

# Small Property, Big Market:

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## A Focal Point Explanation

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## Abstract

Based on one-year of fieldwork, this article presents a real estate market without legal titles to challenge formal property rights as a precondition for markets. In Shenzhen, the iconic city of China's market economy, more than half of the buildings are developed and transferred against the law. These illegal buildings are called small properties because their property rights are "smaller" (weaker) than legal properties. This article 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.

### I. Introduction

Can a real estate market form without legal titles? Is so, how, and by what means does it operate? The answer to the first question has conventionally been no. Scholars such as De Soto (2000) give the impression that life in the informal settlements, where formal property rights are absent, is poor, nasty and brutish. For example, literature reveals that in informal settlements in Peru one adult must occupy the house 24 hours a day to avoid the grab of possession by others (King 2003). The presumption is that informal property rights must be uncertain and insecure and thus transactions must be very limited (e.g., De Soto 1989). 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*, no more than five pages covered real estate transactions in the former and none in the latter.<sup>1</sup> In the following years, most of the research has focused on calculating the value of legal titles—how titling programs have increased tenure security, promoted investment, and the value of the property (e.g., Galiani and Schargrotsky 2010; Field 2005, 2007; Besley 1995; Alston and Libecap 1996; Alston et al. 1995). In a book titled "Hernando de Soto and Property in a Market Economy," published in 2010 and consisting of essays authored 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

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<sup>1</sup> The Other Path 25 (discussing the limits of selling and renting informal housing); 30-33 (illegal land sales).

argument that property formalization is sufficient to bring the benefits of a market economy to the poor has received sustained criticism (Barros 2010, 2).” [emphasis added]

To my knowledge, one significant exception is that Annette M. Kim (2004) 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. In line with this rare exception, this article is a further effort to explore how a real estate market can form and operate in the absence of legal titles.

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 (China Net 2008). People in China call these illegal buildings **small properties** (*xiaochanquan* in Chinese) because their property rights are “smaller” (weaker) than those on the urban/formal housing market, which have “big” property rights protected by the government. Shenzhen is the city with the highest ratio of small-property houses, which contribute 47.57% of its total floor space, compared to 30% in Xi’An and 20% in Beijing (Song 2012). 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 huge amount 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? (Interview 06-07-12)”

I spent one year in Shenzhen investigating how the market of small properties has evolved. From August 2011 to May 2012, I did 94 interviews in total. The forms of these interviews vary. The majority are in-depth interviews, typically a one to two-hour conversation. Some are half or a whole-day road trips to villages located in the different districts of Shenzhen, including visits to a dozen of small-property neighborhoods, during which I usually had conversations with real estate brokers, residents, and potential buyers and sellers of small-property houses. For calculation purposes, I have counted one such a trip as one interview.

Another important part of my fieldwork was the participation in a research project commissioned by the Shenzhen government to draft policies to address widespread small properties. The team included 20 members and did three concentrated and in-depth field research in 2012: April 15th–20th, June 25th–July 9th, and August 13th–August 16th. Afterwards, we drafted a report and had meetings and discussions with numerous Shenzhen government officials, including the Mayor and the Municipal Commissioner of Urban Planning, Land and Resources. The research team had almost full access to government employees and government data and covered many more villages than I could alone. All the interviews were well taped and recorded. I now have transcripts of all of the interviews, totaling 401,770 words. In addition to the interviews, I also collected various materials including government investigation reports and other documents, court files, village maps and records, transaction documents, and news reports.

In Shenzhen, small properties have been rented or sold to millions of people, including millions of migrant workers, middle-income white-collar workers, start-up entrepreneurs, and even real estate speculators (Southern Metropolis Daily 2011). The emergence and operation of this market seem a mystery: how did this market form against 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 (e.g., Macaulay 1963; Cooter and Landa 1984; Landa 1981) or supported by systematic institutions (e.g., Bernstein 1992, 1996, 2001: industrial associations). However, in Shenzhen there existed no centralized institution to enforce contracts of small-property transactions. A common response I got 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, which has been addressed by both economists and legal scholars. Nobel Laureate Thomas Schelling (1960) first observed that, in situations requiring coordination, anything that makes salient one behavioral means of coordinating tends to produce self-fulfilling expectations that this result will occur.

Schelling calls the salient solution the “focal point.” Weingast (1997) 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 (1996) explains self-enforcing conventions about coordination, reciprocity and property rights that resolve rival claimants disputes as arising from focal point equilibria. Myerson (2004) argues that Schelling’s focal point is among the most important ideas in social theory and that the foundations of political institutions can be understood in terms of focal equilibrium selection in a more fundamental game. Dixit (2006) 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 deliberately select an equilibrium from multiple self-enforcing coordination equilibria (e.g., Cooter 1998; McAdams 2000, 2005). Both McAdams and Myerson observe that a rule recognizing possession as the basis of property rights can avoid wasteful contests over the property through coordinating the strategies of rival claimants: the concept of “rightful” ownership is expected to be applied and thus the “rightful” owner will rationally claim and the other will rationally recede (see Rose 2013 for a critique of viewing property as hawk-dove games). Most recently, Hadfield and Weingast (2012) 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 (2004) 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 through applying the updated insights from coordination games and focal points to examine a contemporary example of a market without formal property rights.<sup>2</sup> It also contributes a significant real world example to the theories of coordination games and focal points, which have been mostly based on laboratory experiments.

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<sup>2</sup> For research that integrate game theories and sociological materials, see Leeson 2009 and Greif 1994, though both studies examine historical materials rather than contemporary cases.

This paper is organized as follows. Part II presents the fact of the small-property market as a challenge to the conventional understanding of property rights and market transactions. Part III discusses in more detail coordination games and focal points, models the formation of the small-property market as an assurance game among social entrepreneurs in Shenzhen, and models the operation of the market through addressing the demolition risk as a hawk-dove game between the Shenzhen government and market participants, and addressing the contract risk as a hawk-dove games between contract parties. Part IV briefly discusses the limitation of this focal point explanation and summarizes the theoretical implications of this case study.

## **II. The Market**

### **A. Chinese Property Law Reform and Small Properties**

The Chinese Communist revolution before 1949 had no intention to follow the Communist Manifesto to abolish property in land. Instead the Chinese Communist Party (CCP) won the civil war with its promise to reallocate landlords' land to millions of peasants. However, this promise was soon broken during the Great Leap Forward movement from (1958-1961), during which the private land of Chinese farmers was collectivized by the People's Communes and the transfer of rural houses became *de facto* impossible because of the strict control on population migration. In the urban area, most Chinese people lost their houses and land to various organizations in the name of the state during the Cultural Revolution (1966-1976) (Zhou 2012). The 1982 Constitution recognized both the collective ownership of rural land and the state ownership of urban land, and prohibited commercial alienation (renting and sales) of land in accordance with the Marxism ideology against land commodification (Xu 2005, 388). Rural land was collectively-owned by farmers of the respective villages. (In general, farmers are villagers; villagers are farmers--I use the terms "farmer" and "villager" interchangeably, depending on the specific contexts.) village collectives (in the form of villagers' committees or village co-ops) were responsible for the management of land within their respective villages; rural land could only be used for agriculture and rural land development was strictly limited to very few construction purposes, mainly building village enterprises and public facilities; each household was also entitled to a plot (80-200 square meters, standards varied across time and locations) to build a residential house only for the use of family members. (15-50 square meters per person;

standards varied across time and locations) Under the state ownership, local (county/city) governments were responsible for the planning and allocation of urban land to different users for various construction purposes.

