

HOUSING AND LAND

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Published in The Other Hong Kong Report : 1992, Chinese University Press, Hong Kong
1992 pp. 309-350

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Introduction

Throughout Hong Kong's post-war history, the government had intervened in the housing market on a massive scale through the provision of public housing and the imposition of rent control without realizing the full consequences. These actions have affected the lives of ordinary citizens and the development of Hong Kong in profound and damaging ways. By contrast, planning and land development have largely been left to market forces with little negative intervention. This has facilitated property and land development to keep in pace with Hong Kong's rapid economic growth. In the preceding twelve months, important proposals and measures have been taken that could potentially alter the framework guiding the pattern of post-war housing and land development with important and lasting effects.

First, the government belatedly proposed a new bill to phase out rent control by stages between now and 1994, which if successful would bring to an end one of the most misconceived policy measures ever to be pronounced at the end of World War II, but only after it had created almost half a century of irreparable damage to housing development.

Second, the Housing Authority's bid to sell a limited number of public housing units to the sitting tenants at a deep discount to their market values ended in failure when the tenants rejected the offer. Four decades of cheap public housing is not an easy habit to kick. So, has privatization of public housing stock been tried and failed? The answer as we shall see is no. The real folly lies with those who unwittingly allowed the public housing program and other related housing schemes to grow into Leviathan-like proportions.

Third, determined opposition from a new styled legislature forced the Financial Secretary to abandon his budget proposal to increase property rates and to promise further tax relief in next year's budget and an interim investigation into immediate housing help for the sandwich class. Middle class relief appears to be a popular subject with legislators in search of a constituency.

Fourth, market sentiment in the property market for domestic residences became extremely bullish, fuelled in part by growing confidence, increasing prosperity, surging inflation, and falling interest rates. As speculative activities intensified, popular pressure from aspiring home owners mounted, forcing the government to intervene in the housing and mortgage markets to curb speculation.

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Fifth, in a bid to exercise more control over development by the planning authorities, a recent consultative document released in July 1991, proposed changes to the Town Planning Ordinance that could lead to delays in the development process, increase uncertainty in property markets, and undermine the contractual nature of development.

The full implications of these policy initiatives are difficult to evaluate without a comprehensive analysis that goes deep into history. The interaction among evolving circumstances, policy responses, and outcomes must be correctly interpreted if we are to understand the significance of many policy measures. Housing and development matters are necessarily of huge proportions and extend far into the future. The consequences of decisions made today will take years and decades to work out. The following exposition, using primarily an economic and historical perspective, outlines the key issues that are relevant for public debate.

Removing Rent Control

At the end of World War II, the government imposed rent control on all pre-war housing. Discrimination against new immigrants was implicit. Between 1945 and 1950, massive immigration from China increased the local population from 600,000 to 2,100,000. Land around the fringes of the urban areas were invaded by the new immigrants. Squatter settlements literally mushroomed overnight.

The process of urban redevelopment was severely complicated by the imposition of rent control on pre-war housing. The Landlord and Tenancy Ordinance provided that rent on these units could not be raised unless a tenant vacated his premises. In actual practice the cost of evicting tenants was made prohibitive by the legal process. It became almost impossible to repossess existing premises for reconstruction purposes. This severely limited the incentive for private developers to undertake housing reconstruction during the immediate post-war years. It is a mistake to conclude that this was a case of market failure in the housing market. A market solution was rendered impossible from the very beginning because of rent control. An interventionist solution in the form of a public housing programme soon appeared as the only feasible alternative.

The situation became critical as the economy grew rapidly and housing demand increased. There was growing pressure on government to either (1) resettle squatters in order to clear the illegally occupied squatter settlements, or (2) relax the conditions for evicting tenants for urban redevelopment purposes. The government did both. The decision to resettle large numbers of squatters into multi-storeyed public housing blocks after the fire in December 1953 was taken before the Landlord and Tenancy Ordinance was amended in August 1955.

The situation after 1955 was radically altered. The Buildings Ordinance was amended on December 21, 1955 to permit considerably higher structures. The gains from evicting tenants thus rose dramatically. The pressure to reduce the cost of repossessing buildings for reconstruction purposes mounted. The Landlord and Tenant Ordinance was amended on August 17, 1955. Henceforth, the Tenancy Tribunal was effectively granted the power of eminent

domain in reconstruction proposals and to determine the rate structure of compensation. The cost of evicting tenants was greatly reduced.

