only when he perceives that a change is not only what he expects, but also what other entrepreneurs expect and what the majority of the society will come to expect. Even then, a potential social entrepreneur would only act in situations where he has a significant chance of successfully making the change by moving first. In other words, change agents want an assurance that other people expect the change to occur. A focal point can help people’s expectations converge to bring about such change. To simplify the discussion, we can imagine an Assurance

Game in which two farmers, acting as potential social entrepreneurs, must decide separately whether to initiate a change:

Table 3.1. An Assurance Game of Market Formation

<table>
<thead>
<tr>
<th>Player 1</th>
<th>Player 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy A</td>
<td>Strategy A</td>
</tr>
<tr>
<td>Strategy B</td>
<td>0, -c</td>
</tr>
</tbody>
</table>

- **Strategy A**: To challenge the legal prohibition on rural land development and transfer
- **Strategy B**: Not to challenge the legal prohibition on rural land development and transfer.
- a, c>0. a, c, and 0 are numbers used to describe payoffs to the two farmers. Each values the right to rural land development and transfer at the amount of a. Punishment by the government would cause a loss of c to a single challenger.

This game is an Assurance Game. If a potential social entrepreneur expects the other not to challenge the prohibition, he will also not challenge the prohibition, even if he prefers the change. This occurs because the potential social entrepreneur does not want to bear the punishment for challenging the law on his own, which comes at a loss of c for the single social entrepreneur who challenges the prohibition. The status quo is maintained if neither potential social entrepreneur challenges the prohibition, resulting in a gain of 0 for both parties. However, if a potential social entrepreneur expects the other party to challenge the prohibition, he will challenge the prohibition as well. When this occurs, the norm change will succeed and both will gain a from the change. As a result, the parties prefer that they both use strategies that bring about the change (A, A) rather
than both using strategies that result in non-change (B, B). However, the optimal result may not occur because A is a riskier strategy than B. Choosing to challenge the prohibition might result in either a large profit or a loss, while choosing not to challenge the prohibition guarantees that there will be no loss. For this reason, both social entrepreneurs might choose not to challenge the prohibition despite the fact that each regards non-change as worse than change. Thus, the players face a problem of coordination—each needs to assure the other that he is going to play the riskier strategy and challenge the legal prohibition to induce the other to do the same.

A focal point can resolve this coordination problem. In making a decision, each player considers what choice the other would make. If both expect the other to choose strategy A, the result will be optimal for both parties. That is to say, to initiate a change, not only does a new profit opportunity need to exist, but the new opportunity should also be made salient as a focal point so that a potential change agent could reasonably expect others to share his expectation for change.

2. Application to the Shenzhen Case

Without a doubt, rural land development and transfer represented a lucrative new profit opportunity in Shenzhen, the first SEZ to pilot reform. However, even though the Shenzhen government allowed villages to rent their land to investors to build factories, rural land development and transfer was still legally prohibited at that time. It was clear that breaking this legal prohibition would be a very profitable change. My interviews with village heads, government officials and other participants shed light on how this change occurred.

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46 See Chapter Two, Part I for more details.
A Hong Kong investor, after running his business in a village for several years, wanted to buy a plot to build his own house. Considering that his business required him to live in the village for more than 200 days a year, and he may have had a second family there, this need seemed very reasonable. Also, as a Hong Kong entrepreneur, he might have had a stronger sense of private property and a more acute sense of the changes occurring in Shenzhen and in China. The focal point created in the urban land-use reform in Shenzhen must have been clear to this entrepreneur: (1) land could be sold for money, a fact readily apparent to the Chinese central and local governments, especially the Shenzhen government; (2) old laws could be broken and revised in the reform era. The Hong Kong investor was very conscious of these factors in his decision to buy land from villages. He expected others to see the same trends that he did. The Hong Kong investor contacted the village co-op head to make his request. The village co-op head, who had done everything in his power to attract and satisfy outside investors, had made profits for the co-op from the early capitalization of rural land through joint ventures with outside investors. He was aware of the government reform of the urban land-use system and expected rural land-use reform to be the next step. As a result, the village co-op head approved this request and sold a plot to the Hong Kong investor, even though it was illegal to do so.

Social entrepreneurs included not only Hong Kong investors, but also other major players in the rural industrialization of Shenzhen. Government agencies responsible for investment approval and land administration, such as the Bureau of Land Administration (“BLA”) and the Bureau of Investment Promotion (“BIP”), observed these types of situations and studied the legal and policy issues. These bureaus likely determined that
the focal point of rural land development and transfer was so powerful that it would become a widespread trend. The old government housing allocation system had not been able to keep up with the explosive population increases. Directors of the bureaus were troubled by the problem of how to house their employees, and my interviews reveal that casual conversations with village leaders and other players often led to suggestions that village land could be used for employee housing.

In another example taken from these interviews, a land developer, who had leveled the hilly land in Shenzhen to build roads and other infrastructure for a village, asked the village for payment. Over a dinner conversation, the village head told the developer that the village had no money to pay him, but offered two hills in the village instead. The village head told the developer that if he leveled them, the land developer could have the land. While the land developer preferred a cash payment, he had little choice. Moreover, he was well aware of the emerging focal point through his contacts with village co-op heads, government officials, and Hong Kong investors in his land development businesses. As a result, he accepted this offer and built a luxury villa neighborhood in Shenzhen on the land he received as payment.

These types of land transactions encouraged other parties to buy and sell rural land. These parties included a village head who had managed all the transactions with Hong Kong investors and government agencies and wanted to develop and transfer some of the excess land he was allocated; an official in the BIP, who did not receive an apartment from the bureau but had money to spend on personal housing; other government employees who were eager to resolve their housing shortage after learning of this trend from friends in the BIP or BLA; and a migrant worker who made enough
money to afford such housing.\textsuperscript{47} Government employees participated so widely in rural land development and transfer that the Shenzhen government had to take special measures to address this situation in the 1980s.\textsuperscript{48}

After this cluster of social entrepreneurs made the first move, their friends and relatives followed.\textsuperscript{49} The social entrepreneurs were all influential people in their social networks and, thus, had much more weight in influencing the changing of norms.\textsuperscript{50} Further transactions encouraged more transactions, and this continued until the formation of a small-property market in Shenzhen, during which the focal point of rural land development and transfer overcame the legal prohibition and ultimately served to coordinate people’s behaviors.

B. Two Hawk-Dove Games of Market Operation

1. A Hawk-Dove Game of the Demolition Risk

In 1999, one year after the 1998 LAL revision, the Shenzhen government initiated its campaign against rural land development and transfer, calling the rural buildings “lishi

\textsuperscript{47} Interview with a retired government official, in Nanshan District of Shenzhen City (Mar. 13, 2012).
\textsuperscript{48} The Shenzhen government’s declarations prohibiting its employees from participating in rural land development and transfer were often seen in the first pages of the Shenzhen SEZ Daily in the 1980s, a testament to the prevalence of the practice. The general rhetoric was that the government would build houses for its employees and that all government officers should stop building private houses on rural land by a fixed date. Punishments would be imposed on violators. The number of such declarations demonstrated, paradoxically, the limited enforcement and effect of the government’s efforts. \textit{See, e.g.,} 《违章建私房、陈煌被撤职》，《深圳特区报》1981年9月8日第1版; 《要制止任意乱建私房》，《深圳特区报》1982年12月27日第2版; 《我市清理违章建私房取得成效》，《深圳特区报》1984年2月20日第1版; 《市政府办公厅宣布继续违章乱建私房一律没收》，《深圳特区报》1985年4月3日第1版.
“yiliu weifa jianzhu,” or “historical illegal buildings.” In 2004, the Shenzhen government established lingdao xiaozu, a group headed by the mayor and made up of directors of relevant government departments to deal with illegal rural land development and transfer. Later in 2009, the Shenzhen government established the Department of Land Use Monitoring (“DLUM”), which had branches in all 57 sub-districts of Shenzhen. Demolition of illegal buildings was often reported in the local newspapers. Still, the small-property market remained active and robust. Based on interviews with local farmers, buyers of the small-property houses, and government officials directly in charge of demolishing illegal buildings, I found that demolition cases were, in reality, rare and symbolic – for instance, the government seldom demolished finished buildings.

The focal point of rural land development and transfer plays an important role in the interactions between the Shenzhen government and farmers with regards to rural land development and transfer. The Shenzhen government hopes its threats are an effective signal to people to stop developing and transacting rural land. In turn, Shenzhen farmers hope the government will yield to the prevalent practice. Whether Shenzhen farmers would continue to develop and transfer rural land and whether the Shenzhen government would demolish the buildings if they did depends on each party’s respective expectations. Their interactions can be explained by a Hawk-Dove Game, a general way of modeling any situation where an individual chooses between an aggressive or submissive strategy, as shown in the following table:

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Table 3.2. A Hawk-Dove Game of Demolition

<table>
<thead>
<tr>
<th>Player 1-Shenzhen Government</th>
<th>Player 2-Farmers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>H2</td>
</tr>
<tr>
<td>H1</td>
<td>-a, -d</td>
</tr>
<tr>
<td>D1</td>
<td>0, c</td>
</tr>
</tbody>
</table>

- **Strategy H1**: Shenzhen government plays hawk and demolishes small-property buildings.
- **Strategy D1**: Shenzhen government plays dove and does not demolish small-property buildings.
- **Strategy H2**: Shenzhen farmers play hawk and fight against the Shenzhen government’s demolition efforts.
- **Strategy D2**: Shenzhen farmers play dove and accept the demolition of their small-property buildings without any resistance.
- \(a, b, c, d > 0\); \(a, b, c, d, \text{ and } 0\) are numbers used to describe the payoffs to the Shenzhen government and farmers. \(p\) is the probability of the government not enforcing the law.

The starting point of this game is that small-property buildings have been built, resulting in the separation of legal rights and de facto control. Maintaining legal control over the land is valued at \(b\) for the government, while maintaining de facto control over the land is valued at \(c\) for the farmers. Assuming the probability for the farmers to maintain de facto control over the land without suffering legal enforcement from the government is \(p\), the probability for the government to maintain legal control over the land would be \(1-p\). Therefore the payoffs for the government and the farmers under the status quo would be \((1-p)b\) and \(pc\). Under this status quo, the government was not ready to demolish the small-property buildings at the risk of conflict with the farmers, while the farmers were not ready to resist the demolition. The Shenzhen government and the farmers might wait for a change of situation that would give one party an advantage over
the other, or they might negotiate with each other to share the benefits of developing and transferring rural land. This would not be a stable situation until the parties reached a deal and each party believed that the other would honor the deal.\(^{52}\)

If the Shenzhen government played hawk to enforce the legal prohibition and the farmers were not prepared to fight the demolition efforts, the small-property buildings would be demolished. As a result, farmers would lose their de facto control, and their payoff would be 0; the government would gain its legal control over the land and its payoff is \(b\).

On the other hand, if the farmers were willing to protect their buildings against government demolition and the Shenzhen government was not prepared for conflict with the farmers, small-property buildings would not be demolished. This would result in the ineffectiveness of the government’s land use control, and the government’s payoff would be 0. The farmers’ payoff would be \(c\), the de facto control over the land getting rid of the risk of legal enforcement.

If the government decided to demolish the small-property buildings at any cost, while the farmers were also ready to protect their buildings, the parties would have a conflict. At some point during the conflict, a winner would emerge and take control, while the loser would accept defeat. However, under this set of circumstances, both the winner and the loser would suffer some harm in the fighting.\(^{53}\) Conflicts between both parties would cause loss in the amount of \(a\) to the government and a loss in the amount of \(d\) to the farmers.

\(^{52}\) A solution is provided in Chapter Four.