In the 1980s, the 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.

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 expropriate 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.<sup>3</sup> As a result, the more the urban real estate market develops, the more unlikely that the central and local governments would liberalize the rural land development and transfer, which would jeopardize their monopoly over land (Yang 2010).

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 can only be legally achieved through requisition by the state.

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

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<sup>3</sup> Compensation for the expropriated rural land is mainly based on its agricultural output, but the government transfers it at urban land market price. Because rural land expropriation is almost the only way to satisfy the vast need for construction land in China’s urbanization process, the “public interest clause” has been essentially moot.



government decided to replace its housing allocation system with a housing market (Fang 2004). According to official statistics, from 1998 to 2007, the annual growth rate of the nationwide sales of residential houses was 1000% (National Bureau of Statistics 2008). As a result, land has become a scarce resource. Under such circumstances, rural land, especially that which is located near urban area, has become attractive. Local governments are extremely incentivized to grab rural land. The general mechanism is that the government expropriates the rural land, converts it to urban land, qualifying it for various construction purposes, and then sells it to commercial land developers. Millions of acres of rural land have been urbanized in this way in China since the 1980s, creating more than 40 million landless farmers (Xinhua Net 2011).

One response of Chinese farmers to this unjust law is the evasion of the legal prohibitions on rural land development and transfer. Farmers living in the rural areas near big cities often have great 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 from agricultural use. Their illegal transfers of land for non-agricultural uses have made a huge informal real estate market in China.

The prices of small properties are significantly lower than those of legal properties, ranging from one-fifth to three-fifths of those of legal properties (REICO 12-3). For good or bad, small properties have become a serious option for many Chinese people. According to an investigation in 2011, 60.3% of the respondents viewed small properties as an option in buying houses (Yuan 2011).

## **B. Small-Property Market in Shenzhen**

Shenzhen, a city in the southern part of Southern China's Guangdong Province and situated immediately north of Hong Kong, has been the literal and symbolic heart of the Chinese economic miracle (e.g., French 2006). 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) to pilot market-oriented reforms (e.g., Jiang 2010). Within this special economic zone, investment from overseas Chinese, Hong Kong, Macau, and foreign companies would be allowed and used for urban construction.

Since the establishment of the SEZ, a miracle of economic growth and urbanization has occurred in Shenzhen. In 1979, the urban population in Shenzhen was no more than 30,000, and all of the remaining population of 284,100 was rural (Shenzhen Statistical Yearbook 2011, 4). Agriculture was the main and nearly only industry of the county in 1979. There was no decent public infrastructure within the urban area, even no sewerage system. From 1979 to 2010, the annual average growth rate of GDP in Shenzhen was 25.3% (Shenzhen Statistical Yearbook 2011, 5). The population of Shenzhen has grown from 314,100, of whom 312,600 have local hukou (household registration) in 1979 to 10,372,000 in 2010, of whom only 2,510,300 have local hukou (Shenzhen Statistical Yearbook 2011, 4). Shenzhen ranked fourth in GDP and first in GDP per capita among mainland Chinese cities in 2009 (Le 2010, 16). In 2010, the GDP of Shenzhen was over 958 billion RMB (Shenzhen Statistical Yearbook 2011, 5). Shenzhen has ranked first since 1993 in the total value of exports among all mainland Chinese cities (Le 2010, 121). Moreover, the economies of Shenzhen and Hong Kong are closely inter-connected; an integration plan has even been officially proposed (England 2007). More than half of the foreign direct investment in Shenzhen has been from Hong Kong.<sup>4</sup>

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 was 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 expropriated most of the rural land (mostly farmland) and converted it to urban land, reserving the rural land on which residential homes and village factories had been built because of the higher social and economic costs that would be incurred by expropriation. 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 area of 1,993 square kilometers of land in Shenzhen, the government failed to convert

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<sup>4</sup> In 1986, 78.86% 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 YEARBOOK 2011, at 284.

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 composing 47.57% of the total floor space of Shenzhen (Shenzhen Municipal Government 2010).

In Shenzhen, each village set up a co-op responsible for the management of their land. Villagers divided the land under their control into two categories: collective development land and residential land. Income from the collective development land will be used for public infrastructure investment and allocating shareholder dividends to village members. Village co-ops usually develop the collective development land for factories, commercial real estate and condominium apartments. Residential land is divided into equal-sized plots (usually 100-120 square meters) and distributed to villagers for free or bought by village members at nominal price. The general principle is one plot for each household, on which villagers could build their own houses. Rural land in these villages has been developed far beyond the legal restriction. Legally, a household can build at most 480 square meters of houses and cannot transfer either the house or the plot, but most buildings in intra-city villages of Shenzhen are over 800 square meters and many are not owned by original villagers. Legally, collective development land can only be used for village factories and cannot be transferred except in the situation of bankruptcy, but village co-ops have built huge amount of commercial real estate and condominium apartments for renting and selling, and even sell land directly in many cases.

In the peri-urban area, the actual problem is not to find a small property, but to find a legal property. In a report on small properties in Shenzhen, a journalist found that even an official building of a sub-district government had no legal titles (Zhuang 2009). About 12% of the small properties are over fifteen floors and 2,000 square meters, most of which are well-built apartments for sale (Shenzhen Municipal Government 2010). According to officials from the Bureau of Construction of the Shenzhen 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 (Interview 06-29-13).” This is a stark contrast to the conventional view of informal settlements presented by De Soto and many others. De Soto (1989, 25) further states, with no empirical statistics, that both the selling and the renting of the illegal buildings are limited because of the lack of legal titles. In the following, I present some

statistics from the Shenzhen government to discuss the scale of the market, which turns out to be not limited to exchanges between farmers and their familiars.

According to a comprehensive investigation of the Shenzhen government in 2010, there were 356,852 small-property buildings, totaling 390 million square meters and composing 57.49% of the total buildings and 47.57% of the total floor space of Shenzhen.

#### Illegal Buildings in Shenzhen

	Number of Buildings	Total Floor Space
Illegal Buildings	356,852	392 million
All Buildings in Shenzhen	620,800	824 million
Percentage of Illegal Buildings (%)	57.49	47.57

(Source: Shenzhen Municipal Government 2010, 11)

For residential buildings, about 34 percent of the current owners were not villagers, the only category of legal owners. For non-residential buildings, 60.75% of the owners were not village co-ops, the only category of legal owners. Regarding the land used in building these small properties, for residential buildings, 43.53% of the land had been transferred to non-villagers; for non-residential buildings, 30.2% of the land had been transferred by village co-ops to non-villagers. These did not include the transactions between different village co-ops.