These two amendments together led to a belated surge in housing reconstruction, which reached a peak in 1959, when some 12,000 private domestic units were built. The tearing down of numerous old premises, which had been delayed for 10 years, within a narrow span of time led to a short run worsening of the squatter situation as large numbers of tenants were evicted, thereby creating more pressure to expand the public housing programme. Saturation of market demand thereafter caused a decline in building activity until 1961.

Even more disastrous was the decision by the courts to allow the rate structure of compensation to be essentially frozen throughout the period from the late 1950's to the early 1970's. Market rents had meanwhile skyrocketed. Landlords were soon finding it increasingly cheap to evict tenants. This set the stage for the rush towards excessive reconstruction. The disastrous building rush between 1962 and 1965 was partly due to the low compensation rate structure, but the principal cause was an oversight in an amendment to the Building Ordinance that occurred in September 1962.

The high intensity of reconstruction after the relaxation of building volume controls in 1956 had increased urban congestion, and imposed severe strains on the transportation system and the re-provisioning of utility services. The government then decided to scale down the permitted intensity of development. In September 1962, a plot-ratio amendment was enacted to take effect in 1966, restricting the ratio of gross floor space to the area of the site. An odd thing happened. The amendment included an escape clause, which allowed any landlord who could apply for reconstruction with a plan before the end of 1965 was exempted from these new restrictions. Since the amended plot-ratio implied a decrease in the supply of floor space in the future, it was in the interest of the landlord to beat the deadline.

During the period of grace between 1962 and 1966 there was an unprecedented wave of private residential development so that by 1966 there were 18,000 vacant domestic units in the private sector. The housing market became vastly oversupplied. A series of bank runs in 1965 caused a retraction of investment in private housing. The housing boom had collapsed into deep depression which lasted until 1970. The human and economic costs are immeasurable. Beginning in the 1970's, market rents started to rise because the existing rent control ordinance did not apply to the majority of the units in the private market. Most of the pre-war units had been torn down during the reconstruction boom. Tenants who had been accustomed to stable rents protested and the government promptly reimposed rent control on post-war housing as a temporary measure. The temporary measure has been in force ever since despite several amendments.

Fortunately, the disastrous effects of rent control on property values and private housing development prompted government to progressively eliminate the most onerous effects through a series of amendments. The newly gazetted Landlord and Tenant (Consolidation) (Amendment) Bill 1992 will eliminate rent control by the year 1994, affecting some 39,000 private housing tenants. The proposed legislation would allow landlords of pre-war tenancies to raise their rents to a minimum of 60 percent of true market value this year, going up to 75

percent in 1993, and 92.5 percent in 1994. Post-war domestic tenancies created before June 1983 for flats built before 1981 may see rents rise to 77.5 percent of the market rate this year, then to 85 and 92.5 percent in the following two years.

The legislation if approved would be a blessing for Hong Kong, which as we have seen has been primarily responsible for the high degree of volatility in the building cycles and of property prices in Hong Kong that had at times threatened the integrity of the banking system. It is a great tribute to those in and out of government who, despite earlier mistakes, have finally managed to bring us back from the brink of disaster. Many years ago the Swedish economist Assar Lindbeck called rent control as the best way of destroying a city short of bombing it. The main lesson to be learned from Hong Kong's history is that rent control should be avoided at all costs.

Privatizing Public Housing

In 1991, 576,313 households or 36.5 percent of all domestic households live in public and aided rental housing blocks at heavily subsidized rents. The programme has often been hailed as a major social achievement and as evidence of the positive and necessary aspects of government intervention. Nothing can be further from the truth.

In principle, a public housing program should help the poor and permit them to consume more housing than they would have in its absence. Available evidence shows that this is not the case. In both 1981 and 1986, about 52 percent of the households who live in public housing were consuming less housing than their counterparts in the private sector with similar incomes and other demographic characteristics. The public housing program failed to help half of its clients to obtain better shelter than what they otherwise would have been able to obtain in the private market. Half the households were worse off in terms of housing consumption, but chose to stay in the program because of the cheap rent.

The poor were not the main beneficiaries of the public housing program as well. In 1986, the income distribution of renters in public housing was not significantly different from that in private housing (see Table 1). Indeed at very low levels of income there were proportionately more poor families who were private renters than public renters. This meant that there would be continuing pressure to expand the public housing program because of pressure from poor private renters. The long queues of people waiting eagerly to get into public housing is clear evidence to this effect.