\(^{53}\) SUDGEN, supra note 39, at 62-3.
If the Shenzhen government had played hawk to enforce the old law, it would incur a huge loss resulting from a direct clash with farmers. This loss would encompass social instability, which would discourage foreign investment, as well as fierce resistance from farmers when attempting to requisition their undeveloped and unsold land. In a country where local governments tend to seize villagers’ land arbitrarily, it is at first puzzling that the Shenzhen government has not been able to deter illegal rural land development and transfer. However, upon closer scrutiny, it is clear that the enforcement costs for the Shenzhen government against the small-property market are unusually high. Shenzhen farmers have both the political and social resources to inflict large costs to the local government, since they have much stronger political and social connections than farmers in other areas of China. Shenzhen farmers have become the wealthiest farmers in China by making money from the land over which they have maintained control, with the accompanying political influence. The Chinese government, both at the central and at the local level, has also held prosperous Shenzhen villages as the shining example of China’s successful economic reform. All the former supreme leaders of China in the reform era, Deng Xiaoping, Jiang Zemin, and Hu Jintao, visited villages in Shenzhen. For instance, in 1984, during his first southern tour after designating Shenzhen as the first SEZ, Deng visited the village of Yumin and viewed the farmers’ two-story houses as an indication of the success of his “reform and opening-up” policy. In another symbolic example, hundreds of houses built by local farmers stand at the entrance of the village of Nanling, behind a huge portrait of the former Chinese President Hu Jintao, who visited the village.

twice. In addition, several village heads are members of the National People’s Congress or the Provincial People’s Congress.

What’s more, many Shenzhen farmers have family overseas, who fled to Hong Kong before 1980 and became residents there. These huaqiao, or overseas Chinese, have access to overseas newspapers and other public media and thus can inflict great reputational cost to the Shenzhen government and even the Chinese central government. The influence of overseas Chinese was amply demonstrated by a situation in Wukan, a village two hundred kilometers from Shenzhen, at the end of 2011. The government of Guangdong province, to which Shenzhen belongs, gave in to key demands of protesting villagers after a nearly two-week standoff with police. The government agreed in a rare compromise to release detainees and return some land to farmers.56 During the villagers’ confrontation with the government, their overseas families and friends, mostly located in Hong Kong, gave timely support by donating food and other supplies and, most importantly, by mobilizing wide overseas media attention, without which Wukan would have been just another voiceless village of several thousand landless farmers.

Shenzhen is an icon of China’s market economy. Since 1978, the Chinese government has tried to maintain a policy of “reform and opening-up” to attract investment and support from overseas Chinese. If legal enforcement were to result in confrontation with local villagers, the Shenzhen government would not dare to take forceful action, since the government cannot afford to acquire a reputation for repression.

In the past three decades, the Shenzhen government has requisitioned a large amount of rural land from villagers, but has managed to avoid bloodshed by paying the villagers very well. It is widely reported that a village redevelopment plan initiated by the government in 2009 created multiple village millionaires. In addition, for the farmers, a direct conflict with the government would result in the loss of their small-property buildings, additional fines, and criminal prosecution if they were to use violence against the government. As a result, both parties prefer to avoid \((H_1, H_2)\).

We can further analyze this situation by noting that both the Shenzhen government and the farmers would choose to play hawk if the other party chose to play dove and would choose to play dove if the other party chose to play hawk. The equilibrium would be either \((H_1, D_2)\) or \((D_1, H_2)\). However, the political and economic changes in Shenzhen made rural land development and transfer the focal point. The Shenzhen government has tried to change ordinary people’s expectations through selective enforcement to signal that laws will continue to be strictly enforced. But even these selective cases, rather than signaling strict legal enforcement, often merely serve to show the Shenzhen government the power of the social resources a rural land user can mobilize to defend his “rights” of development and transaction. The key is the prevalence of the focal point of rural land development and transfer. Even government employees who enforced the laws did not agree with the legal prohibition, and they often discounted the effect of legal enforcement. For example, a government enforcement officer reported often telling farmers, “The leader of the Shenzhen government required me to enforce the laws. So don’t do these things in the daytime. But I have no obligation to watch you 24

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57 南方都市报编著：《岗厦涅槃》[SOUTHERN METROPOLIS DAILY ED. The Rebirth of Gangxia (2009)].
hours. [It is] just a campaign, which will cease soon.” Since rural land development and transfer served as a focal point, the equilibrium became \((D_1, H_2)\), and the legal prohibition was not enforced. Demolition cases were rare and symbolic in Shenzhen, and the small-property market continued to expand despite the threat of demolition from the Shenzhen government.

2. A Hawk-Dove Game of the Contract Risk

In addition to the risk of government demolition, we can also model transaction risks using a Hawk-Dove Game. Because the small-property houses have no legal titles, none of the transactions are recognized or protected by the government. A seller could refuse to surrender possession of the illegal buildings to the buyer or could revoke the contract at any time. Yet, buyers from all over the country still buy small-property apartments. Surprisingly, on the small-property market, several formal documents are widely used, which use professional legal terms and constitute a form of “legal magic.” In the following part, I analyze the legal implications of the formal documents and apply a Hawk-Dove Game model to explain why the legally-void contracts are still obeyed, taking into consideration the social meaning of these formal documents in the bargaining between contract parties as well as the specific circumstances.

a. The Legal Magic

Compared to other informal transactions, such as drug or organ transactions, which are more removed from formal laws, the involvement of government-recognized village co-ops and lawyers confer an aura of legality on illegal rural real estate transactions. This phenomenon is a form of “legal magic.” For instance, a seal from a village co-op company costs a buyer 6,000 RMB, while a testimony from a lawyer costs
500 RMB. In some cases, privately-made real estate certificates and certificates of honorable villager-ship are also used. The question is whether these documents have any legal effect beyond casting an aura of legality on the transaction.

(1). Contract of Cooperative House-Building

Cooperative house-building is a mechanism where a group of individuals pool their money and construct a multi-apartment building together. In the end, each person receives an apartment. In the 1980s and 1990s, the centralized system of housing allocation could not supply enough houses to people, and cooperative house-building was encouraged as a way to provide housing. Employees of a government agency or a company could form a co-op. The government agency or the company would collect money from its employees, apply for a plot from the government, build houses, and allocate one unit to each contributor. There has been a revival of the idea of cooperative house-building in recent years, since houses on the formal market are too expensive, and the practice is viewed as a cheaper way to own houses by avoiding payments to big real estate companies. Cooperative house-building is not prohibited, and is theoretically feasible.

However, it is well-established within the legal profession that the cooperative development of rural land is still considered to be a way of developing and transferring rural land, which directly defies the LAL. Therefore, it does not seem that the term “cooperative house-building” officially camouflages the illegality of rural house sales, which would help explain why most transactions adopt contracts of cooperative house-building. Since contracts of cooperative house-building cannot make small-property
house transactions legitimate in the eyes of the law, this raises the question of what function these kinds of contracts serve.

(2). Village Co-Op Seal, Lawyer Testimony, Private Real Estate Certificate, etc.

Village co-ops manage the land within the villages and issues dividends to their villager shareholders. The co-op company, which serves as the core of a village community, also builds roads and other public facilities within the village. A village co-op seal on the sales contract is an endorsement of the contract and is widely used in small-property transactions. Village co-ops are often one party to small-property transactions, and they sign and seal the contracts. In other situations, such as houses developed by individual villagers or outside investors, the village co-op charges to affix its seal on the sales contract. However, from a legal perspective, the village co-op seal means nothing because the development and transfer of rural land are prohibited and cannot be legalized by a village co-op’s endorsement.

Lawyer testimony is also nearly always part of such transactions. A lawyer testifies that the transaction is made according to both parties’ real intentions and is consistent with the principle of freedom of contract. As there is no centralized system for keeping small-property records, the lawyer typically keeps a copy of all transaction documents on file, to be available for reference. If a buyer wants to sell the purchased house, he must surrender all the documents to the lawyer, who would then make another file for the new buyer. In one law firm, the earliest record can be traced back to 2003.58 The lawyer testimony says nothing about the illegality of the transaction, which might give the parties the impression of the transaction’s legality due to the lawyer’s perceived

58 Interview with a law firm partner, in Futian District of Shenzhen City (Apr. 5, 2012).
authority. As a result, the Lawyers’ Association of Guangdong, the province to which Shenzhen belongs, has forbidden its members to provide testimony for transactions of rural houses. In reality, this prohibition is only effective on large law firms, and many small law firms continue to provide this service. In some other cases, privately-made certificates play a role in securing the transactions. For instance, some real estate developers issue certificates to buyers. These certificates look very similar to official certificates, even including unique numbers for each apartment.

If neither village co-op seals, nor lawyer testimony, nor privately-made real estate certificates can make these illegal sales contracts legal, why are they so popular and why are buyers willing to pay for them? What is the magic of these legal constructs? The answer comes from outside the law.

b. The Game

In this contract game, the issue is the effectiveness of the contract. Both parties could claim that a contract is legally void if that result benefits him. In the past decades in China, the prices of small-property houses have increased several-fold, due to the increasing housing demand and rocketing prices on the legal housing market. Thus, sellers often have incentives to go to court to void the contract. The courts would refuse to enforce the contract, and the seller would have the right to return the buyer’s money and get his house back. In Beijing, one rural house transaction case caught nationwide media attention when a seller wanted her house back for the increased value after the transaction. According to a judge in Bao’An district court of Shenzhen city, as of the

59 王秋实：《宋庄画家村小产权房续：艺术家索要 48 万房屋差价》，《京华时报》2008 年 1 月 4 日 [Qiushi Wang, Small-Property Houses in the Painters’ Village Continued: The Painter Asked for
time of interview (May 15, 2013), similar disputes were still relatively few in number, but were on the rise.\textsuperscript{60} The courts in Shenzhen declined to adjudicate most of the cases involving small-property transactions. According to a senior judge in the Shenzhen city intermediate court, Shenzhen courts declined to accept such cases because they involved a policy matter for which the Shenzhen city government was actively exploring solutions.\textsuperscript{61} In the following table, I apply a Hawk-Dove Game model to analyze the parties’ choices of whether to void a contract. The purpose is to explain why both parties typically honor contracts detailing small-property transactions in most of the situations in Shenzhen.

Table 3.3. A Hawk-Dove Game of Contract Effect

<table>
<thead>
<tr>
<th>Player 1-Seller</th>
<th>Player 2-Buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td>( H_1 )</td>
<td>-b, -c</td>
</tr>
<tr>
<td>( D_1 )</td>
<td>0, a</td>
</tr>
<tr>
<td>( H_2 )</td>
<td>a, 0</td>
</tr>
<tr>
<td>( D_2 )</td>
<td>a/2, a/2</td>
</tr>
</tbody>
</table>

- \( H_1 \): Void the contract after the value of the house has increased.
- \( D_1 \): Do not void the contract, despite the fact that the value of the house has increased.
- \( H_2 \): Insist on the binding effect of the contract after the value of the house has increased.
- \( D_2 \): Do not insist on the binding effect of the contract after the value of the house has increased.
- \( a, b, c>0; b>c. a, b, c \) and 0 are numbers used to describe the payoffs to

\textsuperscript{480,000 for Difference in Prices, JINGHUA DAILY, (Jan. 4, 2008).}  
\textsuperscript{http://www.chinanews.com/estate/tswq/news/2008/01-04/1123147.shtml.}  
\textsuperscript{60 Transcript of Xia Linfei’s Interview with a judge, in Bao’An district court of Shenzhen city (May 15, 2013).}  
\textsuperscript{61 Interview with a judge, in Shenzhen intermediate court (July 2, 2012).}
both players. Conflicts would cause losses to both parties at the amount of b and c, respectively. If one is a hawk while the other is a dove, the dove retreats leaving the increased value for the hawk.

The starting point of this game is that the value of small-property houses has multiplied since the occurrence of the contract, but it is unclear which party will receive the increased value, which is in the amount of a. Both parties can choose whether to play an aggressive hawk strategy or a submissive dove strategy. If the seller insists on voiding the contract to get the increased value, while the buyer is not ready to fight, the seller will receive a payoff in the amount of a. In contrast, if the seller immediately concedes defeat when the buyer shows any inclination to fight, the seller’s payoff would be 0, while the buyer would receive the increased value in the amount of a.