#### Illegal Transfer of Land and Buildings

	Owner	Land
Residential Buildings	34% were not original villagers.	43.53% were transferred to non-villagers.
Non-Residential Buildings	60.75% were not original village co-ops.	30.2% were transferred to non- villagers.

(Source: Shenzhen Municipal Government 2010, 49, 50, 63, 64)

The Shenzhen government also did an investigation of small-property high-rises, which are fifteen floors or higher and mostly built after 2000. The total floor areas of these buildings totaled 21,598,800 square meters (Shenzhen Municipal Government 2010, 77), which was about one third of the total floor space of legally-saleable residential houses built in Shenzhen from

2000 to 2009.<sup>5</sup> There is no data available for the number of transactions of small properties. But according to a government official in Bao’An, one district of Shenzhen, there were 1,400,000 legal sales of apartments in 2011 in that district; the number of illegal sales of small properties was about half of legal sales. (Interview 06-26-2012) These transactions are not limited to villagers and their personal contacts; rather they happen daily between strangers. Village co-ops, real estate brokers, and land developers, have formed a network to support this small-property market (Qiao 2013c). Small properties can be used and rented freely, sold and mortgaged subject to some constraints, and compensated according to the same standard of big properties when expropriated by the government (Qiao 2013b).

### **III. Focal Point, Coordination Games and the Market**

#### **A. FOCAL POINT**

##### **1. Theory**

As Schelling (1960, 57) 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.” [emphasis added]

In his classic *The Strategy of Conflict*, Schelling (1960, 54-8) began his analysis with the study of tacit bargaining—bargaining in which communication is incomplete or impossible, and 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. In the Grand Central example, the location of the sample was in New Haven, Connecticut and 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

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<sup>5</sup> From 2000 to 2009, the official market of residential houses supplied 59,220,000 square meters of houses in total. (Shenzhen Real Estate Year Book 2011, 151.)

as the Empire State Building (see also McAdams 2000). People were thus able to meet each other at the same place in the absence of prior arrangements. Schelling then proceeds into tacit bargaining of divergent interests. The outcome of his experiments suggests that among all the available options, some particular one usually seems to be the focal point for coordinated choice, and the party to whom it is a relatively unfavorable choice quite often takes it simply because he knows that the other will expect him to (Schelling 1960, 60). Schelling (1960, 67) at the end investigates explicit bargaining in which communication is possible and there is no apparent need for intuitive rapport. There is abundant evidence that the influence of 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 (Schelling 1960, 70).” These particular outcomes are what Schelling calls focal points. Schelling presents the focal point theory as generally applicable to situations involving coordination, such as formation of interest groups, spontaneous revolt, and bargaining (Id., 70-4). In the past decades, a number of researchers have observed high coordination rates in games with a focal point and symmetric payoffs; while Crawford et al. (2008) find that asymmetry of payoffs in a game might counteract the effect of a focal point, resulting in the weaker influence of focal points in situations of divergent interests. 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 (2010, 2011), two of the foremost researchers of focal points, have proved that focal points also play an important role in explicit bargaining situations.

## **2. 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 anticipated to “blaze a bloody trail,” i.e., break the old rules, which encouraged people in Shenzhen to innovate new institutions. Third, the Shenzhen farmers had observed how the Shenzhen

government made money from land expropriated from them and saw no justification for being deprived of the same profit opportunities. Overall, it was widely believed among Shenzhen people that they 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 of foreign investment was financing. The central government could provide very limited support towards the huge financial cost required for infrastructure construction (Feng 2006). The answer came to the local leaders of the Shenzhen government from a Hong Kong lawyer: “Isn’t the land money? Even your ancestor Marx admitted that land was wealth.” The Shenzhen government leaders got this 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 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.

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) (Leng and Wang 2004, 510)!” “To attract foreign investment, it would adopt different administration and policies, mainly market-oriented (Id., 33),” which were the main support the Shenzhen government got from the central government. In this situation, the Shenzhen government decided to challenge the old Constitution. It started with what was explicitly allowed by the central government: the charging of land-use fees to foreign investors in the SEZ.<sup>6</sup> The “land-use fees” did fill a pressing financing gap, but was far from enough. Public land ownership and the inalienability of land still dominated 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.

The Shenzhen government eventually gained enough motivation to break with the old norm of land inalienability as its need for money became more urgent. 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

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<sup>6</sup> See Article 12 of the 1980 Guangdong Province Regulation on Special Economic Zones and Article 5 of the 1979 Sino-Foreign Equity Joint Venture Law.

square meters to a Chinese company for the price of RMB 5,250,000 (Feng 2006). In October 1987, the Shenzhen government invited celebrated theorists from all over the country to attend a conference on urban land administration reform. The focus question was whether land could be a commodity. Delegates of the Shenzhen government concluded the hot disputes between scholars by asking: “We have collected a lot of money from alienating land. Isn’t land a commodity? (Feng 2006)” 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 plot auctioned was eventually won by the government’s own land company after 44 companies competed, perfectly demonstrating the high value of land (Id).

Five months later, the National People’s Congress (NPC) passed a constitutional amendment: 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. As discussed in Part IIA, the State Council made a law according to which *urban* land use rights can be transferred in 1990; a corresponding legal authorization according to which rural land use rights can be transferred has never come out.

The first (unconstitutional) public auction of land use rights in Shenzhen became a landmark event in the history of Shenzhen and widely praised as one of Shenzhen’s most important contributions to China’s economic reform. I was told this story many times in my interviews with government officials, indigenous farmers, real estate developers and other people of various backgrounds, all of whom did not hesitate to say “We SEZ people promoted the constitutional amendment by the first public auction! Shenzhen is the city of reform!”

The urban real estate industry began to prosper after the establishment of a legal system that allows and facilitates the transfer of urban land use rights. Shenzhen has been 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. In 2010, the real estate industry contributed 4.82% to the GDP



growth of Shenzhen and 11.1% of tax revenues, the lowest number in the past two decades; in 1999 the number reached the record at 14.49%.<sup>7</sup> From 1988 to 2010, the Shenzhen government made at least 170 billion RMB from the direct sales of land (Shenzhen Real Estate 2010). Participants of the small-property market are well aware of the big profits the Shenzhen government has made from land development. Ordinary Shenzhen people, in particular the farmers, have seen how the Shenzhen government expropriates land from them at low price and sell it at many times higher. They mocked 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,” which is a Chinese version of the American proverb “one may steal a horse while another may not look over the hedge.”