Table 1
Household Income Distribution in 1986

Household income (\$)	<u>Private renters</u>		<u>Public renters</u>	
	Percent	Cumulative percent	percent	Cumulative percent
0-999	3.23		1.68	
1,000-1,999	9.64	12.87	4.56	6.24
2,000-2,999	14.81	27.68	10.17	16.41
3,000-3,999	17.08	44.76	18.10	34.51
4,000-4,999	12.39	57.15	16.20	50.71
5,000-5,999	9.09	66.24	12.49	63.20
6,000-6,999	6.85	73.09	9.58	72.78
7,000-7,999	5.02	78.11	6.50	79.28
8,000-8,999	4.36	82.47	5.61	84.89
9,000-9,999	2.57	85.04	4.21	89.10
10,000-11,999	4.44	89.48	4.94	94.04
12,000-14,999	3.15	92.63	3.62	97.66
15,000-19,999	3.23	95.86	1.78	99.44
20,000-	4.14	100.00	0.57	100.00

At the end of 1970, the total stock of public sector housing units was already greater than the total in the private sector. The public housing programme had become very large and expensive, and became even more so under the governorship of Sir Murray MacLehose, during whose tenure we saw the setting up of a new Housing Authority and the introduction of new programmes, including the Home Ownership Scheme (HOS) and the Private Sector Participation Scheme (PSPS) in 1976.

The Housing Authority found itself to be the custodian for the housing needs of half the population. The real dominant voice of this blessed group was not the poor, but the lower middle class whose interest now was in obtaining better housing. They were not willing to give up their cheap public housing units for the more needy unless a better bribe was offered. The HOS and PSPS served primarily their interests. At present, two thirds of these units are allocated to public housing tenants and one third to private housing tenants.

In a further bid to encourage more well-off tenants to become home owners, the Housing Authority proposed in 1985 to double public housing rents for tenants who have been in the programme for more than 10 years, if their family income exceeded 1.5 times the qualifying income level of new applicants. Opposition to the proposals was severe, but the policy was put into practice.

Since the HOS and PSPS units were offered at concessionary rates, the government sought to limit profit taking by putting limitations on the resale options available to the home owners. From the point of view of the public housing tenant, the ownership of a home that entails financial outlays at the outset and cannot be transferred for many years may be inferior to having a permanent claim to public housing tenancy rights. Such claims were almost risk free and whose value may appreciate over time if the government is perceived to be committed to a policy of replacing current buildings with better structures over time.

Nevertheless, the large stock of aspiring home owners in both the public and private sectors could not be accommodated quickly enough. The competing demands of private renters who could not afford to buy homes and were waiting to join the public housing programme also limited the rate of expansion of home ownership because of limited resources. The Housing Authority had to maintain a balance between the provision of public housing and home ownership units.

In October 1990, the Housing Authority proposed a limited program to sell some of its public housing units to current tenants. This is by far the most interesting initiative of the Housing Authority to date. Various grass root organisations concerned with public housing have reacted negatively to the proposal. They accuse the government of relinquishing its commitment to house the poor. Public housing tenants were more concerned about the price at which government will sell the units. In the end, the tenants refused to accept the offer even when the units were being offered at 43 percent of the estimated market price. The Housing Authority is now apparently reconsidering its offer with the possibility of giving an even more generous offer.

The real reason why the tenants refused to take up the offer made by the Housing Authority was simple: there were severe limitations imposed on the resale options. These limitations were similar to those imposed on the sale of HOS flats. They reduced enormously the value of the flat as a transferrable asset. Everyone knows that an asset which cannot be transferred on the open market can only be sold at a deep discount to its true market value. It would be logical for most tenants to be unwilling to pay more than the present value of their expected rental expenditures if they are unable to reap any capital gain when they sell the asset.

Indeed it may be more in their interest to remain as a public housing tenant and retain the benefits that accrue from a permanent entitlement. They can at least look forward to lobbying the government to improve housing over time as the economy prospers. The reason why the initial sale of public housing units failed is therefore not that the price was not cheap enough, or that the tenants could not afford it, or that the quality of the units were not good enough, but simply that you are trading a valuable permanent entitlement for an asset whose market value is limited by transfer restrictions.