The most desirable outcome for each party comes from playing hawk against the other party’s dove. If the seller expects the buyer to yield to his request to void the contract, he will play hawk and gain a, the increased value of the real estate, if the buyer does yield to the seller’s request. If the buyer expects the seller to yield to his insistence on the binding effect of the contract, he will play hawk and gain a if the seller does agree to the effectiveness of the contract. The buyer would keep all the increased value of the real estate. Another alternative is that the buyer and the seller could both play dove and share the increased value of the real estate. Neither party will gain if they play dove against the other’s hawk. Therefore, both parties prefer an outcome where they play hawk against the other party’s dove. However, the worst outcome would be that the seller plays hawk, insisting that the contract is void, against the buyer’s hawk, insisting on the binding effect of the contract. The cost of these disputes would be high for both parties.
(1). The Cost of Hawk-Hawk

If the seller insists on voiding the contract, the buyer might resort to private sanctions, since the Shenzhen courts are likely to decline to hear such cases. Some might wonder how serious these private sanctions could be, considering that sellers are usually local villagers or land developers, while buyers are often members of the migrant population, who can only afford an apartment on the informal market. It is true that local villagers and land developers are both wealthier and more powerful than the newcomers who can only afford the small-property apartments. However, that does not mean that sellers are more likely to win in a hawk-hawk situation. Sellers view the dispute as just one apartment in a building of hundreds, and they have made money from the transaction with the buyer. The seller could gain more by revoking the contract, but the marginal gain from this move is relatively low. For buyers, the price is higher, as the apartment is their home and is a substantial investment of their money. While buyers are not typically wealthy or powerful, they do possess “weapons of the weak.” As one buyer told me, “[A]s far as the seller wanted to stay in Shenzhen, he would not dare void the contract. I know where he lived and who his family is.” To make private sanction an effective deterrence, a party has to make sure that he can locate the person he wants to sanction. The legally-void documents play an important role here. In contracts of cooperative house-building, sellers’ addresses are written clearly and are easy to verify. It might be difficult for an outsider to know the history of the transactions involving the real estate in question, but this does not matter as far as the village co-op is willing to endorse the contract, which would be an implicit promise that the village co-op will be responsible if

63 Interview with a buyer, in Bao’An District of Shenzhen City (Nov. 14, 2011).
there are any conflicts regarding rights to the real estate. Lawyers are outsiders, but they
are also professionals paid for their testimony. Regardless of the contents of the
testimony, the bottom-line is that a lawyer may not participate in contract fraud.
Moreover, lawyers’ services are often localized and are not easily relocated. Therefore,
the village co-op’s seal, lawyer testimony, and other privately-made documents are not a
way to legalize the informal sales, but they do serve as a way to reveal information
regarding the transactions and local parties.

In addition, buyers within the same buildings find it easy to unite to take action
against the seller. Disputes with buyers would also expose the sellers’ business to public
attention, which would damage his reputation and might make his business an easy target
for the local government’s selective legal enforcement. As a last resort, the buyer might
report the dispute to the local government. In such a case, the seller can no longer ensure
that the Shenzhen government will continue to turn a blind eye to his illegal business.64 In
the village of Wanfeng in Shenzhen, villagers found their co-op’s share of profits from a
small-property project was significantly lower than it used to be, and they blocked the
entrance to the sold small-property building to ask for more money from the developer.

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64 The illegality of the small-property business includes two complementary parts: illegal land development
and illegal transfer. As discussed in section 1 of Part IIB, through the years, the Shenzhen city government
has taken measures to demolish small-property buildings, which are called illegal buildings by the
government. See also Chapter Four. In the illegal transfer of real estate, including both land and apartments,
sellers and buyers are not usually subject to punishment. However, the risk of legal punishment does exist,
although it rarely occurs. For example, a local villager was prosecuted for “illegal transfer of land use
rights,” a crime defined in Article 228 of the Chinese Criminal Law as illegal transfer of land use rights
“with the purpose of making profits and in violation of land administration laws.” See Chapter Five for
more details. A red-head document issued by the Yantian district government of Shenzhen city instructs
the Yantian Division of the Shenzhen Bureau of Public Security to “assist other government departments in
dealing with illegal buildings, strike hardly violent resistance to legal enforcement, and investigate and
punish suspect criminal activities including illegal fundraising (jizi), illegal investment and sales of small-
property apartments, and illegal printing and alteration of real estate certificates.” 深圳市盐田区人民政府
《关于印发盐田区查处违法建筑销售行为专项整治工作方案的通知》（深盐府办【2009】58号）
[Shenzhen Yantian District People’s Government, Notice on the Issue of Work Plan on Investigating and
Punishing Sales of Illegal Buildings, No. 58, 2009].
In response, buyers, most of whom were from outside of Shenzhen, hung out a banner saying, “Who stole my house? I want to go home! Give back my home!”\textsuperscript{65} The conflict turned to a “mass incident,” and in the end, the village co-op leaders were forced to assure buyers that the apartments were theirs because they had paid for them and that they should not worry that their apartments would be taken away.\textsuperscript{66}

In cases involving an individual buyer, the more powerful sellers might still need to use coercive measures, typically violence, to regain possession of the contested real estate, which would trigger criminal punishment from the government. For example, a group of villagers were prosecuted and sentenced to prison for kidnapping and beating a buyer of their small-property real estate.\textsuperscript{67}

In short, the hawk-hawk scenario is costly even more so to the sellers, so in the chart above, $b>c$.

(2). The Focal Point and the Choice of the Equilibrium

There are two equilibria in the Hawk-Dove Game between buyers and sellers: (1) the seller plays hawk, while the buyer plays dove and (2) the seller plays dove, while the buyer plays hawk. Given these possibilities, what matters in determining the outcome is what each party expects the other to do. In short, there is room for a focal point to influence both parties’ expectations. As previously discussed, rural land development and transfer are widely recognized in Shenzhen. The various documents involved in the transactions, such as contracts, lawyer testimony, and the village co-op’s seal, serve as


\textsuperscript{66} See Chapter Five.

\textsuperscript{67} Id.
evidence and a reminder of this fact. Thus, the seller would expect the buyer to insist on the binding effect of the contract, even though the contract is not legally enforceable.

The buyers, fully aware of this focal point, would expect the seller not to void the contract, and they would choose to fight if the seller tried to void the contract. The buyer is also confident that he would be able to mobilize other members of the community who share this focal point to fight with the seller under the worst-case scenario. Buyers often bond with each other to form a powerful community, which can effectively sanction sellers who breach their promises. These communities are so powerful because colleagues, relatives, and friends often buy apartments in the same building. During my interviews, buyers of small-property houses repeatedly insisted that they were not worried about the risks of not having legal titles because many of their friends lived in the same building. The sellers themselves may inadvertently facilitate such communities. For instance, sellers of small-property houses may require a former customer’s recommendation to permit an outsider to buy an apartment. While this may reduce the seller’s uncertainty in bringing in an unknown buyer, this requirement also increases the solidarity of the buyer community, making them more powerful in enforcing their contracts against the sellers. In a survey conducted by the Shenzhen government, when asked whether they considered the risks of not having legal titles when they bought small-property houses, a common response was that buyers did not worry because so

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68 Consider the medieval Iceland case: For several hundred years, Iceland had functioning courts with no formal or informal enforcement powers. During this time, courts issued rulings to resolve disputes and proclaimed appropriate penalties, but there was no executive arm—police or sheriffs—to execute these judgments. Nonetheless, there was private enforcement of court decrees, carried out by the kin of the judicial winner. The explanation, according to McAdams, is that, “Each party expects the one declared by the court as being “in the right” to play the Hawk strategy—enforcing the remedy with violence, if necessary.” McAdams, supra note 8, at 1682.
many others have bought small-property houses. As a result, an equilibrium occurs where the seller plays dove and the buyer plays hawk.

III. Conclusion

This chapter challenges the conventional view of the necessity of formal property rights in a market economy by providing a concrete example from first-hand fieldwork in which an impersonal market has developed in the absence of legal titles. Secondly, this paper provides a new perspective on law and economic development by introducing and applying research on coordination games and focal points to this real-life situation. Finally, it contributes a significant and contemporary case study from the real world to theories of coordination games and focal points, which have, to date, mostly relied on laboratory experiments.

For a long time, property rights in developing countries remained a mystery, since we did not fully understand the dynamics between property rights and market transition, and we did not have a proper theoretical approach to explain why many titling programs sponsored by the World Bank and other international aid organizations did not work. One reason for this is the failure to fully incorporate the historical, political and other contextual factors that not only structure the interactions of relevant parties but also influence their expectations, into our analysis of their incentives. Therefore our strategies


to change their incentives are often misguided. Modeling the formation and operation of a market as coordination games presents a framework that incorporates contextual factors into the interactive analysis of relative incentives. In coordination games, the focal point theory explains one way that contextual factors influence relevant parties’ expectations of each other. This chapter argues that the incorporation of these theories provides a more powerful and nuanced explanation of property rights in developing countries.

This chapter’s analysis has substantial explanatory force in the so-called “China problem,” or why China has enjoyed three decades of rapid economic growth with a weak legal system. Nobel Laureate Ronald Coase and Ning Wang co-authored a book to address the question of how China became capitalist in 2012. Joseph Stiglitz and David Kennedy co-edited a book titled Law and Economics with Chinese Characteristics to understand the China mystery in 2013. Two opposing terms are used by The Economist magazine in recent years to depict “capitalism with Chinese characteristics,” or “bamboo capitalism,” i.e., capitalism grown bottom-up from China; and state capitalism, i.e., the state’s visible hand as the driver of China’s economic success.

Undoubtedly many of China’s crucial economic reforms were initiated by entrepreneurs from the bottom up. Examples include the invention of the household responsibility system (HRS) in Xiaogang Village of An’hui province, which replaced the

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inefficient collective farms in China in the 1980s; the emergence of the township and village enterprises (TVEs), which was the engine for economic growth in China in the 1980s; and the flourishing of private enterprises (PEs), which have provided many job opportunities for China. There is one character these reforms share: all of them have developed in the absence of a legal mandate.

However, it would be unfair to ignore the Chinese government’s contributions to these economic reforms. Entrepreneurs are everywhere and in every age - why did the HRS, TVEs and PEs fail to emerge in Mao’s era, but rather emerged in the reform era? Thus a pure bottom-up explanation cannot resolve the so-called “China problem.” A plausible speculation from this study is that the focal point of economic development created by the Chinese government in 1978 and further strengthened in the following years provides the missing link. As in the Old Testament, God said, “[L]et there be light; and there was light.” Deng Xiaoping made market reform a focal point for coordinating people’s expectations in the absence of a corresponding legal regime.

This chapter also has broad implications for research on law and economic development. Scholars have referred to exchanges of untitled real property in their studies of Vietnam property reform, squatters in Hong Kong, and informal housing in

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Peru, the Brazilian Amazon and the U.S. frontier. Systematic case studies of informal real estate markets around the world would greatly enrich our understandings of law and economic development. Structuring these informal property markets as coordination games and delving into historical and political backgrounds to understand the contextual factors that shaped bargaining would deepen our understanding of how to build modern market economies in developing countries.

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“How to deal with these illegal buildings?” I frequently was asked in my interviews with government officials in Shenzhen. To demolish them has proved to be a mission impossible; to legalize them would encourage more illegal buildings. This binary choice seems difficult. The complication is that the small-property problem is a multiple period, multi-person game rather than a one-period, two-party game. In a pure one-period, two-party game, compromise is often a better strategy than conflict between both parties. In the real world, the government does not want to compromise with an individual owner due to concerns about the consequences in the future: it would encourage other owners to develop their land illegally, and even this particular owner to develop this particular plot illegally again in the future.

This logic also explains why most countries do not allow adverse possession against the government. However, adverse possession against the government does de facto exist all over the world and a simple “law enforcement” strategy does not work.¹ Adverse possession is a useful framework for thinking about the small-property problem. Traditionally, our thinking about adverse possession is who should have the title—the adverse possessor or the original owner? This is also consistent with our understanding of the structure of legal entitlements before Calabresi and Melamed published their landmark piece “Property Rule, Liability Rule, and Inalienability: One View of the Cathedral” in 1972, in which they developed a framework (“cathedral”) of legal

entitlements and in particular introduced the concept of liability rules. In 1985, Thomas Merrill suggested protecting an original owner’s property in adverse possession with liability rules. Since then, the cathedral of legal entitlements has been further refurbished and expanded. In particular, Ian Ayres and his coauthors have reconceptualized liability rules with option theory: there are both “call option” liability rules and “put option” liability rules. This chapter frames the Chinese small-property problem as adverse possession against the government in light of this expanded cathedral of legal entitlements. My argument is that the allocation of initial options matters at least as much as the allocation of initial entitlements and that options should be granted to parties that have the best information to make decisions. In the small-property case, these are the individual owners of small-property houses.

Part I frames the case as an adverse possession question, applies Ayres’ structure of legal entitlements to analyze adverse possession, and introduces his best-chooser principle to resolve the small-property problem. Part II discusses Shenzhen government’s policies in addressing small-property houses, categorizes them into six rules of legal entitlements, and compares their effects. Part III concludes and considers the role of options in resolving the tension between informal property rights and formal property law in developing countries.