## B. COORDINATION GAMES

The role of the focal point is to enable coordination. It is thus necessary to determine at the outset whether a coordination problem is involved before applying the focal point theory. What is coordination? “The problem of coordination arises 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. (McAdams 2008, 219)”

Coordination games have multiple equilibria<sup>8</sup> and therefore the payoffs alone do not determine the behavioral outcome (McAdams 2008, 212). It thus has to look into the specific social settings and individual participants to determine the final outcome, leaving room for injecting living reality (history, politics, etc.) into oft-abstract economic models. Moreover, it

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<sup>7</sup>This group of statistics were provided in 2011 by Wang Fan, the then Director of the Urban Planning, Land and Resources Commission of Shenzhen City. *Wang Fan: qu nian fang di chan qi ye qi ye shui gong xian lv da dao 11.1%* [Real Estate Enterprises Contributed 11.1% of Shenzhen's Revenue Last Year], <http://sz.house.163.com/11/0711/23/78NG7MB400074KDB.html> (last visited February 15, 2013).

<sup>8</sup>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 ones the others choose. A pair of strategies will form a Nash equilibrium if each strategy is one that cannot be improved upon given the other strategy. We establish whether a particular strategy combination forms a Nash equilibrium by asking if either player has an incentive to deviate from it. (Baird et al. 1996, 310)

often presents a choice between conflicting preferences of different individuals, rather than a solution making everyone better off. All the above makes coordination game models closer to reality than the prisoners' dilemma model, which has long dominated the application of game theory in legal studies (McAdams 2008).

Classic coordination games include the Assurance (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, where sharing a stag with the other hunter is the best outcome, but where hunting hare is safer because one can succeed on one's own (Id., 219). The formation of the small-property market in Shenzhen was a revolt against the formal law, which is a huge "stag" that needs people to coordinate with each other to hunt. The name "Hawk/Dove" comes from a fictional game between teenagers who drive their cars directly at each other, where the one who swerves first loses face, but the failure of either to swerve is catastrophic (Id., 224). In the operation of the small-property market, the interactions between the Shenzhen government and farmers on whether to demolish the illegal buildings, and between contract parties on whether to void a legally ineffective contract, are Hawk/Dove games: neither wants to swerve first; nor do they want direct clash with each other. Following I will apply the two game models to analyze the formation and operation of the small-property market in Shenzhen.

### **C. THE SMALL-PROPERTY MARKET: COORDINATION GAMES WITH A FOCAL POINT**

#### **1. An Assurance Game of Market Formation**

##### *a. An Assurance Game of Social Entrepreneurs*

The formation of the small-property market can be viewed as the change of social norms from the inalienability of real estate in the communist era to the alienability of real estate in the post-communist era. If the change was not brought by legal reform, how did the change of norms occur? Ellickson (2001), Sunstein (1996) and many others (e.g., Posner 1998, 2002; McAdams 2001; Carbonara et al. 2008) have emphasized the role of social entrepreneurs in the evolution of social norms: when an exogenous change creates new cost-benefit conditions that favor a switch to a new norm, social entrepreneurs would initiate the switch. They call this category of social entrepreneurs norm entrepreneurs. It is true that there exist entrepreneurial people more likely to initiate a change in a society. However, it would be an oversimplification to assume that

whenever there is an exogenous change, entrepreneurs will accordingly change the norm. As North (1990, 7) would agree, it is common that inefficient institutions persist in human history. There is always room for improvements, most of which do not occur.

If the room for improvement always exists and some potential social entrepreneurs are always present, why do potential entrepreneurs initiate a change at a certain time and in a certain place? They have to bid their time. I thus further qualify the “exogenous change” in the above framework: It is not simply just a change to new cost-benefit conditions, like the rise of fur trade with Europeans in the North Indian tribes (Demsetz 1967), but also requires a change in a 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 others expect, and in situations where he has great chance to successfully make the change by moving first. In other words, change agents also want an assurance that other people expect the same thing. A focal point can help people’s expectations converge. To make it simple, we can imagine that two social entrepreneurs have to decide separately whether to initiate a change:

Player 2

		Player 2	
		Strategy A	Strategy B
Player 1	Strategy A	a, a	-c, 0
	Strategy B	0, -c	0, 0

- *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.*
- $a, c > 0$ .

It is an assurance game. If a potential social entrepreneur expects the other not to change, he will not take any actions even if he prefers the change because he would have to bear the cost of punishment for challenging the old law on his own. The loss would be  $c$  for him. If no potential social entrepreneur expects to change, the status quo will be maintained. The gain for both in the status quo is 0. If a potential social entrepreneur expects the other to change, he will

initiate the change; then the norm change will succeed and both will gain a from the change. As a result, both of them prefer change (A, A) to non-change (B, B). But the optimal result might not occur because A is actually a riskier strategy than B. Choosing to change might result in either a big profit or loss, while choosing not to change guarantees that there will be no loss. For this reason, both social entrepreneurs might choose not to change 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 to challenge the legal prohibition on rural land development and transfer, so the other should as well.

This problem can be resolved by a focal point. In making a decision, each player would consider what choice the other would make. If both expect the other to choose A, the result will be the optimum. That's to say, for a change to be initiated, not only need there be a new profit opportunity, but also that the new opportunity should be made salient as a focal point so that a potential change agent could reasonably expect others to share his expectation for change.

#### ***b. Application to the Shenzhen Case***

Now back to Shenzhen: It is without doubt that there was a great new profit opportunity in rural land development and transfer. For Shenzhen, the first special economic zone to pilot reform, getting foreign investment was the top priority of the Shenzhen government, which encouraged every unit under its jurisdiction to get foreign investment, including villages.

Each village in Shenzhen had one or more so-called industrial zones, in which they built factories and got investments from Hong Kong and other parts of China. Most were called joint ventures, basically meaning that villages contributed factories and investors contributed money, technology and management. This was the early phase of capitalization of rural land in Shenzhen. The Shenzhen government encouraged investment in villages and made rules on the capitalization of rural land, such as the guideline of land leasing rates, notwithstanding the then effective constitutional prohibition on alienation of land (Li 1999). Once investment came, factories were built and villages became commercial centers. Millions of migrant workers flooded in. Most of them worked for the factories. In the 1980s, the supply of housing was the responsibility of the local government, which was unable to build houses to keep up with the demand of even its own employees. Migrant workers, who are the main force of Shenzhen's

foreign-investment sectors, were not even counted in the Shenzhen government's plan of housing supply because they were not legal residents of this city.<sup>9</sup> The huge demand for houses made rural land development and transfer very profitable. Besides the Shenzhen government allowing villages to rent their land to investors for building factories, rural land development and transfer was still generally legally prohibited in that time. Breaking this legal prohibition would be a very profitable change. But how did it occur? Following are representative stories I was told in my interviews by then village heads, government officials and other participants.