It is important to recognize that public housing is a transfer-in-kind rather than a cash subsidy. Tenants have little choice with respect to location, size and other housing characteristics when they took up the units. You either accept the offer or go back into the queue and wait for an uncertain period until you are called again. Therefore, acceptance of an

unit does not imply that you value it at its full market value, but only because the rent is so cheap that you are willing to tolerate all the unpleasant and inconvenient aspects of accepting the offer. For example, if someone who works in Aberdeen gets a public housing unit in Tuen Mun, he will not value the unit as much as someone who works in Tuen Mun.

According to two separate estimates I obtained for 1981 and 1986, we know that on average the public housing tenant values the unit in which he lives in at only 58.70 percent and 64.65 percent of the market value of the unit. In other words, for each dollar the public spent on the public housing programme, only 60 cents worth of benefits were obtained by the tenant. An enormous amount of resources were wasted. The total losses to society as a whole can be derived from these efficiency estimates of the housing program. For 1981 and 1986, they amounted to 1.18 percent and 0.48 percent of gross domestic product for the respective years. This is a huge amount of wasted resource and they stem from the fact that public housing units are not provided by the market.

The key question for privatisation to succeed is therefore transferability. If the units could be freely transferred after the tenant acquires it, then an initial selling price set at 43 percent of the market price as originally proposed by the Housing Authority would be attractive. The tenants would have implicitly received a capital gain equal to 57 percent of the value of the unit. One would be foolish not to accept it. Banks would be willing to offer mortgages of up to 100 percent of the initial sale price since they would have as security an asset whose value is substantially higher. There would be little need for making an initial down payment.

With privatisation the ex-tenant could also sell his unit at the market price, but what can he purchase in return? To the typical public housing ex-tenant most existing private housing units are beyond his budget. The ex-tenant who wishes to relocate is compelled to choose from other privatised public housing units. If only a small proportion is privatised then ex-tenants who wish to relocate will have a very limited choice. The full benefits of privatisation is realized only when the vast majority of the public housing units are sold off. Administratively this would of course take time.

While there may be some concern that allowing public housing tenants, who have already benefited from living in subsidized housing for so many years, to further benefit from capital gains through privatization today is unfair to those who have been deprived of both benefits. While the concern appears reasonable, this is not an excuse for not going ahead with privatization. A greater injustice is perpetuated by wasting vast amounts of resources tied down in public housing estates that has no alternative use. Privatization will make available to the Housing Authority vast resources through the sale of public housing units so that private tenants and those in temporary housing can look forward to faster provision of both public housing and home ownership units. The government has nothing to lose by privatising public housing. Land on which these massive estates sit has already been give away, it is merely a matter of allowing them to realize their full market worth. Society on the other hand has much to gain from acquiring such vast amounts of wealth.

The Housing Authority is now looking at privatisation as a solution to its problems. It is seeking to partially re-create the market which it had gradually destroyed over four long

decades. But to succeed it must go all the way to relax existing restrictions on resale options and implement the program on a large scale. The privatization of public housing is a step in the right direction and should be applauded. To succeed, however, the Housing Authority must take even more bold steps.

Housing Relief for the Sandwich Class

Financial Secretary Hamish Macleod's budget proposals came under heavy fire. Changes to tax thresholds and increased property rates were criticised by legislative councillors who felt that Mr. Macleod had not provided adequate relief for the so-called sandwich-class, whose interests have been hurt by double digit inflation, especially rising property prices. This group is popularly defined as those with monthly household incomes between \$18,000-\$40,000. The lower limit denotes the level of income above which a family is not eligible to apply for subsidized public housing and HOS units and the upper limit denotes the level of income necessary to support mortgage payments for a small unit in the private sector.

Based on this classification, 16.3 percent of the households are in the sandwich class according to figures from the 1991 Census of Population (see Table 2). The sandwich class are therefore in the top quintile of the household income distribution. In 1991, a family with two children having a monthly income of \$30,000 would have to pay the standard tax rate of 15 percent of total assessable income. If the same family had an income above \$13,800 it would have to pay taxes at the maximum 25 percent marginal rate until it reaches the standard tax rate level.

Table 2

Distribution of Households in 1991

Monthly Income	below \$18000	\$18000-\$40000	above \$40000
Owner Occupier	467,539	156,345	49,183
Tenant:	726,197	89,023	22,131
Public housing	513,105	58,002	3,142
Private housing	213,092	31,021	18,989
Employer Provided	32,575	10,849	9,261
Rent Free	15,071	1,323	575
Total	1,241,382 (78.6%)	257,540 (16.3%)	81,150 (5.1%)

The sandwich class are clearly those at the bottom of the high tax bracket, whose interests have been hurt by inflation in two major ways: real incomes and real savings have been eroded. Inflation can erode after tax real incomes not because nominal incomes do not rise fast enough, but because inflation erodes real tax thresholds. This problem can be easily solved by

indexing tax allowances and tax brackets to inflation. Another benefit of indexing is that taxpayers can have greater certainty about their anticipated tax liabilities.

