

# Institutional change and redevelopment of urban villages in China: A new institutional economics perspective

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**Abstract:** Open policy reform has been implemented more than 40 years, the city construction and development of China turns out new face very fast. China evolved the grid and applied it to the planning, construction and ordering of its great imperial capital cities. Urban villages are a product of China's urban-rural dual system and rapid urbanization. In early China, the renovation of urban villages mainly focused on demolition and reconstruction, neglecting the residents' demand for high-quality housing. With institutional changes and the development of urban governance concepts, urban village renovation has begun to adopt organic renewal and micro renovation methods, and more emphasis has been placed on the quality of urban living. This research mainly explores the impact of policy changes on the transformation of urban villages from the perspectives of institutional change theory and transaction cost theory. This study also compared the policy differences and impacts of urban village renovation between Zhengzhou and Shenzhen. In the process of urban village transformation, it is necessary to consider the impact of institutional environment on urban village transformation policy.

**Keywords:** Institutional change, Urban villages, Institutional change theory, Transaction cost theory.

## 1. Introduction

Since the economic reform in the 1980s, China's urban construction has made great progress. The urbanization rate has increased from 17.92% in 1978 to 63.89% in 2021. In the process of urban expansion to the surrounding areas, a large amount of agricultural production land has been expropriated by the city and the original rural non-agricultural construction land has been retained in the urban space. With the development of urban economy, it has further grown to form the unique form of urban village. Under China's special urban-rural dual land ownership system, urban land is mainly divided into formal urban areas (state-owned land ownership) and urban villages (collective land ownership)(Lai & Tang, 2016)<sup>[1]</sup>. In 2008, the promulgation and implementation of the Urban and Rural Planning Law of the People's Republic of China effectively controlled the urban growth boundary. Urban construction is gradually changing from expanding new urban area to using and rebuilding existing land. With the rapid development of some large and medium-sized cities, such as Beijing, Shenzhen, Guangzhou, there is a large demand for land. In order to improve the land use efficiency in the urban built-up area, the local government has begun to take the lead in promoting redevelopment the of urban villages in the built-up area. Thus, the Chinese government and development enterprises have made great efforts in promoting the redevelopment the of urban villages, which has implemented many reconstruction strategies, policies and plans in various regions of the country in the hope of obtaining higher economic value.

The research on urban villages has been widely concerned in the academic circle since the mid 1990s. Most of the early studies regarded the village in the city as a special social place and their beneficial functions as social communities (Liu & Liang, 1997; Ma & Xiang, 1998)<sup>[2][3]</sup>. Previous studies have extensively explored the negative consequences of

redevelopment urban villages. They mostly criticized the process, which included the demolition of affordable housing for migrant workers (Wu et al., 2013)<sup>[4]</sup>. However, other scholars believe that the redevelopment of urban villages can have positive socio-economic and environmental impacts and benefit migrant workers (Lin et al., 2014)<sup>[5]</sup>.

Through the reconstruction of urban villages, the villagers of urban villages can obtain settlement houses and capital compensation benefits. Through the urban village reconstruction project, the government gains benefits from political achievements, economic development and urban image improvement, which increases the motivation of the government to promote the urban village reconstruction. At the same time, there are some problems in the process of urban village reconstruction. First, in order to obtain high profits, villagers continue to add to the existing houses. There will also be haggling with the government overcompensation. The compensation cost and transaction cost of reconstruction are increased. Second, in order to smooth the reconstruction, the government acquiesces in the illegal construction behaviors of villagers, which encourages the speculation and illegal construction behaviors, thus leading to huge investment by all parties before the reconstruction of urban villages, and increasing the time cost, capital cost and opportunity cost in the reconstruction process. If the transformation is completed according to the existing policies, all parties can obtain better expected benefits. If the transformation policy changes in the process of transformation, the high-cost input in the early stage appears the uncertainty of income. The expected income of some villagers decreases, and they may form interest groups to game the institutional changes.

In order to standardize the transformation of urban villages, the Chinese government has issued a series of policies for the transformation of urban villages, which define the transformation methods and compensation methods. The

binding nature of the system standardized the transformation process. China's system is provided by the government. Therefore, the transformation policy of urban villages is formulated by the government. The introduction of policies will be affected by the institutional environment. In the process of urban village transformation, the change of institutional environment will lead to the change of urban village transformation policy, which is mandatory by the government. In November 2018, Shenzhen issued the Overall Plan for Urban Villages (Old Villages) in Shenzhen (2018-2025) (draft for comments), and officially issued the Overall Plan for Comprehensive Renovation of Urban Villages (Old Villages) in Shenzhen (2019-2025) in March 2019. The transformation policy of urban villages has undergone qualitative changes in the two government policies before and after.