A Hong Kong investor, after starting his business in a village for several years, wanted to buy a plot to build his own house. Considering that he had to stay in the village for more than 200 days a year and might even have had a second family there, this need was very reasonable. Also, as a Hong Kong entrepreneur, he might have stronger sense of private property and more acute sense of the changing times in Shenzhen and in China. The focal point created in the urban land-use reform in Shenzhen must have been readily apparent: (1) land could be sold for money, a fact of which the Chinese central government and local governments, especially the Shenzhen government were clearly aware; (2) old laws could be broken and revised in the reform era. The Hong Kong investor was very conscious of this point in his decision to buy land from villages. He expected others to expect the same as him. He contacted the village co-op for his demand. The village co-op, which had done everything to attract and satisfy outside investors, had made profits from the early capitalization of rural land by building joint ventures with outside investors. It was also 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 approved this request and sold a plot to the Hong Kong investor, which was illegal at that time.

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), Bureau of Investment Promotion (BIP), etc., which had observed all the above moves and even studied the legal and policy issues, also determined that the focal point of rural land development and

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<sup>9</sup> Migrants are largely excluded from the mainstream housing distribution system, as the linkage between household registration and urban housing is largely intact. *See e.g.,* Wu Weiping, *Migrant Housing in Urban China: Choices and Constraints*, 38 URBAN AFF. REV. 90 (2002).

transfer was so powerful that it would probably become a trend. As discussed in Part IIB, the old government housing allocation system had not been able to keep up with the explosively increasing population. Directors of the bureaus were probably troubled by how to house their employees.<sup>10</sup> Maybe in a dinner conversation, a village committee member, after listening to the director of the BIP complaining about employee housing, said “hey, buddy, why don’t you build apartments for your employees on my land?”

A land developer, had leveled the land (Shenzhen was quite hilly) and built the roads and other infrastructure for a village and asked for payment from the village. Also, in a dinner conversation, the village head told him, “hey, buddy, I really have no money to pay you, but how about the two hills in my village? If you could level it, it would be yours.” The land developer would prefer to get cash for the payment, but had few choices. Moreover, he was well aware of the focal point through contacts with village co-ops, government officials and Hong Kong investors in his land development businesses. Thus he accepted this offer. That was how a luxury villa neighborhood in Shenzhen I visited came to be about.

Later, the land transactions above encouraged other related people and institutions to buy/sell rural land. They were a village head who had managed all the transactions with Hong Kong investors and government agencies, and who wanted to develop and transfer some of the excess land he was allocated, an official in the BIP, who did not get an apartment from the bureau but had some money, other government employees who learned from their friends in the BIP or BLA a way to resolve their housing shortage, and a migrant worker who made enough money (Interview 03-13-12). 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.<sup>11</sup>

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<sup>10</sup> See Part IIB.

<sup>11</sup> Shenzhen government’s declarations prohibiting its employees participating in rural land development were often seen on 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; all government officers should stop building private houses on rural land since 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. *See, e.g., Building Houses Illegally, Chen Huang Being Fired from His Office* (September 8, 1981, the first page); We

After this cluster of social entrepreneurs took the first move, their friends and relatives followed (Picker 1997). The social entrepreneurs were all influential people in their social networks and thus had much more weight in influencing the change of norms (Kuran 1989). Further transactions would encourage more transactions, and this continued on and on 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 to coordinate people's behaviors.

## 2. TWO HAWK-DOVE GAMES OF MARKET OPERATION

### *a. A Hawk-Dove Game of the Demolition Risk*

In 1999, one year after the 1998 LAL revision,<sup>12</sup> the Shenzhen government initiated its campaign against rural land development and transfer, calling the rural buildings “historical illegal buildings.” (*lishi yiliu weifa jianzhu*). In 2004, the Shenzhen government even established a leading small group (*lingdao xiaozu*) headed by the mayor and constituting directors of relevant government departments to deal with illegal rural land development and transfer. In 2009, the Shenzhen government established a new Department of Land Use Monitoring (“DLUM”), which has branches in all 57 sub-districts of Shenzhen (Shenzhen Land Use Monitoring 2012). Demolition of illegal buildings was often reported in the local newspapers. But why does the small-property market remain so active? 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 rare and symbolic – for example, 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 on rural land development and transfer. The Shenzhen government hopes its threats are an effective signal to people to stop developing and transacting rural land. Shenzhen farmers hope the government can yield to the prevalent practice. Whether Shenzhen farmers would develop and transfer rural land and whether the Shenzhen government would demolish the buildings if they do will depend on their

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Must Stop Building Private Houses Illegally (1982.12.27, the second page); Our City Made Success in Stopping Private House Construction (1984.02.20, the first page); The Office of the Municipal Government Declared that All Illegal Buildings would be Confiscated (1985.04.03, the first page).

<sup>12</sup> See Part IIA.

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:

		Player 2-Farmers	
		Strategy H <sub>2</sub>	Strategy D <sub>2</sub>
Player 1- Shenzhen Government	Strategy H <sub>1</sub>	-a, -d	b, -c
	Strategy D <sub>1</sub>	-c, b	0, 0

- *Strategy H<sub>1</sub>: Shenzhen government plays hawk to enforce the legal prohibition on rural land development and transfer;*
- *Strategy D<sub>1</sub>: Shenzhen government plays dove to not enforce the legal prohibition;*
- *Strategy H<sub>2</sub>: Shenzhen farmers play hawk to challenge the legal prohibition on rural land development and transfer;*
- *Strategy D<sub>2</sub>: Shenzhen farmers play dove to not challenge the legal prohibition on rural land development and transfer.*
- a, b, c, d >0;

First, consider the pre-reform period where  $c > a$  for the government, and  $d > c$  for the farmer. Player 1 and Player 2 represent the Shenzhen government and farmers, respectively. The beginning was  $(H_1, D_2)$ , where a farmer played dove by not challenging the legal prohibition on rural land development and transfer, and bore the loss of profit opportunities,  $c$ . The Shenzhen government played hawk by enforcing the legal prohibition on rural land development and transfer and gained  $b$  by maintaining the integrity of the old regime.<sup>13</sup> Alternative  $H_2$  was not a credible option for farmers because they expected  $c > a$  for the government, and thus the government to always play hawk. Under this scenario, a direct clash with the government under  $H_2$  would incur loss  $d$ , such as being thrown into prison, which is much larger than the loss of  $c$ —losing the profit opportunities under  $D_2$ .

After Deng began to support economic reform nationwide and designated

<sup>13</sup> If a farmer loses nothing by playing dove to obey the old law, the government would play dove because there was no challenge to the legal prohibition at all. That is the equilibrium of  $(D_1, D_2)$ , which was not the situation in Shenzhen. The government at least talked tough in its stated willingness to enforce the law.