These inflation induced changes in the tax burden may not be as important to the sandwich class as the effect of inflation on their real savings. With double digit inflation, real savings fall rapidly over time. The flight to property as an inflation hedge is a natural response. Households who do not own property will find their lifetime wealth position decline rapidly both in absolute and relative terms.

In 1991, domestic property prices surged. Private tenants who were not eligible for subsidized public housing and HOS units, discovered that their hopes of acquiring a unit vanish within the span of a few weeks. They could no longer afford to buy a unit at current prices and probably not in the near future as well because the gap between the value of accumulated savings and property prices will grow.

At the government's urging, banks reduced their mortgage loans in order to curb speculation in property. This made it even more difficult for the sandwich class to acquire property. Individual legislators have urged government to provide some form of subsidized housing for these households. Others have urged the government to penalize property owners for holding vacant flats. One cannot be optimistic about the feasibility and desirability of further interventions into a market which is already heavily dominated by inefficient and inequitable housing programs.

The effect of inflation on real savings can only be addressed by increasing the supply of assets that can serve as a hedge against inflation. In Hong Kong and elsewhere the single most important asset that serves such a purpose for most households is property. If every household were to become a property owner then the problem will be largely resolved. The magnitude of the problem can be estimated on the basis of the number of households who are not home owners.

Figures from Table 2 indicate that 42.6 percent of the households are home owners, 36.3 percent live in public rental housing, and 16.7 percent live in private rental housing. Among private renters 213,092 have incomes below \$18,000, whereas only 31,092 are in the sandwich class. Whether government should spend resources to help the top quintile of the income distribution at the expense of the relatively poor in society can be debated, but surely their case cannot be supported on equity grounds.

A staggering 574,249 households live in public rental housing. While these tenants do not have a housing problem they do not own the units they live in. If these public housing units could be sold to the tenants with full transfer rights both they and society would be better off. Tenants would obviously welcome the idea if prices for these units were set at a discount to the market value. At a time of high inflation, privatization would at one stroke of the pen create an asset that can serve as a hedge against inflation for more than one-third of the population.

What policy can be more genuinely equitable at so little cost. Resources made available to the Housing Authority through the sale of public housing units will also help speed up the

provision of HOS units to private tenants, including those in the sandwich class. This is a more effective and efficient way of helping households in the sandwich class.

Any attempt to operate a subsidized home ownership program for the sandwich class is not only expensive, but will inevitably lead to massive fraud and social injustice. In 1991, households in the income bracket between HK\$18000-40000 numbered 257,540. Of these there were 156,345 home owners, 58,002 public housing tenants, and 31,021 private housing tenants. The incentive for some existing home owners to sell their units in order to qualify for any new program targeted at the sandwich class will be substantial. The cost of distinguishing between the genuine and non-genuine sandwich class will be enormous. If the Housing Authority has failed to screen people effectively for the public housing program, what assurance can we have for doing a better job with the more difficult task of screening the sandwich class.

The large scale privatization of public housing with unrestricted transfer rights provides the best long term solution for society as a whole. With privatization one can look forward to creating a society of genuine home owners within a realistic time span. It is in the interest of the sandwich class to support such a policy for they would like to have their own home but do not wish to pay more taxes. A society of home owners contributes enormously to social stability. Unlike public housing tenants who lobby incessantly for transfers in their favour by robbing others in the name of social justice, home owners have a stake to defend and strive to strengthen the integrity of private property rights.

Privatization would also help shape future debates on the budget in a healthy direction and help preserve the essential features of Hong Kong's successful budgetary policy in an age of political change: low taxes and limited spending. The great advantage of the income tax system is its enormous simplicity, low tax rate, and high predictability. It is popular to view personal income taxes solely in distribution terms and to argue in favour of higher tax rates. But the greatest benefit of low tax rates is that it facilitates economic growth by providing powerful incentives for individuals to improve their situations. For this reason, Hong Kong's tax regime is really the poor man's best friend.