This study focuses on the impact of policy making on the transformation of urban villages in the process of urban village transformation. From the perspective of institutional change theory and transaction cost theory, this paper discusses the impact of policy change on the transformation of urban villages.

## 2. Literature Review

### 2.1. Transaction Cost

Transaction cost researchers define an economy as a group of organizations involved in internal and external transactions that are subject to institutional arrangements (Lai & Tang, 2016)<sup>[1]</sup>. The transaction cost framework takes transaction as its basic unit of analysis. A transaction is an exchange of property rights that allows the owner to exclude others from use, divert rent, and transfer assets (Lai & Tang, 2016)<sup>[1]</sup>. Organizations incur transaction costs when conducting economic exchanges or transactions (Treas, 1993)<sup>[6]</sup>. Barzel (1997) linked transaction costs to the transfer, acquisition and protection of rights. Although transaction costs are defined differently to meet different purposes, they usually refer to costs other than the actual cost of production.

Land development can be understood as a collection of transactions. Transaction cost provides a research perspective for analyzing land system and land development. Land can be defined in terms of physical objects and property. First of all, as a kind of real object, land can be understood by studying its physical attributes (such as location, shape, size and use), while as a kind of property, land can be understood as a bundle of rights, including refusal to use, gain, change the form and substance, and transfer of ownership of the asset (Pejovich, 1990)<sup>[7]</sup>. In this sense, land development involves changes in land use and property rights. From the perspective of transaction costs, these changes occur through transactions between related parties with contractual agreements. Therefore, the land development process can be defined as a series of transactions involving the exchange of land property rights.

### 2.2. Institutional Change

A system is a collection of formal and informal rules that impose constraints on people. The transformation policy of villages in cities is a constraint on all parties involved in the transformation, which is a form of system. System includes two meanings: system environment and system arrangement. The system will change according to the change of environment and time. The motivation of personal pursuit of

maximum benefits plays an important role in promoting institutional change. Institutional change can be either institutional innovation or the transformation from the old system to the new system. Institutional change needs to consider two factors: potential costs and potential benefits. The pursuit of interests is the driving force of institutional change. Successful institutional change should increase total income. In principle, it should be ensured that no one suffers losses in this transition. In the current theoretical research on institutional change, there is little concern about the impact of institutional environment. Recent work by historical Institutionalism scholars has examined gradual endogenous institutional change (Mahoney & Thelen, 2010)<sup>[8]</sup>. It argues that if institutions are a set of rules that are enforced or followed, then in order to understand endogenous change we must examine gaps in enforcement and compliance, requiring us to unravel the inner life of institutions. There is a lack of comparison between the cost and benefit changes of the trading parties after the institutional change. There is a difference between the institutional change in China's context and the adaptability in the Western context.

## 3. The Influence of Urban Village Redevelopment Policy on The Implementation of Redevelopment

The transformation of urban villages is closely related to the transformation policy of urban villages. The formulation and implementation of transformation policy is an important decision-making behavior for the government to promote transformation. The change of policy directly affects the income and trading behavior of all parties involved.

### 3.1. Zhengzhou stable redevelopment policy

The transformation of villages in the city of Zhengzhou started in 2003, starting with the transformation of Xishizhao Village in Jinshui District, and at the beginning of the transformation, the market-oriented operation was the leading factor. In 2007, Zhengzhou Municipal People's Government issued the Notice of Zhengzhou Municipal People's Government on Several Provisions on Further Regulating the Reconstruction of Urban Villages (Zheng Zheng Wen [2007] No. 103), which stipulated that legal buildings below 3 floors (including 3 floors) above the villagers' homestead would be given 1:1 compensation and resettlement. During this period, there were many villages to be transformed, and the enterprises involved in the transformation gained more economic benefits. This compensation policy was successfully implemented. In 2011, Zhengzhou issued the Administrative Measures for the Reconstruction of Urban Villages in Zhengzhou (Zheng Zheng Wen [2011] No. 258), which standardized the land distribution of the reconstructed villages on the basis of keeping the original compensation standard unchanged. It is specified that the resettlement development ratio shall not exceed 1:2, that is, the area of the development plot provided to the enterprises participating in the development shall not be more than twice the area of the resettlement plot. Since then, the reconstruction policy of urban villages has been implemented according to this document. Each villager can obtain about 500 square meters of resettlement houses from the reconstruction of urban villages.

From 2003 to 2011, Jinshui District of Zhengzhou completed the reconstruction of 14 villages in the city. From

2012 to 2016, the relocation of all the remaining 56 villages in the city and 24 villages combined with the city was completed. During the reconstruction of urban villages, Jinshui District will compensate the area of villagers' resettlement houses in accordance with the Administrative Measures for the Reconstruction of Urban Villages in Zhengzhou City (Zheng Zheng Wen [2011] No. 258) and give a certain amount of demolition subsidies to buildings with more than three floors. According to different building structures, the standard of demolition subsidy varies from 120 yuan to 600 yuan per square meter. Most of the urban villages in Jinshui District are built on more than 6 floors. In addition to about 500 square meters of resettlement houses, each building can still receive cash compensation of about 300000 yuan. The additional cash compensation increases the economic cost of government transformation. However, because the transformation of villages in cities can obtain many cheap lands to obtain economic benefits and political achievements and other factors, the government is still paying a high cost to reach a transaction with the villagers for the transformation of villages in cities.