Shenzhen as the first SEZ to pilot market-oriented reforms, the Shenzhen government experimented with the urban land-use reform and successfully challenged the old Constitution. Hence the legal prohibition on land development and transfer based on the Marxist orthodoxy became outdated, although *rural* land development and transfer remained prohibited. The Shenzhen government's threat to enforce the legal prohibition became less credible to farmers, who now believed that  $a > c$ . As the result, rural land development and transfer became a more salient choice for Shenzhen farmers, who thus shifted from  $D_2$  to  $H_2$ . Once the Shenzhen farmers played hawk to challenge the legal prohibition, the Shenzhen government would have to choose between  $H_1$  and  $D_1$ . If it played dove to not enforce the law, it would lose  $c$  from the decrease of its credibility, which might encourage further violation of law, and from losing future opportunities to make use of the same land. As previously discussed, "blazing a bloody trail of reform" had been the mission of the Shenzhen SEZ; therefore, the loss of credibility in enforcing the old law did not matter that much to the Shenzhen government. Moreover, when the farmers began to develop and sell rural land in the 1980s, land was still relatively abundant that the farmers' behaviors was not foreseen to interfere with the government's need for rural land expropriation.

In contrast, if the Shenzhen government had played hawk to enforce the old law, it would incur a huge loss of direct clash with farmers, including social instability that would discourage foreign investment and fiercer resistance from farmers when expropriating their land that had not been developed or sold. In a country where local governments tend to grab villagers' land arbitrarily (Chin 2010), it can seem puzzling that the Shenzhen government has not been able to deter the illegal rural land development and transfer. But the cost for the Shenzhen government of enforcement against the small-property market is unusually high. Shenzhen farmers have both political and social resources to inflict big costs to the local government. They have much stronger political and social connections than farmers in other places in China. By making money from the land over which they have maintained control, Shenzhen farmers have become the wealthiest farmers in China, 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 supreme leaders of China in the reform era, Deng Xiaoping, Jiang Zemin and Hu Jintao, have visited villages in Shenzhen.

In 1984, during his first southern tour after designating Shenzhen as the first SEZ, Deng visited Yumin village (village of fishing men) and viewed the farmers' two-story houses as an indication of the success of his "reform and opening-up" policy (Liang 1997). At the entrance of Nanling village, behind a huge portrait of the current Chinese President Hu Jintao, who visited the village two times, are hundreds of houses built by the local farmers. Several village heads are members of the National People's Congress or the Provincial People's Congress.

What's more, many Shenzhen farmers have families overseas, who fled to Hong Kong before 1980 and became residents there. These overseas Chinese (*huaqiao*) have wide access to overseas newspapers and other public media and thus can inflict great reputational cost to both the Shenzhen government, and even the Chinese central government. The influence of overseas Chinese was amply demonstrated by what happened in Wukan, a village two hundred kilometers away 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, agreeing in a rare compromise to release detainees and return some land to farmers (see e.g., Jacobs 2012; Wong 2011; Buckley 2011; Wines 2011). After the villagers' confrontation with the government, their overseas families and friends, mostly in Hong Kong, gave very timely support, both by donating food and other stuff and, more importantly, by mobilizing wide overseas media attention, without which Wukan would have been just another village of several thousand landless farmers.

Shenzhen is an iconic city of China's market economy. Since 1978, the Chinese government has tried to maintain a reputation of "reform and opening-up" to attract both investment and support from overseas Chinese. If legal enforcement incurred confrontation with local villagers, the Shenzhen government would not dare take forceful actions. The Shenzhen government cannot afford a repressive reputation. In the past three decades, the Shenzhen government has taken a lot of rural land from villagers, but has never incurred any bloodshed with local villagers. Rather the Shenzhen government has paid the villagers very well. It has been widely reported that a village redevelopment plan initiated by the government created tens of village millionaires in 2009 (Southern Metropolis Daily 2009). Put simply, a is much bigger than c.

In summary, both the Shenzhen government and the farmers would choose to play hawk if the other party chose to play dove and choose to play dove if the other party chose to play hawk. The equilibrium would be either  $(H_1, D_2)$  or  $(D_1, H_2)$ . But 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 send out a signal that laws would be strictly enforced. But even these selective cases, rather than signaling strict legal enforcement to ordinary people, often showed the Shenzhen government how much 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 laws did not agree with the government's strict enforcement of laws, and often discounted the effect of legal enforcement. For example, a government enforcer often told a rural land user: "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 hours. Just a campaign, which will cease soon." Due to the focal point of rural land development and transfer, the equilibrium  $(D_1, H_2)$  was achieved and the legal prohibition was not enforced. Demolition cases were rare and symbolic in Shenzhen; the small-property market continued to expand despite the threat of demolition from the Shenzhen government.

***b. A Hawk-Dove Game of the Contract Risk***

There is not only risk of government demolition, but also transaction risks. Because the small properties have no legal titles, none of the transactions are recognized or protected by the government. A seller can refuse to surrender the possession of the illegal buildings to the buyer or revoke the contract any time. Yet buyers from all over the country buy the small properties. Surprisingly, on the small-property market, several formal documents have been widely used, which use professional legal terms and constitute a form of "legal magic." In this part, I firstly analyze the legal implications of the formal documents and apply a hawk-dove game model to explain why the legally-void contracts are often obeyed, taking into consideration the social meaning of the formal documents in the bargaining between contract parties and the specific circumstances.

## (1). The Legal Magic

As compared to other informal transactions which are more removed from the formal laws, such as transactions in drugs or organs, the involvement of government-recognized village co-ops and lawyers confer on illegal rural real estate transactions an aura of legality, much like a form of legal magic. A seal from a village co-op company would cost a buyer 6,000 RMB; a testimony from a lawyer 500 RMB. In some cases, privately-made real estate certificates and certificates of honorable villager-ship are also used. Do they have any legal effect?

### *i. 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 would get 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. Generally, 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 to each. There is a revival of the idea of cooperative house-building in recent years—houses on the formal market are too expensive and it has been viewed as a cheaper way to own houses by saving the profits paid to big real estate companies. Cooperative house-building is not prohibited and theoretically feasible.

However, it is clear within the legal profession that the cooperative development of rural land is still a way of developing and transferring rural land, which is in direct defiance of the LAL. Does the term “cooperative house-building” camouflage the illegality of rural house sales, which might explain why most transactions have adopted the contracts of cooperative house-building? The answer is negative— with the nationwide propaganda of the illegality of small-property houses, it is doubtful whether a contract of cooperative house-building can achieve that. If not, what is the function of this kind of contracts?