The experience of the welfare states in the industrialized West shows that the only permanent escape from poverty has to come from self help and not hand outs. The state is not a reliable relief agency in the long run. If the economy slows down due to higher taxes then the state will sooner or later run out of funds. The middle class in Hong Kong, more than anybody else, knows this. It would be a serious mistake to believe that they prefer higher taxes as a redistributive measure despite its populist appeal, but like everybody else they would like to have free-lunches for themselves but not others.

Property Market Interventions

Overall prices in the property market for domestic residences soared by almost 52 percent between 1990:Q4 and 1991:Q4 (see Table 3), and was still climbing in the first half of 1992. Speculative activities intensified rapidly, especially in the pre-sale market for large housing developments, causing considerable public concern.

In the beginning, the major public concerns centred around two issues. First, triad members wishing to turn a quick profit often used strong-arm tactics and queue jumping, making it difficult for law abiding buyers to acquire the units directly from the developer. Second, final users who wait in queues on the announced date of public sale often find that many of the choice units had already been privately sold ahead of time to property agents or speculators. Many buyers are therefore compelled to pay a considerable premium in order to acquire their units from property agents and speculators.

As property prices continued to escalate, public concern began to shift to two other issues. First, whether the property market boom was leading to a speculative bubble. This was of public concern because in Hong Kong's extremely open economy and under the present linked exchange rate regime the government had limited scope to curb the demand for property through monetary measures. Second, as the gap between property prices and household income widened, there was increasing fear that home ownership would become unaffordable for the middle class, many of whom were eagerly looking for a hedge against high inflation.

These concerns led the government to intervene in the property market. Several measures were adopted. The first goal was to deter queue jumping by triad members because it threatened public order. The problem was addressed through more vigorous law enforcement and a change in the procedure for arranging the pre-sale of units to the public. After much discussion the developers adopted a lottery system and queue jumping disappeared. This did not, however, deter speculation. In fact speculative activities spread to the general public who could now compete effectively against triad members.

A more controversial issue is on the need to curb speculation. The government decided to intervene in the property market through a number of measures: imposing stamp duty on the transfer of pre-sale units, forcing banks to tighten mortgage requirements, and restricting the proportion of pre-sale units that developers could sell internally.

Whether these measures are warranted depends on the answer to several concerns. First, whether speculative activities in the property market is undesirable. Second, whether the method used by developers to pre-sell housing units in advance of their completion date reflects a monopolistic practice. Third, whether the current price surge in the property market reflect excessive speculation creating a bubble that may threaten the integrity of our financial markets. The answers to these concerns require a careful analysis of the reasons behind the current property market boom and how property markets function in Hong Kong.

Economic Boom and Property Investments

It is a mistake to view the current property market boom as a recent phenomenon (see Table 3). It is important to note that in the preceding six years (the period between 1985:Q4 and 1991:Q4), overall property prices had risen at an average rate of almost 25 percent a year. In the first three of those six years (the period between 1986:Q1 and 1989:Q1), property prices had been steadily climbing at the average rate of 26 percent a year. There was a brief crash after the crushing of the democracy movement in Tiananmen Square on 4 June 1989, but by 1989:Q4 prices had recovered to its pre-crash level. In the year between 1989:Q4 and 1990:Q4, prices

increased by almost 15 percent despite the uncertainties of the Gulf Crisis and the impasse over the Sino-British airport negotiations.

Table 3

Interest Rate, Property and Price Inflation

Year : Quarter	Property Price Inflation rate	Rental inflation rate	Consumer price inflation rate	Real best lending rate
81:Q1	34.55	9.02	12.04	4.96
81:Q2	36.36	28.10	12.76	4.24
81:Q3	19.35	37.29	12.27	5.73
81:Q4	5.07	49.53	12.89	3.11
82:Q1	-7.43	9.66	11.46	4.54
82:Q2	-12.00	4.52	12.99	2.01
82:Q3	-15.54	-0.62	10.80	1.20
82:Q4	-17.93	0.63	11.42	-0.92
83:Q1	-18.25	-3.77	11.05	-0.55
83:Q2	-14.39	-8.64	9.27	4.23
83:Q3	-12.80	-9.94	9.99	6.01
83:Q4	-13.45	-13.66	10.85	2.65
84:Q1	-6.25	-8.50	9.72	0.28
84:Q2	-7.08	-4.73	10.18	3.57
84:Q3	-8.26	-2.76	8.86	5.14
84:Q4	-1.94	1.44	6.24	4.76
85:Q1	0.00	2.14	4.75	5.25
85:Q2	4.76	3.55	3.29	4.71
85:Q3	16.00	7.09	3.66	3.34
85:Q4	18.81	9.22	3.85	3.15
86:Q1	16.39	9.56	4.53	2.47
86:Q2	11.10	9.09	5.27	2.23
86:Q3	11.55	7.21	4.91	1.59
86:Q4	11.82	6.82	5.46	1.04
87:Q1	19.61	6.67	5.78	0.22
87:Q2	27.45	8.20	6.52	0.98
87:Q3	24.07	11.29	6.83	0.67
87:Q4	19.64	12.70	7.76	-2.26
88:Q1	14.75	12.50	7.74	-1.74
88:Q2	18.46	16.67	8.42	0.08
88:Q3	22.39	15.94	9.46	0.04
88:Q4	31.34	22.54	9.69	0.31
89:Q1	40.00	30.56	10.65	0.85
89:Q2	31.17	32.47	10.96	0.04
89:Q3	19.51	26.25	11.04	-1.04