From the perspective of villagers in urban villages, the compensation policy of Zhengzhou is stable in the transformation of urban villages after 2012. The general trend of the transformation of villages in cities has been deeply rooted in the hearts of the people, and most villagers agree with the inevitability of the transformation. Based on this judgment, villagers have a certain degree of expected benefits for the transformation of villages in cities. Therefore, since 2012, the phenomenon of building in urban villages in Zhengzhou, such as housing capping, illegal construction, and surprise construction, has continued to occur. The reconstruction of Miaoli Village in Jinshui District was started in 2016. Each homestead in the village received a compensation resettlement house with three floors or less at a ratio of 1:1, and a subsidy of 600 yuan per square meter was given to houses with more than three floors according to the measured area. In order to obtain high income, villagers-built houses in the vacant land of their own homestead or built many temporary simple houses on the top of the houses. The sudden construction of houses increases the opportunity cost and expected income of villagers. Correspondingly, it increases the difficulties in negotiation and compensation determination between the government and villagers and increases transaction costs and uncertainties.

The compensation policy for the transformation of urban villages in Zhengzhou is relatively stable. Villagers have high income expectations. Under the stable policy environment, the increase of speculation leads to the increase of transaction costs and the overall cost of urban village reconstruction. Faced with the increased transaction costs, the government did not take institutional changes to reduce transaction costs, but facilitated the completion of the transaction as soon as possible, mainly because it could obtain higher benefits. Even though the reconstruction policy of urban villages in Zhengzhou City has enabled villagers to obtain high compensation, some villagers are still dissatisfied with the compensation system and do not sign agreements, which increases the cost of negotiation with the government. Some villagers eventually became difficult households and could not complete the transaction. The villagers failed to obtain the due benefits and bear higher institutional costs. Transaction failure turned the potential transaction costs into sunk costs.

## **3.2. Transformation of Shenzhen urban renewal policy**

### **3.2.1. Phase I: urban renewal policy focuses on demolition and reconstruction**

The Outline of the Overall Planning for the Reconstruction of Urban Villages (Old Villages) in Shenzhen (2005-2010) released in the early stage of Shenzhen pointed out that the reconstruction of urban villages in Shenzhen includes two types: comprehensive reconstruction and comprehensive renovation. Comprehensive reconstruction can take the modes of off-site reconstruction, overall demolition and construction, and local demolition and construction. Comprehensive renovation is aimed at urban villages that will not be renovated soon. The dominant idea of the document is the comprehensive transformation of villages in cities. The Interim Provisions of Shenzhen City on the Reconstruction of Urban Villages (Old Villages) (2004) issued by the Shenzhen Municipal People's Government pointed out that if the compensation for housing is in the form of property rights replacement, the area of real estate compensated to residents shall not exceed 480 square meters per household in principle, and monetary compensation shall be applied to the area of legal housing exceeding the area. If the reconstruction of villages in cities is realized, the economic value of the property compensated by each household will exceed ten million yuan according to the housing price of commercial housing in Shenzhen.

### **3.2.2. Phase II: Urban renewal policy focuses on comprehensive improvement**

In November 2018, the Shenzhen Municipal Commission of Planning, Land and Resources released the Overall Plan for Urban Villages (Old Villages) in Shenzhen (2018-2025) (Draft for Comments), which is the second time that Shenzhen has made a special plan for the reconstruction of urban villages (old villages). In the draft, it is proposed to focus on comprehensive improvement. The land used in the comprehensive renovation area shall not be included in the urban renewal unit plan for demolition and reconstruction. In 2017, the Notice on Accelerating the Development of the Housing Lease Market in Large and Medium Cities with Net Inflow of Population jointly issued by the Ministry of Housing and Urban Rural Development and other eight departments listed Shenzhen as the first city to carry out housing lease pilot. In this draft, Shenzhen proposed to implement the strategic arrangement of the municipal party committee and government to retain the villages in the city and strengthen the management of the rental market of the villages in the city. The introduction of the draft has obvious political considerations. The draft was publicized and the Overall Plan for Comprehensive Renovation of Urban Villages (Old Villages) in Shenzhen (2019-2025) was officially released in March 2019. The potential cost and potential income pattern of the future urban village renovation in Shenzhen will change.