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I. Framing the Question: Adverse Possession in Ayres’ Cathedral

A. The Concept: From Possession of Things to Possession of Rights

Adverse possession is a method by which someone, without the owner’s permission, acquires a new root of title to property already owned. The adverse possessor acquires title in this fashion by possessing the property until the statute of limitations for the relevant action by the title owner to recover possession has run out. American law often requires that possession must be exclusive, open and notorious, actual, continuous, and adverse under a claim of right.

The concept of adverse possession can be extended beyond the possession of things. For example, the revival of research on adverse possession in the 1980s was attributed partly to a decision of the California Supreme Court, Warsaw v. Chicago Metallic Ceilings, Inc., which was about prescriptive easement. Prescription is “the effect of lapse of time in creating or extinguishing property interests.” It is based on the theory that if “one makes non-permissive use of another’s land, and the landowner fails to prevent such use, such acquiescence is conclusive evidence that the user is rightful.” A prescriptive easement is created “by such use of land, for the period of prescription, as would be privileged if an easement existed, provided its use is (1) adverse, and (2) for the period of prescription, continuous and uninterrupted.”

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6 Id. at 35.
7 Merrill, supra note 3.
9 Id.
10 Id. at 86-7.
Merrill calls prescriptive easement a first cousin of adverse possession.\textsuperscript{11} Prescriptive easement and adverse possession are different in that the former involves nonpossessory use of property, which ripens into an easement, and the latter possession of property, which ripens into a fee simple. Though the non-possessory nature of an easement generally means that the continuity and exclusivity elements must be interpreted differently, the same legal requirements apply to both adverse possession and prescriptive easements. Scholars often do not distinguish too sharply between the rules of legal entitlements under adverse possession and prescriptive easement. Probably due to the more significant position of adverse possession in property law, the discussions of “the effect of lapse of time in creating or extinguishing property interests” are discussed more often under the framework of adverse possession.

In essence, village collectives own rural land, but cannot develop or sell it to other entities or individuals for non-agricultural uses or real estate development. Only the state can convert rural land to urban land and sell it to real estate developers. In such a case, villagers are entitled to compensation equal to the agricultural value of the land. Therefore, the right to develop, a crucial stick of property rights, has been detached from collective ownership of rural land and added onto state property rights.\textsuperscript{12} Individual villagers and village collectives have the legal rights to possess their village land, but no legal rights to develop the land. Thus, small property rights are the result of adverse possession of the government’s rights to develop rural land. It is not exactly a prescriptive easement as defined in either American law or Chinese law. However, it is

\textsuperscript{11}Merrill, \textit{supra} note 3, at 1124, footnote 11.

\textsuperscript{12}See Chapter One for more details about state monopoly on rural-urban land conversion.
prescription, that is, prescriptive acquisition of incorporeal interests.\textsuperscript{13} If we could discuss prescriptive easement under the framework of adverse possession, it is also proper to discuss the small-property case under the same framework. Both cases have to deal with the tension between the de facto possession and the de jure rights and to resolve whether de facto possession could lead to de jure rights with the lapse of time.

B. Property Rule, Liability Rule and Adverse Possession

As Calabresi and Melamed write, the first issue which must be faced by any legal system is one we call the problem of “entitlement.”\textsuperscript{14} Whenever a state is presented with the conflicting interests of two or more people, or two or more groups of people, it must decide which side to favor. Moreover, the state must decide not only which side wins but also the kind of protection to grant. Calabresi and Melamed define three types of entitlements: entitlements protected by property rules, entitlements protected by liability rules, and inalienable entitlements.\textsuperscript{15} An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the seller agrees upon the value of the entitlement.\textsuperscript{16} Property rules protect entitlements by deterring nonconsensual takings. Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, the entitlement is protected by a liability rule. Liability rules protect entitlements by compensating the entitlement holder if such takings do occur.\textsuperscript{17}

\begin{itemize}
\item \textsuperscript{13} Ackerman and Johnson, \textit{supra} note 8, at 87–8.
\item \textsuperscript{14} Calabresi and Melamed, \textit{supra} note 2, at 1090–92.
\item \textsuperscript{15} \textit{Id.}
\item \textsuperscript{16} \textit{Id.}
\item \textsuperscript{17} Ayres, Optional Law, \textit{supra} note 4, at 5.
\end{itemize}
Applied to adverse possession disputes, the state can choose among four different rules.

Table 4.1. Calabresi and Melamed’s Two-by-Two Box Applied to Adverse Possession\(^{18}\)

<table>
<thead>
<tr>
<th>Initial Entitlement</th>
<th>Method of Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Owner (“OO”)</td>
<td>Property Rule</td>
</tr>
<tr>
<td></td>
<td>Liability Rule</td>
</tr>
<tr>
<td>Adverse Possessor (“AP”)</td>
<td>Rule 3</td>
</tr>
<tr>
<td></td>
<td>Rule 4</td>
</tr>
</tbody>
</table>

- Rule 1: the state prohibits adverse possession—OO has the title, which cannot be taken nonconsensually.
- Rule 2: OO has the title, but AP can take it by paying compensation.
- Rule 3: the state grants title to AP without requirements of compensation to OO.
- Rule 4: the state grants title to AP, but OO can take the title back by compensating AP.

The Calabresi and Melamed categorization has dominated the discussions of legal entitlements—scholars have discussed different aspects of these rules, tried to expand their contents and even invented new rules. Among many others, Ayres significantly expanded the content of liability rules by introducing option theory into this field.\(^{19}\)

Options are defined by identifying who has the option, (whether the option is to buy (a call) or to sell (a put), and the price of exercising the option.\(^{20}\) A call option is an option to buy. The option holder can force a sale at the exercise price even if the seller does not want to sell. According to Ayres, traditional liability rules give potential takers a call option to take. A liability rule gives at least one party an option to take an entitlement nonconsensually and pay the entitlement owner some exercise price. Once the traditional

\(^{18}\) For a similar table, see *Id.* at 14.
\(^{19}\) *Id.* at 5–15.
\(^{20}\) *Id.*
liability rules were reconceived as granting a potential taker a call option, it became almost inevitable to think about put-option rules. A put option is an option to sell. While call options give the option holder the choice of whether to pay a non-negotiated amount, put options give the option holder the choice of whether to be paid a non-negotiated amount. Call options when exercised give rise to “forced sales”; put options give rise to “forced purchases.”

Applied to adverse possession disputes again, the possibility of put options suggests two additional rules:

- Rule 5: the state grants title to AP, but also gives AP the option of waiving his title in return for compensation from OO.
- Rule 6: OO not only can keep his title, but also has the option to give up his title and receive compensation from AP.

Incorporating the possibility of “put option” rules, the structure of legal entitlements in adverse possession is as following:

Table 4.2. Ayres’ Two-by-Three Box Applied to Adverse Possession\(^\text{21}\)

<table>
<thead>
<tr>
<th>Initial Entitlement</th>
<th>Property Rule</th>
<th>Liability Rule Call Option</th>
<th>Liability Rule Put Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>OO</td>
<td>Rule 1</td>
<td>Rule 2</td>
<td>Rule 6</td>
</tr>
<tr>
<td>AP</td>
<td>Rule 3</td>
<td>Rule 4</td>
<td>Rule 5</td>
</tr>
</tbody>
</table>

According to the distribution of asset and options, the structure of legal entitlements in adverse possession can be depicted as following. In Rules 2 and 4, one party’s title is subject to the other party’s call option. In Rules 5 and 6, one party not only has the title, but also a put option.

Table 4.3. Ayres’ Table of Claims Applied to Adverse Possession²²

<table>
<thead>
<tr>
<th>Rule</th>
<th>OO’s Claim</th>
<th>AP’s Claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rule 1</td>
<td>Asset</td>
<td>0</td>
</tr>
<tr>
<td>Rule 2</td>
<td>Asset - Call</td>
<td>Call</td>
</tr>
<tr>
<td>Rule 3</td>
<td>0</td>
<td>Asset</td>
</tr>
<tr>
<td>Rule 4</td>
<td>Call</td>
<td>Asset - Call</td>
</tr>
<tr>
<td>Rule 5</td>
<td>-Put</td>
<td>Asset + Put</td>
</tr>
<tr>
<td>Rule 6</td>
<td>Asset + Put</td>
<td>-Put</td>
</tr>
</tbody>
</table>

C. The Best-Chooser Principle

How to allocate legal entitlements efficiently? Ayres’ optional law theory tells us that: “Liability rules delegate allocational authority—allocational options—to privately informed disputants. The delegation effect gives us strong reasons to believe that liability rules do a better job than property rules in harnessing the private information of disputants.”²³

In the small-property case, the government knows its own needs and valuation of the right to develop; individual small-property owners have the information of their illegal real estate. The government has double roles in this case: one as a disputant and potential entitlement holder; the other as a policy maker, which can decide who decides, and does not have to decide the final allocation of entitlements. Thus the policy-maker in

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²² Ayres, Optional Law, supra note 4, at 17.
²³ Id. at 183.
this case has complete information about one disputant—the government, but has not enough information about numerous small-property houses and their owners’ valuation of them, which is more speculative than that of the government.

As Ayres writes in the American law context: “When the court is choosing between a litigant whose value is commonly known and another litigant whose value is not, the litigant with the known value is never the efficient chooser because he has no private information to bring to the allocative table.”

In this case, the government’s information is known to itself as a policy-maker; what it does not have in making a policy is the information of numerous individuals. Thus, the government is not the efficient chooser in this case. Small-property owners should be the efficient choosers because they can bring their private information to the allocative table.

Krier and Schwab have argued that less-numerous parties are more efficient choosers than more-numerous parties because of the collective-action problem. As Ayres has correctly pointed out, Krier and Schwab focus too narrowly on numerosity as the exclusive determinant of which side will be the more efficient chooser. As discussed previously, information is still a crucial element in deciding which party is the more efficient chooser. Moreover, the cost of overcoming the collective-action problem of numerous parties also varies according to the specific institutional and social contexts. As

\[24\] Id. at 45.
\[26\] Ayres, Optional Law, supra note 4, at 31.
Ostrom, Ellickson and many others have proved both theoretically and empirically, the problem of collective action can be overcome if the numerous parties constitute a close-knit community or has a well-functioning decision-making mechanism, as shown in the Caiwuwei case in the following part.

Ayres makes another point: “The litigant with the more speculative valuation will tend to be the more efficient chooser because he has greater informational advantage.” This also applies to the small-property case. Individual valuation is more speculative to the market than government’s valuation of land development. The number of individuals amplifies the government’s information disadvantage. It is impossible for the government to have precise information about each individual’s valuation of his or her particular small-property houses; or even to set an average valuation.

The third point is about the problem of multiple takings. As recognized by Ayres, liability rules might induce disputing parties to engage in a protracted series of destructive takings of the same entitlement from one another, and multiple takers to threaten taking. Epstein argues that Ayres’ optional theory only applies to two parties playing a one-period game, and that traditional property rules work better when many parties play the game over many periods. Epstein correctly points out that “in all real world settings, the legal rules must work over many periods and must be resistant not only to the machinations of the two parties to the original dispute, but also to third parties

29 Ayres, Optional Law, supra note 4, at 44.
30 Id. at 125.
who might come in.” Epstein supports his critique with a real world case—whether the government is entitled to decree without paying compensation that owners are not allowed to develop their land if that development will interfere with the survival of endangered species. In this specific case, Epstein argues:

“The rule which denies the owner compensation could induce him to destroy valuable habitat lest his lands be frozen by government action. A decision to allow the government to designate land as habitat makes renegotiation of property rights impossible. The owner who buys back the rights faces the risk that a second designation will result in another loss of these rights to the government.”

Small-property development and its legalization is a multi-period and multi-party game. There is a concern similar to Epstein’s, but in the opposite direction: The Shenzhen government is worried that legalizing the existing illegal buildings would encourage further illegal development of rural land, not only on the land of existing small-property buildings, but also on the land that small-property buildings have not been built. Over time, small-property buildings have grown from two floors to four floors, to six floors, and to over eight floors or higher today; the number of illegal buildings and the land area they cover also have exploded.