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Published in *The Other Hong Kong Report* : 1992, Chinese University Press, Hong Kong 1992 pp. 309-350

89:Q4	17.05	19.54	11.10	-1.10
90:Q1	8.16	14.89	10.92	-0.92
90:Q2	6.93	7.84	11.27	-0.27
90:Q3	15.31	9.90	11.46	-0.96
90:Q4	14.56	7.69	11.54	-1.54
91:Q1	16.98	5.56	12.26	-2.76
91:Q2	30.56	6.36	10.93	-0.43
91:Q3	40.71	7.21	10.15	-1.15
91:Q4	51.69	7.14	10.03	-1.53

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- Notes:
1. All figures are year on year rates.
 2. Consumer prices are the Hang Seng Consumer Price Index.
 3. Real best lending rate as quoted by the Hongkong Bank minus the rate of consumer price inflation.

One obvious hypothesis is that the recent property market boom in the past eighteen months is little more than making up for the lost ground due to the events of Tiananmen Square, the Gulf Crisis, and the Sino-British airport negotiations. Had it not been for these shocks, the market would have arrived at its current level of prices in a less spectacular and explosive manner. If this is indeed the case, then there is nothing extraordinary about the recent property market boom.

Such a hypothesis is not incredible since the growth prospect of the Hong Kong economy looked better in the late-1980's than in the mid-1980's. The opening of China and especially Guangdong province expanded enormously the opportunities for Hong Kong businesses in outward processing activities. More than three million workers in Guangdong are reportedly employed by Hong Kong firms. The scale of activity can be seen from the fact that re-exports from China as a share of Hong Kong's gross domestic product rose from 18 percent in 1986 to 44 percent in 1990. Hong Kong's economy was in a massive boom which was not adequately revealed in gross domestic product figures.

The growing cross border economic activity created an enormous demand for support services in Hong Kong. A tight labour market translated such demand pressures into higher wages and prices. Inflation rose from 4-5 percent in 1986 to 10-11 percent in 1991 (see Table 3).² Meanwhile the best lending rate rose moderately from 6.5-7.5 percent in 1986 to 8.5-10.5 percent in 1991. As a consequence, the real interest cost on home mortgages went from being positive to negative (see Table 3). The general public soon realized that it was economically sound to invest in property and protect their savings from being eroded by inflation. Any hesitations they had vanished when major uncertainties regarding the Gulf Crisis and the airport negotiations were cleared one after another in 1991.

²This consensus view has been advanced by a number of economists, see for example, John Greenwood, "China Factor in Hong Kong Inflation" (*Asian Wall Street Journal*, November 26, 1991).

By 1992, property prices had escalated to levels that many considered was out of reach of the typical prospective home owner. Some studies reported that the affordability index (a measure relating the cost of mortgage payments to the median household income) had reached levels indicating that few households could afford to buy a small or medium sized unit at current price levels. Indeed some reports suggested that the affordability index was getting close to levels experienced shortly before the 1982-83 property market crash. This contained an implicit warning that current property prices may be increasingly speculative. In other words, the bubble could burst.

The analogy with the previous property market crash is misleading since the major cause for the last property market crash was the unanticipated increase in U.S. interest rates, when Fed policy was targeted at combatting inflation during the Reagan era, thereby precipitating a recession. There is little reason to believe that such a scenario will be repeated now.