### *ii. Village Co-Op Seal, Lawyer Testimony, Private Real Estate Certificate, etc.*

In Shenzhen, each village has a shareholding co-op company, which manages the land within the village and allocates dividends to villager shareholders. It also builds roads and other

public facilities within the village. It is the core of a village community. A village co-op seal on the sales contract is an endorsement of the contract and widely used in small-property transactions. Village co-ops are often one party of the small-property transactions and thus sign and seal the contracts. In other situations, such as houses developed by individual villagers or outside investors, it charges for its sealing of the sales contract. From a legal perspective, a sealing by the village co-op 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 almost always part of all transactions. A lawyer testimony testifies that the transaction is made according to both parties' real intent and is consistent with the principle of freedom of contract. The lawyer would also keep a copy of all the transaction documents on file, which is available for checking. If a buyer wants to sell the bought house, he has to surrender all the documents to the lawyer, who would make another file of documents for the new buyer. In one law firm, the earliest record can be traced back to 2003 (Li 2009; Interview 04-05-12). The lawyer testimony would say nothing about the illegality of the transactions and might leave the impression of legality to the parties because of lawyers' special identity. As a result, the Lawyers' Association of Guangdong, the province to which Shenzhen belongs, has forbidden its members to provide testimony to transactions of rural houses. However, this prohibition is only effective to big law firms. Many small law firms still provide this service. In some other cases, privately-made certificates play a role in securing the transactions. For example, some real estate developers issue certificates to buyers. The certificates look very similar to the official ones and are numbered, i.e., each apartment has a unique number.

If neither village co-op seals, lawyer testimony nor privately made real estate certificates have an effect on the illegality of the sales contract, why are they so popular and why are buyers willing to pay for them? What's the magic of these legal constructs? The answer comes from outside the law.

## (2). 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 is to his benefit. In the past decades in China, the

prices of small properties have increased several-fold, due to the increasing housing demand and rocketing prices on the legal housing market. Thus buyers often have incentives to go to the court to void the contract. As the courts would not enforce the contract, the seller has the right to return the original amount of money to the buyer and get his house back. In Beijing, a case of rural house transaction caught nationwide media attention when a seller wanted her house back for the increased value after the transaction (Wang 2008). Similar cases are not heard from Shenzhen, which is puzzling as sellers in Shenzhen should be subject to the same financial incentives. I apply a hawk-dove game model to analyze the contract parties' choices of whether to void a contract.

Player 2-Buyer

		H <sub>2</sub>	D <sub>2</sub>
Player 1-Seller	H <sub>1</sub>	-b, -c	a, 0
	D <sub>1</sub>	0, a	a/2, a/2

- *H<sub>1</sub>: To void the contract after the value of the house has increased;*
- *D<sub>1</sub>: Not to void the contract despite that the value of the house has increased;*
- *H<sub>2</sub>: Insist on the binding effect of the contract after the value of the house has increased;*
- *D<sub>2</sub>: Not to insist on the binding effect of the contract after the value of the house has increased;*
- *a, b, c > 0; b > c.*

Both parties can choose whether to play an aggressive hawk strategy or a submissive dove strategy. 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 for voiding the contract, he will play hawk and gain a if the buyer does yield to her request. The seller would get all the increased value of the real estate. 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. The buyer and the seller could both play dove and share the increased value of the real estate. For each party, they will gain nothing 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 and he

should get it back, against the buyer's hawk of insisting on the binding effect of the contract. The cost of such disputes will be high to both.

*i. The Cost of Hawk-Hawk*

If the seller insists on voiding the contract, the buyer might resort to private sanctions. Some might wonder how serious the private sanctions could be, considering that sellers are usually local villagers or land developers, while buyers are often 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. For sellers, it is just a business, one apartment in a building of hundreds of apartments. They have made money from the transaction with the buyer. They could gain more by revoking the contract, but the marginal gain from this move is relatively low. For buyers, it is their home to which they have devoted all of their money and cannot afford to lose. They are neither wealthy nor powerful, but they do have "weapons of the weak (Scott 1985)." As one buyer told me, "as far as the seller wanted to stay in Shenzhen, he would not dare void the contract. I know where he lived and who his families were." 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 easy to verify. It might be difficult for an outsider to know the history of the transactions involving the real estate in question. But it 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 there are any conflicts of rights to the real estate. Lawyers are outsiders, but are professionals paid for the testimony. Regardless of the contents of the testimony, it is a bottom-line that a lawyer should not participate in contract fraud. Moreover, lawyers' service is often localized and not easily relocated. Therefore, village co-op's seal, lawyer testimony and other privately made documents are not a way to legalize the informal sales, but a way to reveal the information regarding the transactions and local parties.

Disputes with buyers would also expose the sellers' business to public attention, which would make this seller "stick out" among his peers, bring damage to his reputation, and make his business an easy object of the local government's selective legal enforcement. The buyer might

report to the local government their disputes at the last resort. In such a case, the seller can no longer rely on the Shenzhen government to continue turning a blind eye to his illegal business. In short, the hawk-hawk scenario is costly even more so to the sellers, i.e.,  $b > c$ .

### *ii. 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, it is what one party expects the other party to do that matters. There is room for a focal point to influence both parties' expectations. As previously discussed, rural land development and transfer have been widely recognized in Shenzhen. The various documents involved in the transactions, such as contracts, lawyer testimony and village co-op's seal, serve as evidence and a reminder to 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 would fight to the death if the seller ever tries to void the contract. The buyer is also confident that he will be able to mobilize society members who share this focal point to fight with the seller in the worst-case scenario.<sup>14</sup> Buyers often bond with each other to form a powerful community, which can take effective sanction against villagers and other involved parties who breach their promises. It is often that colleagues of the same company or institute buy apartments within the same building. Once a person buys a small-property house, he often tries to persuade his friends, relatives and other acquaintances to buy. I frequently heard in my interviews with buyers of small-property houses that they are not worried about risks of no legal titles because many of their friends live in the same building. Sometimes sellers of small-property houses also require an old customer's recommendation for an outsider to buy an apartment. The consideration for the seller might be to reduce the risks of uncertainty brought by unknown buyers. However, it also increases the solidarity of the community of the buyers,

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<sup>14</sup> Think about 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 2000, 1682.)



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 no legal titles when they bought small properties, a common response is that “I don’t worry because so many others have bought small properties.” As a result, the equilibrium is that the seller plays dove and the buyer plays hawk.

#### **IV. Conclusion**

The contributions of this paper are mainly the following: First, it challenges the conventional view of the necessity of formal property rights to a market economy by providing a concrete case from first-hand fieldwork in which an impersonal market has developed in the absence of legal titles. Second, it provides a new perspective on law and economic development by introducing and applying the most updated research on coordination games and focal points. Third, 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 remain a mystery—we do not fully understand the dynamics between property rights and market transition; neither do we have a proper theoretical approach to explain the failure of titling programs sponsored by the World Bank and other international aid organizations (e.g., Kennedy 2011; Bromley 2009; Payne et al. 2009). One reason 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 paper argues the incorporation of these theories provides a more powerful and nuanced explanation of property rights in developing countries.