Epstein’s worry about the abuse of government power should be left to the political process, as it is in most land use regulation practices. We should consider not only the possibility of multiple takings, but also which party is more capable of multiple takings in specific case settings. In the situation of land use regulation, such as in my small-property case and in Epstein’s habitat preservation case, it is one government

32 Id.
34 Epstein, supra note 31, at 844-5.
35 See Chapter Two.
36 LAND USE CONTROLS: CASES AND MATERIALS 46 (Robert Ellickson and Vicki Been eds., 2005).
dealing with numerous individuals, who not only have the information advantage, but also the advantage of overall control through their daily possession and operation of a specific plot against the government. These individuals are more capable of using the land according to their will, even when the law prohibits a particular land use, than the government’s law-enforcement capability.

In Shenzhen, the reality has proved that individuals are much more capable than the government in deciding the use of a particular plot when the widespread illegality makes legal enforcement infeasible.\(^{37}\) Huge number of small-property houses makes the situation even more difficult to deal with. Granting legal titles to the existing small-property houses would not only encourage individuals who have not used their land illegally to do so, it also would encourage further illegal use of the land by individuals granted the legal titles. It is exactly a multi-period, multi-party game as depicted by Epstein. However, we need to investigate the real-world specifics to decide which party is more capable of multiple takings of a specific plot. It turns out in cases of one government versus numerous individuals, it is often the individuals that are more capable of multiple takings. The same as in Epstein’s habitat preservation situation, the party that is more capable of multiple takings is the more efficient chooser.

In summary, the best chooser should be the party that has private information unknown to the policy-maker, with the more speculative valuation, and is more capable of multiple takings. As shown in the following part, it is the numerous owners of small-property houses in my case.

\(^{37}\) See Chapter Two and Part IIA of this chapter.
II. Structuring Legal Entitlements for Small Property

As early as in 1982, the Shenzhen government tried to make a feasible plan to deal with the illegal rural houses.\textsuperscript{38} In the past years, the Shenzhen government has tried five of the six rules under Ayres’ optional law framework, the efficiency of which thus could be tested in this case. I analyze and discuss the results of these Shenzhen government’s efforts. The only missing rule in the Shenzhen government policies, Rule 5, is actually applicable to a certain group of cases. I discuss the theoretical application of Rule 5 to these cases. It is worthy of pointing out that the rules below are used to structure the \textit{de jure} entitlements, rather than \textit{de facto} arrangements.

A. Rule 1

Content: \textit{Only the government is entitled to develop rural land; adverse development of rural land is prohibited and deterred through legal enforcement.}

The Shenzhen government’s initial response to the illegal development of rural land was to enforce the legal prohibition on rural land development and to demolish the illegal buildings, which turned out to be a huge task. From 1980s to the mid-1990s, the Shenzhen government promulgated a series of regulations to deal with the illegal development of rural land. However, compared to the widespread illegal development of rural land, the government’s enforcement power seemed to be limited. When daily legal enforcement did not work, the Shenzhen government tried campaign-style legal enforcement, which means concentrating government resources in a fixed period to demolish illegal buildings and to punish people who violated the legal prohibition with a hope of deterring further violations. This was not successful and the number of illegal

\textsuperscript{38}《关于严禁在特区内乱建和私建房屋的规定》（深府〔1982〕1号，1982年3月29日）[Shenzhen City Government. \textit{Stipulations on Strictly Prohibiting Private and Non-Planning Housing Building within the Special Economic Zone}, SZ Gov’t, March 29, 1982.]
buildings has continued to increase as time went by. As land available for development became less and less, the Shenzhen government’s tolerance of illegal rural land development became lower and lower.

In 1999, the Standing Committee of the People’s Congress of Shenzhen made a decision to monitor and punish illegal rural land development. It made a comprehensive plan to deter illegal rural land development, including:

- The Department of Planning and Land should strictly monitor and punish illegal rural land development;
- The Department of Housing Renting should not issue permits to illegal buildings and should seriously punish the renting of illegal housing;
- The Department of Business Administration should not issue licenses to businesses located in illegal buildings and should suspend the licenses of businesses operating in illegal buildings;
- The Department of Construction Administration should not issue permits to illegal rural land development and should punish construction companies that participate in illegal rural land development;
- The Department of Public Security should punish and deter activities held in illegal buildings;
- The Departments of Electricity, Water and Gas should not supply electricity, water or gas to buildings without legal approval documents.

In 2004, the Shenzhen government established a small leadership team headed by the mayor and consisting of the heads of relevant government departments, and a discipline team to supervise government officers to ensure that they fulfill their responsibilities in dealing with illegal rural land development. In 2009, the Shenzhen government established a new Department of Land Use Monitoring (“DLUM”) which

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has branches in all fifty-seven sub-districts of Shenzhen.\textsuperscript{40}

According to a senior government official of Shenzhen, each street-level unit of the Department of Land Use Monitoring has to spend six to ten million RMB each year to monitor illegal rural land development and demolish illegal buildings. A typical demolition of illegal buildings involves dozens of government employees, including construction workers who are responsible for demolition and policemen who maintain order during the demolition.\textsuperscript{41} The huge expense of demolition has become unaffordable to the government. In March 2013, the local People’s Congress published a draft of Regulation of Land Use Monitoring, which required the owners of illegal building to pay the demolition fees. In order to do that, the DLUM could take the owners’ properties, such as automobiles, legal real estate, and bank savings as lien.\textsuperscript{42}

The crackdown was ineffective. Even the small leadership team, the specialized legal enforcement organ, and the supporting legal measures have not deterred illegal rural land development. From 1999 to 2010, the number of illegal buildings has grown from 221,600 to 348,400.\textsuperscript{43}

These legal enforcement measures not only triggered widespread corruption, but also increased social conflicts. In my interviews with journalists, rural land investors, and


\textsuperscript{43} SHENZHEN CITY GOVERNMENT, INVESTIGATION REPORT ON ILLEGAL BUILDINGS IN SHENZHEN 26, (2010) (on file with the author).}
retired government officers, it was widely acknowledged that many government employees bought apartments and even villas developed on the rural land. Villagers intentionally get government employees involved in the business. Selling part of their real estate to government employees is a strategy used in many cases of rural real estate development. Generally, a village head would approach a government officer and tell him that their village has a plot or dozens of apartments for sale, and he can pay whatever price he likes. A Chinese Central TV (hereinafter “CCTV”) report also testified to this fact. In a CCTV reporter’s undercover investigation of a rural building of residential apartments, the reporter was told by both villagers and house brokers that about 40 employees of the district government agency of land administration had bought apartments in the building.\(^{44}\)

At each level of government (street/sub-district, district, and city), there is a division responsible for the enforcement of land laws and the demolishment of the illegal buildings. There are many publicly reported cases of the corruption in this division of the government.\(^{45}\) In reflecting upon its failure to stop rural real estate development, the Shenzhen city government also acknowledged corruption as an important reason. In a reported case, an accounting note prepared by a land developer revealed that the cost of development included a land use fee of 15.3 million and “other fees” of 5 million paid to


government officers.\(^\text{46}\) According to China Securities Daily, about one-third of the profits of the informal housing market fall into the hands of government officers in charge of enforcing land and housing laws.\(^\text{47}\)

In cases where “other fees” are not paid or where the legal prohibition has to be enforced due to political pressure from the city level, social conflicts might occur. Under this risk, each demolition is a battle between the government and villagers, which frequently results in bloody conflicts. Here is a real typical case from Shenzhen:

Hundreds of fully equipped legal enforcement officials assembled in a village to demolish illegal rural buildings. Several miles away, the traffic police blocked the road to stop “irrelevant parties” entering the village. Nevertheless, when the big machines began to demolish the illegal buildings, desperate villagers climbed onto the roof of the buildings and threw stones at the legal enforcement officers. The conflict resulted in five policemen and more villagers hurt.\(^\text{48}\)

On the villagers’ side, the legal enforcement did bring uncertainty to their \textit{de facto} property and brought great loss to them from each successful demolition of illegal buildings. In 2012, the Shenzhen government took 7,093 legal enforcement actions and demolished illegal buildings totaling 1.39 million square meters.\(^\text{49}\) In a case the Shenzhen government flags as a model of legal enforcement, a mall for automobile sales was demolished without any violence. Twenty-three car companies had salerooms in this mall, which employed more than 1,900 employees. The annual sales revenue of the mall was more than six billion RMB. Unfortunately, the building was illegal and was


\(^{47}\) Du and Wan, \textit{supra} note 45.

\(^{48}\) Fu, \textit{supra} note 41.

demolished. The government demolished it with a wide mobilization of government resources, including one working team for each automobile saleroom.\textsuperscript{50} Obviously, this method of legal enforcement cannot be widely reproduced. Additionally, the possessors of the illegal mall incurred huge economic losses from the demolition, not to say other costs that might be caused by the demoralized possessors\textsuperscript{51} or the bribes they paid to evade the legal enforcement.

Finally, organized violence emerged in this illegal world to reduce demolition and social conflicts. For example, in 2012 the Shenzhen City Court adjudicated the case of the so-called biggest mafia in the history of Shenzhen.\textsuperscript{52} In this case, the main business of the gang was illegal rural land development. It exercised huge influence in the governance of many villages within a sub-district of Shenzhen through bribing government officials of the sub-district government and violence against villagers. This is definitely neither the best nor the most efficient order.

\textbf{B. Rule 3}

\textit{Content: The government grants legal titles to adversely developed buildings without demanding compensation.}

In the U.S., an adverse possessor can acquire title by possessing the property until the statute of limitations for the title owner to recover possession has run. Chinese law does not recognize the rights of adverse possession.\textsuperscript{53} But that does not mean there is no adverse possession in reality. Actually, the tension between \textit{de facto} possession and the

\begin{itemize}
  \item \textsuperscript{50} Id.
  \item \textsuperscript{52} See Chapter Five.
  \item \textsuperscript{53} In the legislative process of the Property Law, many Chinese scholars suggested incorporating acquisitive prescription into the law, which is very similar to adverse possession. At the end, acquisitive prescription was not included in the Property Law, in opposition to the consensus among Chinese mainstream scholars. See Yun-chien Chang, \textit{Property Law with Chinese Characteristics: An Economic and Comparative Analysis}, 1 BRIGHAM-KANNER PROP. RTS. CONF. J. 345 (2012).
\end{itemize}
*de jure* rights is particularly acute in the rapidly changing China, as we could see from the small-property case in Shenzhen. The Shenzhen government officials do think very seriously about granting titles to adverse possessors. But they worry that such a measure would encourage further adverse possession. This worry has proved to be well founded.

Rule 3 means the AP gets title without paying for it after satisfying several conditions. The Shenzhen government tried a very similar policy in dealing with small-property real estate. In 1993, in the first regulation that recognized illegal rural land development as a serious problem, the Shenzhen government made a policy that houses built before 1986 could be registered without paying any fines.54 For houses built after 1986, the Shenzhen government cannot afford to grant all of them legal titles. Instead the Shenzhen government said that it recognized indigenous villagers’ rights to have their own residential houses. This meant the legal entitlement to a house on a 80-square-meters plot, with a total floor area of 240 square meters in 1986 (SZ Govt. [1982] 185)55 and to a house on a 120-square-meters plot, with a total floor area of 480 square meters in 2001.56

Meanwhile, to respond to some villagers’ claim that they did not have a chance to build their own houses because of the Shenzhen government’s harsh deterrent of illegal rural land development, the Shenzhen government promulgated a policy in 2006 to issue

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54《关于处理深圳经济特区房地产权属遗留问题的若干规定》（深府〔1993〕426 号，1993 年 11 月9 日）[Shenzhen City Government, STIPULATIONS ON PROPERTY RIGHTS OF HISTORICAL REAL ESTATE PROBLEM , (No. 426, Nov. 9, 1993)]
55 According to a standard set up in a 1982 regulation. See《深圳经济特区农村社员建房用地的暂行规定》（深府〔1982〕185 号，1982 年 9 月 17 日）[Shenzhen City Government, TEMPORAL REGULATIONS ON RURAL COLLECTIVE MEMBERS’ USE OF LAND FOR HOUSING CONSTRUCTION 185 (Sept. 17, 1982)]
56《深圳经济特区处理历史遗留违法私房若干规定》（2001 年 10 月 17 日深圳市第三届人民代表大会常务委员会第十一次会议通过，市人大常委会公告第 33 号）[Shenzhen People’s Congress Standing Comm., STIPULATIONS ON HISTORICAL ILLEGAL RESIDENTIAL BUILDINGS 33 (Oct. 17, 2001)]
permits to villagers to build a house if they have not already built one.\(^{57}\)

This free-titling policy greatly encouraged illegal rural land development. First, villagers devoted substantial resources to obtaining a permit to build a house, regardless of whether they had already built one. Getting a permit sometimes depended on how a “household” was defined. One household could be divided into two households just to get the benefits from the “one household, one house” policy. Many resources were spent on lobbying and bribing government officials with authority to issue such permits. Once villagers obtained such permits, almost no villager built only 480 square meters. Rather, 1000 square meters (eight to ten floors) was the average.\(^{58}\) Some villagers even made fake permits to post at the construction sites. It was difficult to distinguish between the fake permits and the real ones. Thus, this policy has significantly increased the monitoring cost of the government. Not only did it take more time to identify construction projects with fake permits, but it also was costly to deter the construction of the extra floors beyond the legal four (480 square meters). Moreover, with a hope of getting legal titles, villagers devoted time and money to building houses, which they would not have done without this policy. To strengthen their claim of rights under this policy, they also tended to build houses very rapidly—the rate was one floor per two days at the cost of safety and quality. Construction workers built twenty-four hours a day.