## **4. Results and Analysis**

### **4.1. Institutional environment influences institutional change**

The government is the main institutional supplier. Political factors play an important role in institutional change. For the purpose of reducing political losses or improving political gains, the government puts political factors above economic

factors when making decisions. In the process of promoting institutional change, we should consider problems from the standpoint of the government rather than simply from the perspective of the market. Whether it is induced or forced institutional change, political cost and benefit should be considered.

The institutional environment is dynamic. When the institutional environment undergoes new changes and the political costs faced by the government are low or disappear, the government will initiate new institutional changes or even restore the original system. At this time, the economic costs and benefits in the transaction process become the main concern of the government. Institutional change may occur repeatedly due to the change of institutional environment, mainly due to the government's weighing of political factors and economic factors. Therefore, the impact of transaction cost theory on institutional change needs to consider the stability of the institutional environment. If the institutional environment changes, it will inevitably increase the cost of institutional change and the cost of maintaining the system, and the transaction cost will increase accordingly.

The transformation of villages in the city of Zhengzhou described in this paper also has the influence of political factors. The transformation of villages in the city was concerned by the government leaders at that time. There is a certain political incentive, and the government has a greater political benefit in promoting the transformation of villages in the city. In the transformation of urban villages in Shenzhen, the political cost is also considered in the policy change. The political benefits are not clear. If the policy is not changed, the political cost will inevitably increase. For transactions involving the government, it is difficult to accurately predict the political costs and benefits of the government, and there is uncertainty in the transaction.

## 4.2. Transaction Cost Theory and Cost Benefit Comparison

In the process of market transaction, participants have the motivation to reduce transaction costs, and promote institutional change to achieve lower transaction costs. However, if the income of a transaction cannot reach the expected income of both parties, the transaction may not be completed. Transaction cost is only a part of the total cost. Transaction costs also include other costs such as productive costs. People are willing to pay a high transaction cost to complete the transaction, which is related to the potential gains from the transaction. The trading process should consider the income factor. The potential profits obtained after institutional change are less than the cost of institutional change, so institutional change is difficult to occur.

In the process of the transformation of villages in the city, the villagers have opportunistic behaviors such as suddenly adding houses. The purpose of building is to obtain high compensation for demolition. The opportunity cost increases the negotiation cost and uncertainty cost between villagers and the government, and the transaction cost increases. Under the condition that the system has not changed, the potential possibility of completing the transaction is large. Villagers are likely to obtain high expected benefits by paying opportunity costs. On the other hand, compared with the financial, social and political benefits obtained through urban reconstruction, the government can still accept the increase of costs to realize the transaction. In the case of high transaction costs, if the transaction can provide acceptable benefits for both parties,

the transaction can be realized.

## 4.3. Cost change caused by institutional change

Potential benefits can be realized under the condition that the system remains unchanged. Institutional changes affect the cost-benefit changes of both parties, and opportunism aggravates the degree of this change. The interests of both parties in the market transaction are not consistent, and excessive incentives will lead to opportunism. Both parties to the transaction have opportunism, so they have the power to facilitate the transaction to obtain profits. The difference is that the opportunity cost invested by all parties is different. After the institutional change, the opportunity cost becomes a sunk cost, and the potential benefits disappear. In the process of trading, we should consider the uncertainty factors of the system and the resulting losses and evaluate our risk bearing capacity.

The reconstruction of urban villages in Shenzhen described in this paper, if the reconstruction is carried out according to the demolition and reconstruction, every villager can obtain high economic profits. Therefore, there are strong opportunism and speculation among villagers. The transformation of villages in cities is mainly based on comprehensive renovation, so the potential benefits of villagers will disappear, the sunk cost will increase, and opportunism will increase the cost of villagers.

## 5. Conclusion

By sorting out the impact of the transformation policy of urban villages in Zhengzhou City and Shenzhen City on the transaction behavior and analyzing the influencing factors of institutional change and the impact of institutional change on transaction costs, it is found that: (a) The cost benefits of the parties involved in the transaction are different before and after the institutional change. Different parties have different attitudes towards supporting and confronting institutional change, and the transaction may be completed at a higher cost; (b) Institutional environment affects the form of institutional change. When considering the influence of political factors, institutional change will develop in the direction of reducing political costs; (c) Opportunism increases transaction costs. Institutional change may lead to the transformation of opportunity cost into sunk cost, and the potential benefits of opportunists disappear. Thus, opportunists form interest groups to confront institutional change and the implementation of new systems, and even develop into refusal to trade under the new system.

In the process of urban village transformation, it is necessary to consider the impact of institutional environment on urban village transformation policy. Once the transformation policy of urban villages changes, the transformation behavior will change accordingly. Therefore, the formulation of the urban village transformation policy should not only consider the transaction to reduce transaction costs, but also consider the complexity of the policy, the impact of the external environment on the policy, and the confrontation of interest groups that may be brought about by the policy change.

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