This paper’s analysis has substantial explanatory force in the so-called “China

problem”—why China has enjoyed three decades of rapid economic growth with a weak legal system (e.g., Clarke 2003; Upham 2009; Nee and Oppen 2012). Nobel Laureate Ronald Coase and Ning Wang (2012) co-authored a book to address the question of how China became capitalist. Joseph Stiglitz and David Kennedy (2013) co-edited a book titled “Law and Economics with Chinese Characteristics” to understand the China mystery. Two opposing terms are used by the Economist magazine (2011, 2012) to depict “capitalism with Chinese characteristics”: 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 at the bottom. Examples include the invention of the household responsibility system (HRS) in Xiaogang Village of Anhui province, which replaced the inefficient collective farms in China in the 1980s (see e.g., Lin 1988); the emergence of the township and village enterprises (TVEs), which was the engine for economic growth in China in the 1980s (see e.g., Putterman 1997); and the flourishing of private enterprises (PEs), which have provided the most job opportunities for China (see e.g., Gamaut and Song 2004). 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 deny the contribution of the Chinese government to the economic miracle. Entrepreneurs are everywhere and in every age - why had the HRS, TVEs and PEs not emerged in Mao’s era, but rather 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 that “let 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.

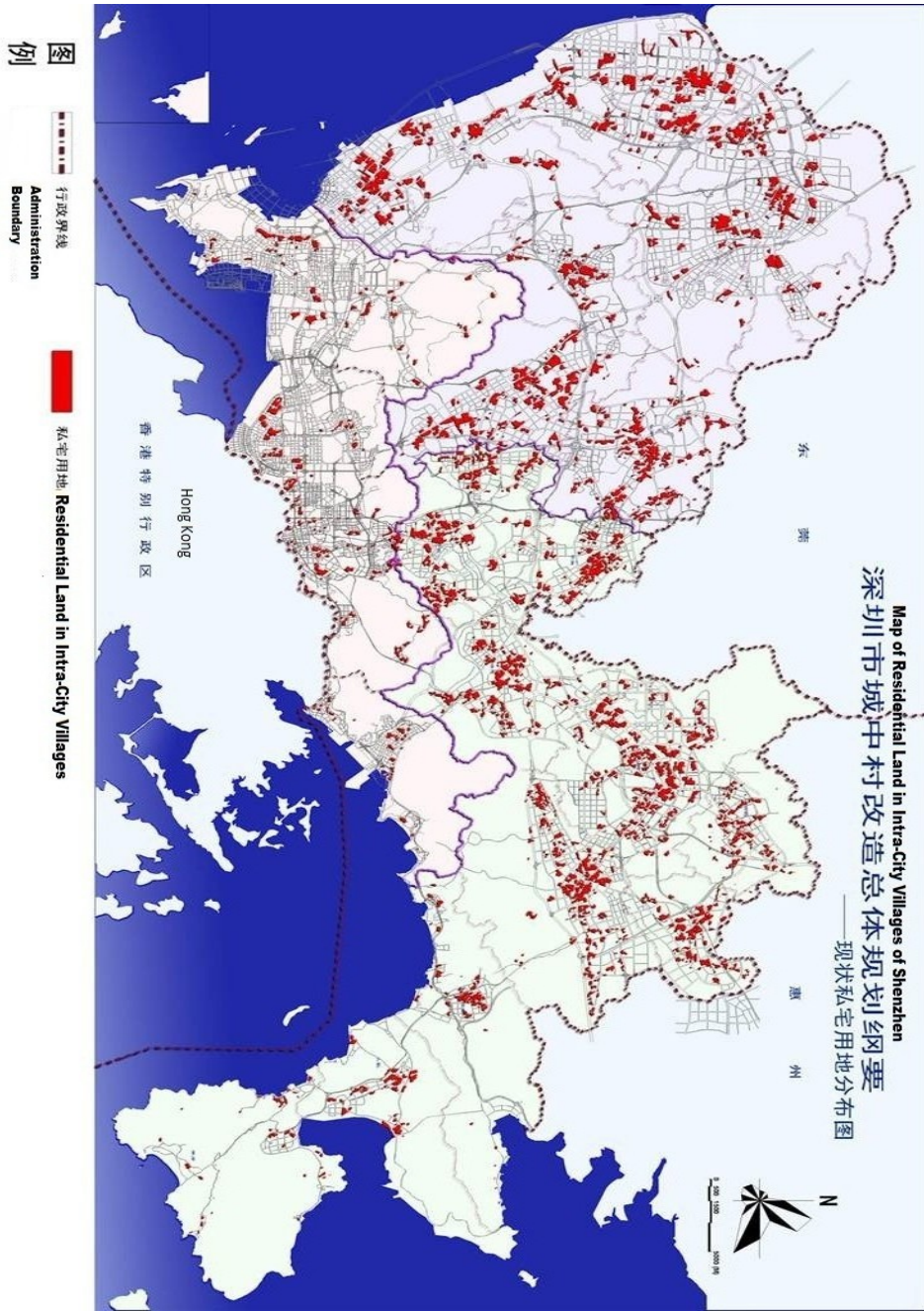
This paper also has broad implications for research on law and economic development. Scholars have referred to exchanges of untitled real properties in their studies of Vietnam property reform (Kim 2004), squatters in Hong Kong (Smart 1986), informal housing in Peru (De Soto 1989), the Brazilian Amazon (Alston et al. 1999) and the U.S. frontier history (Anderson and Hill 1978). 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 the historical and political backgrounds to understand the contextual factors of the bargainings would deepen our understanding of how to build modern market economies in developing countries.

This paper has two significant limitations: First, the divergence of interests between different parties as the market develops can counteract the effectiveness of the focal point, and even transform the coordination games into prisoners' dilemma. As land becomes increasingly valuable with the development of the market, the Shenzhen government's cost of losing control over rural land would increase and might eventually become higher than the cost of conflict with farmers. As a result, the Shenzhen government would choose the tough (hawk) strategy, even if it expects market participants to play hawk. In other words, the Shenzhen government would prefer potential conflict with the market participants over acquiescing to their rural land development and transfer. So do the market participants when their payoffs change. The same logic applies to the game between contract parties. If current payoffs leave little room for a focal point or even permit only one equilibrium, the only way to solve the game is to change the payoffs by sanctions (McAdams 2008). It is in this situation that a centralized legal system that can define and protect property rights would become necessary. Thus understanding market formation and operation as coordination games has its limits.

Second, this paper provides only one view of the small-property market and omits several relevant aspects of the small-property market. Focusing on the contextual and payoff-irrelevant aspects of the small-property market, it does not address fully the political economy of this market; nor does it explain the significantly lower prices of small properties compared to those of legal properties or address how to deal with the co-existence of the small-property market and the legal housing market, which are topics of separate papers (Qiao 2013a, 2013b).

Appendix I: Map of Residential Land in Intra-City Villages of Shenzhen



Source: Shenzhen Municipal Government



## Appendix II: Pictures of Small Properties in Shenzhen

All the following pictures were taken by the author during his fieldwork in Shenzhen:

### I. An Intra-City Village of Small Properties in Shenzhen



II. Small Properties in the Village



III. Inside View of A Small-Property Building



IV. A Real Estate Broker's Office, with Prices of Small Properties Listed on the Door



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