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without adequate safety precautions, and some were hurt or even killed in accidents.\textsuperscript{59}

Second, many people viewed this and other policies that provide mechanisms for villagers to legalize their illegal real estate as a signal that the government was unable to enforce harsh demolition rules and would have to grant legal titles to all the illegal buildings. Villagers responded with more illegal rural land development to secure their claims of rights in the possible situation of free-titling-for-all. This was the main reason that each time the Shenzhen government initiated a campaign to deal with illegal buildings, there was a burst of illegal rural land development.\textsuperscript{60} As time passed, the government was more likely to recognize the historical illegal buildings and to seek to deter future illegal rural land development. For villagers, this gave them an incentive to develop adversely as much and as quickly as possible for fear of losing the chance in the future and in anticipation of receiving legal titles for their developments.

In Shenzhen, the free-titling policy has been limited to the “one household, one house” policy and several other very limited situations. In addition to encouraging illegal rural land development, the Shenzhen government gained very little revenue from this policy.

C. Rule 6

Content: \textit{The government not only has a monopoly of rural land development, but also has the option of giving up its monopoly and receiving compensation from the adverse developers.}

If neither property rule works out, one should consider liability rules. Liability rules under the Calabresi and Melamed framework are actually call-option liability rules.


\textsuperscript{60} Interview Transcript II: 637, 648 (2012).
Surprisingly, the liability rule that the Shenzhen government has used most was a put-option liability rule: Rule 6, according to which the government not only can keep its title, but also has an option to transfer its title to villagers, without the villagers’ consent, in exchange for compensation.\(^6\) This might be simply because the government was accustomed to a top-down approach and control.

Early in 1988, the Shenzhen government promulgated a policy of allowing villagers to keep their illegal houses after paying fines, which were calculated according to the area of the illegally-developed real estate: each household has right to develop 80 square meters; but beyond that, the more they developed, the higher the fines they had to pay.\(^6\) In 1993, an owner of an illegal building could get a legal title after paying RMB 100 per square meter if the building was for industrial use and RMB 500 if for commercial use. Even non-villagers who bought the illegal houses could get legal titles after paying some amount of money.\(^6\)

In 2001, recognizing the reality that almost half of the houses in the city were illegal, the standing committee of the Shenzhen People’s Congress promulgated a

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\(^6\) Chang argues that the Ayresian Rule 6 is not a put as it is premised on the condition that a dispute has happened. He further argues that the contract/in personam nature of options make it incompatible with the in rem nature of property rights. Whether property rights are in personam or in rem rights is an open question. A short response is that whenever we examine a property dispute, it is a relationship between certain parties, and thus in personam relations. Property rights are defined to avoid and resolve disputes. Both property rules and liability rules are rules of protecting a legal entitlement, that is, rules that define available remedies whenever a violation of a legal entitlement happens, and not rules that grant extra in rem rights to an entitlement holder. Thus, put-option liability rule is not supposed to grant a property holder rights to force a random person to purchase his property. In this sense, I do not see put-option liability rules fundamentally different from property rules or call-option liability rules. Also regarding Chang’s critique that a real-world example of Rule 5 “is hard to come by,” Part IIF of this chapter argues that Rule 5 could provide a better solution than direct condemnation to Jingui villagers who have been unable to make use of their illegal buildings due to the environmental regulation in Shenzhen. See Yun-chien Chang, Optional Law in Property: A Theoretical Critique, N.Y.U. J.L. & LIBERTY, Retrieved from http://ssrn.com/abstract=2351651.

\(^6\) 《深圳市人民政府关于处理违法违章占用土地及土地登记有关问题决定》（深府【1988】253 号）[Shenzhen City Government, STIPULATIONS ON ILLEGAL LAND DEVELOPMENT AND LAND REGISTRATION 253 (1988)].

\(^6\) Shenzhen City Government, supra note 54.
detailed decree to legalize most of the illegal buildings. Except for those in serious conflict with the city planning system, such as blocking a main road, the Shenzhen government required all owners of illegal buildings to pay fines and land-use fees and apply for legal titles. The standards of fines and fees were again set according to owners’ identities and the total areas of the buildings. Owners of illegal buildings were required to apply for legal titles from the government within one year of the decree’s promulgation, giving the Shenzhen government information on illegal buildings within its jurisdiction.\textsuperscript{64}

This did not work out well. It was not until 2010 that the Shenzhen government obtained the first detailed report on illegal buildings, which acknowledged that the 2001 legalization plan had not been well received despite the government’s major efforts. From 2002 to 2010, among the 221,600 illegal buildings built before 1999, only 57,400 were granted legal titles. In addition, by 2010, the total number of illegal buildings had increased to 348,400 and kept growing day-by-day.\textsuperscript{65} There were owners of illegal buildings who applied for legalization but who declined to pay the fines and fees at the end. There were also cases in which the local government sent legal certificates to owners of illegal buildings but the latter rejected to accept the delivery.\textsuperscript{66} These owners preferred to stay illegal because they did not want to pay the prices or did not see any substantial benefit from getting their illegal buildings legalized. The government, despite its intention to force all owners to buy legal titles, did not have effective measures to deal with such situations.

\textsuperscript{64} Shenzhen People’s Congress Standing Committee, STIPULATIONS ON HISTORICAL ILLEGAL PRODUCTION AND COMMERCIAL BUILDINGS 34 (Oct. 17, 2001, ]; Shenzhen People’s Congress Standing Committee [2001] 33, supra note 56.

\textsuperscript{65} Shenzhen City Government, supra note 43, at 28-9.

\textsuperscript{66} Interview with a city government official, at Longhua New District of Shenzhen City (March 5, 2012).
In 2009, the government thought it might have set the prices too high and made the procedures too complicated. The People’s Congress of Shenzhen promulgated another decision to legalize the increasing number of illegal buildings with more willingness to compromise.\(^6^7\) Article I of the decision says that the government should respect history (zhong lishi), an indication of its respect for the rights of owners of the illegal buildings. This time the government tried to set lower prices and to make the procedures more convenient. This decision also required that a detailed plan should be made within one year. However, such a plan was not promulgated until December 30, 2013, which adopted both Rule 1 and Rule 6 to deal with small-property houses.\(^6^8\) The Shenzhen government has decided to test this plan in several select intra-city villages before fully implementing it, which would encourage villages not selected to develop further their land illegally.

This plan will not resolve the conundrum with which the Shenzhen government has been confronted. The information cost is too high for the government to enforce the put-option liability rule. It has to accumulate all the information on all illegal building within its jurisdiction, which is actually impossible. First, physical information might be the easier part: the location, height and floor areas are not difficult to collect; however, the history, quality and other invisible characteristics of the illegal buildings are actually very costly to collect. What’s more complicated are the social and economic relations of

\(^{67}\)《深圳市人民代表大会常务委员会关于农村城市化历史遗留违法建筑的处理决定》（2009 年 5 月 21 日深圳市第四届人民代表大会常务委员会第二十八次会议通过）[SHENZHEN PEOPLE’S CONGRESS STANDING COMMITTEE, DECISION ON DEALING WITH HISTORICAL ILLEGAL BUILDINGS IN RURAL URBANIZATION 101(May 21, 2009).]

\(^{68}\)深圳市人民政府：《<深圳市人民代表大会常务委员会关于农村城市化历史遗留违法建筑的处理决定>试点实施办法》（深圳市人民政府令第 261 号，2013 年 12 月 30 日）[SHENZHEN CITY GOVERNMENT, EXPERIMENTAL IMPLEMENTATION OF THE DECISION ON DEALING WITH HISTORICAL ILLEGAL BUILDINGS IN RURAL URBANIZATION 261 (Dec. 30, 2013).]
the illegal buildings: who owns them? Who should get the legal title? What is worse, even with all the qualities of a building fixed and its owner identified, it is hard to know how much the owner values it. The cost of strategic bargaining could be prohibitively high, in particular when the government exercised its put option and thus had no opportunity to know the owner’s evaluation. The complicated titling procedure makes the situation worse. For owners of illegal buildings, the complicated procedures imposed high information costs to them and fostered distrust of the government, both of which might prevent them from even thinking about whether the fees and fines charged by the government are reasonable or not. Several government officials told me that the fees and fines for a particular group of villagers were actually not high at all. Villagers in this particular group told me that they did not understand the government policies and that their friends had told them that the government would charge a lot of money for granting titles to their buildings. The amounts of both sides differed by a hundredfold.

In summary, there might be a price that both the government and adverse possessors would accept for legalization of the illegal buildings. But the government’s put option is too costly to exercise. To make sure that the price was set right, the government had to design complicated rules, which in turn caused great information costs to villagers.

D. Rule 2

Content: *The right to develop rural land belongs to the government, but adverse developers can get legal titles to their adversely developed buildings by paying compensation.*

The most successful and promising solution has been the application of Rule 2. The government has the title, but adverse possessors can take it by paying compensation. This rule gradually emerged in numerous village redevelopment projects of Shenzhen.
Originally in redeveloping the intra-city villages where the illegal rural land development was prevalent, the Shenzhen government insisted that only legally-developed land could be redeveloped and only legally-built houses could be compensated, which turned out to be infeasible. It is clear to both the government, the villagers and other market participants that village redevelopment would bring them substantial profits. Slowly the government relaxed the requirements of legality. Whether the demolished buildings were legal or illegal fell to the wayside when one could build a modern neighborhood or a luxurious commercial center at the same location. In the end the government set its standard: if a redevelopment project can supply 20 percent of its land to the government for free and develop another 12 percent of land for public roads and other public facilities, the government would approve the project without considering whether the old buildings were illegal or legal.69

It is essentially a call-option liability rule. The government has the title, but the village can pay the fixed price, that is, 32 percent of its land, to the government for legal rights to develop the remaining land. It is an option villagers can choose if they find it profitable. (They can choose not to exercise the option if they find it unprofitable.) The government needs to do very little. Villagers know best the value of their land. The cost of getting such information is much lower for them than for the government. This rule differs from the government’s put-option liability rule in several aspects: First, this decentralized approach leaves the decision to villagers, who are more attuned to opportunities in the market, in addition to their better knowledge of the real estate under

69北京大学国家发展研究院：《深圳市土地产权制度改革与二次开发利用机制创新研究报告》[NATIONAL SCHOOL OF DEVELOPMENT, REPORT ON LAND REFORM IN SHENZHEN 33 (2013)], (on file with the author).
their control. Second, titling becomes a continuous process under this rule. Thus, villagers can decide whether to exercise their call option based on real market opportunities, rather than a theoretical prediction that legal titles would increase the value of their real estate. This flexibility in timing can even counteract the negative effects of the government’s potential bad pricing—the price of exercising the call option might be too high for villagers this year, but with new market opportunities and increasing prices of real estate, the villagers might exercise their options anytime in the future. Villagers do not have this advantage when the government exercises its put option. The government could also choose the timing of exercising its put option, but without knowing the villagers’ information, it is more difficult to choose the right time than it is for villagers, who have both their own information and the government’s. Thus, Rule 2 leaves the decision to the party with better information.

Reality has proved that Rule 2 is the most effective one. In 2011, among the newly-developed 3.8 million square meters of houses on the formal market of Shenzhen, 1.5 million square meters came from village redevelopment. Compared with the reluctant responses to other legalization plans, villagers have very actively applied for village redevelopment. From 2009 to 2012, there have been 342 such projects, involving 30 square kilometers of the illegally-developed land. In the following, I would like to present a case example.

Caiwuwei is a village in the central area of Shenzhen. Villagers developed its land illegally, relying on the rent from the illegal buildings for their livelihood. Life was quite good for them because of the strong rental market. Many middle to low income people,

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70 Id. at 33.
including factory workers, restaurant waitresses, and even white-collar company employees, rented apartments in this village because of the convenient location and the lower rents and living expenses in the village. Most villagers did not see any necessity of applying for legal titles to their buildings from the government, which, in turn, did not want the instability risk from demolishing this village where thousands of people lived.

But everybody saw the wide gap between the rental price of small-property apartments within the village and legal apartments outside of the village, which were only one or two blocks away. There was huge capital embedded in this village. After the government set the standards of village redevelopment, village leaders began to think about the possibility of awakening this sleeping capital. Land developers also came to tell villagers how much money they could make from the proposed redevelopment.

The project demolished illegal buildings of about 150,000 square meters and built a 100-floor skyscraper on the plot of 45,000 square meters. The total area of saleable floors of the building was 480,000 square meters, one-third of which were used to compensate the owners of the illegal buildings. (A few villagers chose compensation in cash, which turned out to be a big mistake.) Owners of the illegal buildings received the same supply of apartments after the village redevelopment. However, the value of this real estate was about ten times higher, making many villagers millionaires or even billionaires. The government got revenue of RMB 200 million and well-built public roads, parks, and schools in the neighborhood. The land developer, which spent over six billion RMB redeveloping this village, got about 300,000 square meters of commercial real
estate worth at least 15 billion RMB.\textsuperscript{71}

![Image](image.png)

Picture: Caiwuwei: from an intra-city village to the eleventh highest building in the world; source: Kingkey Real Estate 2011 (The redlined area in the left picture was part of the Caiwuwei village before being developed into the skyscraper as shown in the right picture.)

Not all village redevelopment can bring such a dramatic change. However, the advantage of Rule 2 is that it greatly reduces the information costs required to make it possible. Moreover, since the option is at the hands of villagers, it cannot make the situation worse—\textit{status quo} is the baseline.

E. Rule 4

Content: \textit{The government grants legal titles to the adversely developed buildings, but has an option to take these buildings so long as it compensates their owners.}

Another option that the government tried was to requisition illegal buildings with compensation to the owners. In the past five years, the Chinese central government has required local governments to build some amount of public housing for low-income population. The Shenzhen government did not have enough land to build public housing required by the central government. At the same time, most low-income people in

\textsuperscript{71} \textit{Id.} at 72-4.
Shenzhen lived in the small-property houses. The Shenzhen government found that rather than developing extra houses, requisitioning small-property houses might be a better solution.

Zhongmin Garden was a small-property building built by villagers and outside land developers in violation of the governmental prohibition of rural land development. The total floor area was 74,352 square meters. The Shenzhen government requisitioned it at the price of RMB 3,642 per square meters, which was about one-third of the average price of legal buildings in the surrounding area. The Shenzhen government made a comprehensive examination of the quality of the building and found that it was safe. The reason was that it was designed by qualified construction designers and built by qualified construction companies, as most small-property high-rises were. The price was a bit higher than the construction cost and thus the developer and villagers could still make a small profit.\(^{72}\)

This single case was successful. However, it is unclear how widely it could be replicated. As the number of cases increases, the costs to the government of finding proper buildings and requisitioning them would increase rapidly. Setting a proper price is also a key issue, the failure of which would be more disastrous than Rule 6. There would be social conflicts if the government insisted on requisitioning the illegal houses with too little compensation. The costs of information and bargaining to set the proper price could be high. Moreover, the Shenzhen government could not afford to purchase more than 400 million square meters of illegal buildings and might not even need so much public housing at all. At the end, the purpose of “requisitioning small-property buildings for

\(^{72}\) Interview Transcript II 11–2(2012)
“public housing” is dubious. If small-property buildings were good for public housing and indeed served as homes to low-income population through the small-property market, why should the government intervene?

F. Rule 5

Content: The government not only grants legal titles to adversely developed buildings, but also gives their owners an option of selling their buildings in return for compensation from the government.

Under Rule 5, villagers would not only have the legal title, but also an option to waive their titles in return for government compensation. The Shenzhen government has not taken such a rule in dealing with the illegal rural land development in its history, but this rule could be very helpful in dealing with a special category of illegal buildings in Shenzhen.

Jingui Village is located close to the water sources of the city. It is about 13 square kilometers and has about 1,200 villagers. It has built eight factories on its land in violation of the legal prohibition of rural land development. In 2004, the Shenzhen government delineated ecological control lines and the whole village is within these control lines. There were 408 illegal buildings with the total floor area of 125,000 square meters and total land area of 64,700 square meters. The Shenzhen government could not afford to demolish these buildings because they were shelters and factories on which villagers relied for living. On the other hand, the villagers could not make full use of these illegal buildings or even make necessary maintenance and repairs due to environmental regulations. These illegal buildings were in quite poor states. In contrast to villagers in other parts of Shenzhen who have become rich from illegal rural land
development, Jingui villagers are poor.\textsuperscript{73} Jingui village is not alone. In 2006, the total land area of illegal buildings within the ecology control lines was 31.76 square kilometers, about 500 times of that of Jingui village.\textsuperscript{74}

Some have proposed ecological compensation to involved villagers. Similar to the discussions on regulatory compensation in the U.S., the proposed ecological compensation would be a huge financial burden on the government. Moreover, the value of these buildings and land has not dropped to zero. Not all of them can be used for industry or commerce. It would be hard to decide on the standards of compensation. Instead, Rule 5 is a good choice here. The Shenzhen government should not only grant legal titles to the villagers’ illegal buildings; it also should give them an option to sell those buildings to the government at a fixed price. With all values in consideration (efficiency, aesthetics, quietness, and so forth.), villagers should have the freedom to choose whether to sell their buildings to the government or not. As distributional fairness is a main concern behind this rule, the government does not have to set prices high, and should set them at reasonable levels to help villagers maintain an average standard of living.

III. An Optional Law Approach to Informal Property Rights

The tension between legal entitlements and \textit{de facto} possession is prevalent in developing countries.\textsuperscript{75} How to revive dead capital has been a hot topic in developmental

\textsuperscript{73} Interview Transcript II 418–21(2012)
economics in the past decades. Scholars have argued about whether to formalize the informal property rights but we do not understand well how to incorporate the informal property rights into the formal legal system. In De Soto’s words, how to “root the law in the social contracts?” The conflicts between formal law and informal property rights are essentially those between de facto possessors and de jure owners. Adverse possession provides a feasible mechanism to integrate informal property claims to the formal system, and avoids the shock of a top-down centralized rearrangement of property rights.

More importantly, by applying Ayres’ framework of legal entitlements to the particular area of adverse possession, this case study shows that there are actually more choices for structuring the legal entitlements than simply deciding whether to grant a title to the original owner or the possessor. The essential idea is that the government should decide who decides, rather than deciding the final allocation of resources. Options, rather than titles, should be granted to individual adverse possessors as they are more numerous and more capable of multiple takings than one government, and have both private information unknown to the government and the more speculative valuation of the land than the government.

This case study is also further evidence for the relevance of Ayres’ optional law theory to real-world policy making. It does not investigate the property/liability rule debate comprehensively, but it does provide examples in which liability rules are more efficient than property rules.

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CHAPTER SIX. MARKET TRANSITION: STICKY NORMS OR STICKY LAW?

The Shenzhen government called small-property constructions an urban cancer, but failed to erase them. Worldwide, countries strived to formalize the informal property sector and did not succeed. The idea underlying these disparate efforts is that informal property is a sticky norm that needs to be changed by law. But the question is: which is the problem in market transitions—sticky norms or sticky law?

As the small-property case in Shenzhen, China has showed, what is sticky is not the norms, but the law. The law is an easy target for manipulation by interest groups during market transition. In contrast, property norms are more responsive to the market and social changes.

Professor Ellickson calls for invigorating social norms by law;\(^1\) here I call for invigorating legal change by social norms, at least in the context of developing countries like China, where formal institutional building is full of uncertainty and redundant to social and market needs.

I. The Residual Legal Centralism in Law and Social Norms

The existing research on law and social norms focuses mainly on the evolution of social norms and how law can change social norms, but not how social norms can change law and the *co-evolution* of law and social norms.\(^2\)

\(^1\) ROBERT ELICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 284 (1991).

In the law and social norms literature, the evolution of social norms has been center stage. In a bird’s eye view of the literature, Professor Ellickson proposes a model for the change of social norms, but not for law.\(^3\) He does discuss the politics of ranchers in Shasta, and in particular, how different groups lobby to change the legal rules.\(^4\) But the interplay between law and norms in Shasta presents an incomplete picture in that both the norms and the law are clear-cut rules: “open-range” or “closed-range.”\(^5\) The rules here do not have the depth and flexibility that accommodates changing social situations and corresponding institutional innovation. In short, it is a picture of a mature society in which law is clearly defined by a centralized government authority.

The same can be said about Eric Posner and Richard McAdams’s classic exploration of social norms. Their main focus is why people obey social norms and how law can change social norms.\(^6\) For example, Richard McAdams discusses the expressive function of law, mainly targeting social norms.\(^7\) Other members of the new Chicago School, represented by Sunstein and Kahan, investigate various ways through which law can influence social norms, refreshing our understanding of the ways that law can influence people’s behaviors.\(^8\) Scholars like Sunstein do recognize that the impact of law on human behavior “has everything to do with social norms;” however, Sunstein does not bother to investigate how social norms can promote legal change, not to mention the co-

\(^5\) To determine whether an owner of cattle is liable for damages stemming from unintentional cattle trespass on unfenced land, “open range” means territory where a cattleman is not liable for trespass damages; “closed range” means territory where a cattleman is strictly liable for any damage his livestock might cause while trespassing within the area. Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution among Neighbors in Shasta County*, 38 STAN. L. REV. 623, 626 (1986).
evolution of law and social norms. Cooter examines three effects of social norms on law: expression, deterrence, and internalization, but he does not address the effect of social norms on law from the perspective of institutional change.

A more generous recognition of the positive contribution of property norms is presented in Property Outlaws. Penalver and Katyal discuss the crucial functions of property outlaws to the development and progress of our society, including expressive and redistributive functions. In another paper on a similar topic, Edwards develops a theory of law to explain why property outlaws always exist. He writes:

Sometimes law is enforced, sometimes it isn't; sometimes law is complied with, sometimes not……. I have referred to the limits of socially acceptable deviance around law as 'parameters of acceptable deviance.' Within these parameters are behaviors that are illegal but socially acceptable; their boundaries are the point at which law is actually enforced. Those boundaries become, in a sense, the informal but real law. "Law functions as an anchor on behavior, providing stability, but also space for deviance which permits the evolution of property rights."

But the above researchers still do not address one crucial question: why do some property outlaws lead to changes in the legal system and thus advance social progress, while others lead to conflicts between property outlaws and property laws? Answering this question is the first step to explore the co-evolution of law and social norms.

Even in addressing the inherent limits of property law, Edwards still recognizes that “law functions as an anchor on behavior.” This comfort with law in discussing the relationship between law and social norms decreases when the setting is shifted to

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13 Id.
15 Edwards, supra note 12.
developing countries. In discussing the evolution and chaos of property rights in developing countries, Fitzpatrick investigates the *conflicts* between law and norms, with more focus on the incapacity of law than the above approaches that focus on the role of law in changing norms. As he argues, “Unless social order is established, most commonly through legitimate and capable government, the process of allocating and enforcing property rights will tend to cause conflict because different claimants will resort to competing legal, normative, and coalitional enforcement mechanisms.”

This argument is based on his observation that “in most Third World societies, nonstate resource governance mechanisms have evolved separately from, and often in contradiction to, state institutions.” The idea is that law and norms are exogenous rather endogenous to each other. Thus when the government’s effort to build a unitary property law system creates a confrontation, the result is that “state law has either overridden nonstate governance mechanisms or failed to facilitate adaptation to new circumstances of urbanization, migration, and commodification of rights to land.” This echoes De Soto’s argument rooting the law in social contracts, and this belief is widely shared by people concerned about law and development. This “law or norms” choice reflects another drawback of the existing research: too much of the literature views law in developing countries as a unitary system, which is not true at least in China, and probably in many other countries. Fitzpatrick did notice the “polynormative system of official law,” but he regards it as the result of the government efforts to replace the informal

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17 *Id.* at 1012.
system with a unitary state law. This research treats the layering and fragmentation of law as an inherent characteristic of legal systems in developing countries, an endogenous situation we must consider in understanding property rights in developing countries. The layering and fragmentation of law does not necessarily lead to conflicts between law and norms, but it in fact leads to more possibilities.

The more comprehensive typology on the relationship between formal and informal institutions developed by political scientists can be applied to the relationship between law and norms: this typology includes complementary, accommodating, substitutive, and competing relationships. Social norms can be a catalyst to change law. Nevertheless, even such a typology ignores the fact that the relationship between law and norms is changing over time as both law and norms are changing. When a particular social norm arises, it might challenge and compete with the corresponding law; it might substitute law in regulating the particular social or market relations; law might make adaptive changes to accommodate it; in the end, they may complement each other. We need a more comprehensive and dynamic understanding of the co-evolution of law and social norms.

II. Property Norms Are More Responsive To Social Change than Property Law

The conventional view seems to be that law changes much more swiftly than norms. For example, North argues that:

Changes in informal constraints--norms, conventions, or personal standards of honesty, for example--have the same originating sources of change as do changes in formal rules; but they occur gradually and sometimes quite subconsciously as
individuals evolve alternative patterns of behavior consistent with their newly perceived evaluation of costs and benefits.\textsuperscript{21} [emphasis added]

The process of change is overwhelmingly incremental…. The incremental change may come \textit{from a change in the rules via statute or legal change}. For informal constraints there may be \textit{a very gradual withering away} of an accepted norm or social convention or the gradual adoption of a new one as the nature of the political, social, or economic exchange gradually changes.\textsuperscript{22} [emphasis added]

North does not explain in detail why informal constraints such as norms tend to change more gradually than law.

Ellickson elaborates systematically on why “inefficient social norms tend to be weeded out too slowly.”\textsuperscript{23} Reasons include the cognitive biases in favor of the status quo, the costliness of displacing internalized norms, and the costliness of moving away from a local optimum.\textsuperscript{24}

The small-property case does not fit in either of the analyses above. In Shenzhen, people favor “reform and change” rather than the status quo, cannot wait to displace the old communist norms that prohibit land alienation, and successfully moved away from the old situation.

Both North and Ellickson write about the interest group problem in social change. North writes that “the larger the number of rule changes, the greater the number of losers and hence opposition.”\textsuperscript{25} Ellickson criticizes the interest-group theories of norms, which hold that “members of powerful interest groups manipulate the content of norms to serve

\textsuperscript{22} \textit{Id.}
\textsuperscript{23} Ellickson, \textit{supra} note 3, at 32.
\textsuperscript{24} \textit{Id.} at 32-4.
\textsuperscript{25} North, \textit{supra} note 21, at 6.
their own selfish interests." He argues instead that, “One can readily understand how concentrated lobbies might be able to influence the legal system. The informal control system, by contrast, is much more diffuse, and norms seem stubbornly resistant to deliberate influence.”

Their discussions on interest groups do not address directly the question of whether law or norms change more quickly. But starting from their idea that law is more susceptible to interest group pressure, we can argue that social norms tend to be more responsive to social change compared to law that is hijacked by interest groups. The change of the power structure often takes long time, which is often as unmovable as a mountain. Meanwhile, the emergence of a market is often a natural response of individuals to new profit opportunities, which is as easy as the downward flow of water.

The formation and operation of social norms can be triggered by social change apart from interest group politics. Such market norms are often self-enforcing in the absence of political interference. Social norms, at least, reflect the politically disadvantaged groups’ demand for rule change, and thus provide another discourse on institutional change, while the politically advantaged groups favor the status quo of “sticky” law.

Here I do not try to make a general argument that social norms change more swiftly than law, but instead I try to raise the possibility that in certain cases, particularly against the backdrop of post-communist transition, interest groups can hijack the legal

27 Id. at 96.
change while the market provides plenty of opportunities and incentives for bottom-up institutional exploration.\textsuperscript{29}

It is also worthwhile to point out that property norms in such situations are different from norms such as foot-binding, dueling, the diamond industry in New York City, and even the informal resolution of property disputes among rancher neighbors in Shasta County. The crucial distinction is that property norms in my case are not built on a close-knit community. Rather they are supported by a network of institutional innovators, including local villagers, lawyers and real estate brokers, and are open to anyone who is willing to adopt them. They are more similar to and more encompassing than what Strahilevitz calls norms of “intermediate-knit groups,” which are characterized by a mixture of familiars and strangers. “An intermediate-knit group member anticipates having repeat-player interactions with his proximate companions, but not with the strangers who are also members of the group.”\textsuperscript{30} The network of institutional innovators in the small-property case consists of villagers who know each other, the village co-ops which keep and transmit information, real estate brokers and lawyers who know the villagers, and other buyers and sellers who connect to villagers and to each other through the village co-ops. Such social norms provide another society-wide way of rearranging property rights in defiance of the sticky formal property order. As a result, it also has bigger potential in promoting legal change.

\textsuperscript{29} The existing discussion on sticky norms, based on the assumption that social norms have been internalized, is well-grounded. See Kahan, \textit{supra} note 8. However, internalization is not an inherent characteristic of social norms. See Ellickson, \textit{supra} note 3, at 3; McAdams, \textit{supra} note 2, at 394-97.

III. Reconstitution of Law and Social Norms

This research does not propose a pure bottom-up institutional change approach. As seen from the small-property case, law also plays an important role in the formation, operation and institutionalization of the small-property market. This research presents a more nuanced interaction and co-evolution of property law and norms. The layering and fragmentation of law requires government officials to engage in the reconstitution of law to determine what law, the meaning of the law, and its application, and leaves room for ordinary citizens and organizations to engage in the reconstitution of law to serve their own interests. In the small-property case, villagers in Shenzhen developed widespread norms of rural land development and transfer despite the legal prohibition and government monopoly on rural-urban land conversion. The unsanctioned bottom-up reconstitution of law is often labeled as illegal and might face the risk of legal enforcement. However, the layering and fragmentation of law also leave room for discretion in legal enforcement. Enforcement officials can decide what and how to enforce according to their ideological preference, operational goals of that particular government department, and even career goals and personal interests of particular government officials.31 Reconstitution of law at local settings is also a bargaining process in which government officials and extralegal actors such as village co-ops in Shenzhen negotiate to define the law at stake.32

During the formation and operation of the small-property market, the 1988 constitutional amendment played an important role. Although the official stance was that

32 Id.
the actualization of the right to transfer land use rights should rely on the follow-up promulgation and reform of particular land administration laws, the amendment provided the literal basis on which ordinary people can reasonably claim that the transfer of (both rural and urban) land use rights is consistent with the Chinese constitution and that the 1998 LAL and other administrative ordinances that prohibits the transfer of rural land use rights are actually unconstitutional. Even if many villagers in Shenzhen and other actors of the small-property market might not grasp the legal details, the market-orientated atmosphere and the encouragement of institutional exploration, with endorsements from Deng Xiaoping and other national leaders, and the 1988 constitutional amendment as a concrete and highly-visible milestone, do shape the reconstitution of layered and fragmented laws towards the social consensus and norm of rural land development and transfer.

At the beginning, the reconstitution of laws at local villages was tolerated to a great extent by the formal institutional actors. As institutional building is fraught with uncertainties, the formal institutional architects, such as Deng Xiaoping and other national leaders in the 1980s, seek inspiration from the informal institutions and tolerate their deviation from the formal laws, in particular if such bottom-up reconstitution serves higher goals of the government, such as economic development and social stability, though in conflict with particular lower laws.

At a certain point property norms grow big enough that the challenge they pose to property law can no longer be ignored. As a result, formal institutional actors have to

33 See e.g., 刘连泰，集体土地征收制度变革的宪法空间，《法商研究》2014 年第 3 期。[Liu Liantai, The Constitutional Dimension of Reforming the Requisition Regime of Collective-Owned Land, STUD. LAW & BUS., No. 3 (2014)].
respond to the property norms. Due to the preference for the status quo and other reasons, their first response is often to suppress the property norms, which usually fails. After that, and sometimes even concurrent with the suppression, more accommodating responses are often made, which means alterations to the formal institution. There is, in this sense, a long and bumpy road towards the convergence of property law and norms. In such a transition, different institutional actors, formal or informal, would reconstitute the laws at particular settings according to their needs. Some succeed, some fail. But this apparent chaos should not dampen our cautious optimism. This chaotic process can also be viewed as a process for institutional experiments and competition. Those rules that reduce conflicts between law and social norms prevail over rules that intensify the conflicts.

The following institutional change is a process I would like to call the reconstitution of law and social norms, as it is based on both the existing laws and the emergent norms, which are products of the bottom-up reconstitution of the existing laws. The spread of the small-property constructions and their important function in the local economy prompted the Shenzhen city government’s engagement with and creation of accommodating amendments to its land law and policies. The Suzhou city government and the Guangdong provincial government are also examples of this phenomenon.\(^\text{34}\) In the end, the small-property market also prompted the Chinese central government to set an agenda for an integrated market for urban and rural land use rights. Though this process involved the gradual adaptation and eventual convergence with the property norms, it is not a simple informalization of the formal system, or formalization of the

\(^{34}\text{See Part IV of Chapter One.}\)
informal system. The parallels between property law and norms and the interactions between the systems exist in all societies and time periods.

Property law and norms could be either in harmony or in conflict. If changes in one system are in harmony with the other, their interaction will tend to reduce transaction costs to society; if changes in one system are in conflict with the other, their interactions will tend to increase transaction costs to society. Such transaction costs include the costs of making an exchange and the cost of maintaining the structure of both property law and norms. During the market transition, social change causes change in property norms; while property law might fail to follow such changes due to hindrance by interest groups. As a result, transaction costs to society increase. Such increased transaction costs could lead to changes in property law, though not necessarily. If adaptive legal change is made, and the accompanying reconstitution of law and social norms occurs, transaction costs can be reduced. When both social surroundings and institutional infrastructure settle, transaction costs would be reduced to a low level until new social change brings another round of significant frictions and conflicts between property law and norms.

IV. De Soto Revisited

I am frequently asked how the Chinese example augments our understanding of the vitality of informal property systems as presented by de Soto's works on Peru.

The first is the relationship between modern market economy and property law. In an interview, de Soto said: “I’m not saying… that other reforms aren’t necessary. I’m simply saying that a property rights system is a principal reform, without which other

reforms are difficult to manage. It’s quite clear that property law does not resolve the other problems. But to me, what is also quite clear is that without property law, you will never be able to accomplish other reforms in a sustainable manner.\textsuperscript{36} The small-property market in Shenzhen and China’s land law reform prove that property norms often move ahead of property law in market transition. Thus, it is unrealistic to make creating a property law a precondition of market transition.

The second, and I believe more important, point is how the Chinese example provides a dynamic perspective and, as a result, helps us focus on the interaction mechanism between existing law and norms. De Soto, though recognizing and praising without hesitation the vitality of the informal economy in Peru, compares it to an ideal world with “good law.” My research compares two systems that both exist in the real world and strives to explore the mechanisms of such an interactive system. De Soto focuses on the inadequacy of the informal system and argues for the \textit{demand} for a “good” legal system. My research focuses more on the supply side—why there is “bad” rather than “good” law? How can we transform bad law to good law? The answer actually lies in the informal property systems that de Soto laments. Property norms would trigger a series of reconstitution of law processes, through which the legal system could be improved. This reconstitution thesis differs from de Soto’s formalization argument in that it emphasizes the co-evolution and symbiotic relationship between property law and property norms.

Figure 6.1. What de Soto and Qiao Compare

De Soto

<table>
<thead>
<tr>
<th>Bad Law</th>
<th>Social Norms</th>
<th>Good Law</th>
</tr>
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</table>

Qiao

<table>
<thead>
<tr>
<th>Bad Law</th>
<th>Social Norms</th>
<th>Good Law</th>
</tr>
</thead>
</table>

The shaded areas are the sources of social control that are being compared.