It is also important to note that the median household income is an artificial reference group and may have little bearing whatsoever to the typical prospective home buyer, who may be a combination of investors and owner-occupiers. The problem is further complicated when we make comparisons over time since the proportion of investors and owner-occupiers may change over time. Even the prospective owner-occupier in 1991 may be different from that in 1981 for reasons that are not adequately reflected in household income figures.

According to official Chinese statistics in 1990, joint venture, cooperative venture, and foreign own firms in Guangdong employed 63567 foreign workers, most of whom are likely to be from Hong Kong. The figure does not include those working in export-processing firms. It is not unlikely that as many as 100,000 individuals and their households in Hong Kong derive their incomes substantially from China. These households are likely to have prospered enormously in recent years and may well desire and will be able to afford better housing. Some of these households may be first time home buyers, some may be trading up, and still some others may be investors. Indeed the slow increase of market rents (see Table 3) suggests that the supply of rental units may be increasing as more households begin to have more than a single property.

The changing nature of the market for domestic property from home owners to investors may well be a new feature that will slow down the growing trend towards home ownership in the private housing market, which took place in the last decade. Between 1981 and 1991, the proportion of owner-occupiers living in private housing increased from 27.3 percent to 35.3 percent of all domestic households. Over the same period the proportion of renters living in private housing decreased from 22.6 percent to 13.8 percent of all domestic households. The decline in the degree of sharing (defined as the average number of domestic households per living quarter) in the private housing market from 1.35 in 1981 to 1.03 in 1991 is also suggestive of the shifting nature of demand in the property market. Therefore, assessing whether a market is overheated on the basis of affordability is likely to be increasingly misleading. The proper measure has to be the real rate of return on investment.

Curbing Speculation

The public perception of speculation is quite different from that of an economist. To the public, speculators push up the price of housing making it more expensive for the final user. From this perspective, speculators are evil middlemen who profit by hoarding goods, which they do not produce themselves, and withhold them from genuine users. From an economic point of view, middlemen perform the important function of spreading risks, which would otherwise have to be borne by producers and consumers. The risk is that the price of goods middlemen hoard can rise or fall. Speculation is therefore a useful function and it is not clear why it should be curbed.

Speculative activities can on occasion get carried away so that property prices rise to levels that become unrelated to economic fundamentals. When this happens the speculative bubble bursts and property prices crash. An individual who is not in the market has little to fear from a crash, indeed he may welcome it for it provides an opportunity for him to enter the property market when prices have fallen. For society as a whole, the concern is that market crashes can threaten the integrity of financial markets and bankrupt developers so that normal economic activity may take time to recover. For this reason, it may be necessary to curb speculative bubbles.

The presence of bubbles is not always easy to detect. Opinions often differ. Speculation occurs precisely because there are differences among people in their attitudes toward risk and their assessment of future prospects. Since property purchases are primarily financed by banks, so long as they remain prudent in making mortgage loans, there is little rationale for regulating a purely voluntary exchange arrangement unless there is a clear case of market failure.

It is often alleged that large developers often fuel speculation and push up property prices by arranging to have a substantial portion of their units placed internally. According to some commentators, a case for regulating transactions in the property market can be made because the sale of new residential units in the form of housing futures has an element of market failure. They argue that developers possess location specific monopoly power, especially in large developments. Such powers are enhanced by the fact that housing units are not homogeneous.

The location monopoly argument cannot be ruled out on theoretical grounds, but is it empirically true? To exercise monopoly power effectively, developers have to possess a mechanism that would allow them to sell the units to their respective highest bidders. In other words, there must be price discrimination. This can only be achieved through auctions because developers cannot possess information as to who is the highest bidder for each unit in advance. But the fact that developers have chosen not to use auctions as a means to sell their units is prima facie evidence that price discrimination does not exist and that monopolistic practice cannot explain the method developers use in the pre-sale of housing units.

It has been alleged that auctions have not been adopted by developers because it is costly to administer. It is not immediately obvious that there is much empirical merit in this claim.

But even if this were the case, the monopoly argument still breaks down because it implies that price discrimination is too costly to implement. Since monopoly power cannot be effectively exercised, there is no case for regulation on such grounds.

It is interesting to note that if auctions were adopted it would reduce short term housing speculation because the units would then be held by those with the highest bid. These are more likely to be final users than property agents and speculators because a competitive bidding process is likely to reduce significantly the scope for making speculative profits. This means that if price discrimination could be effectively employed then the incentive to engage in speculation would be reduced significantly. In other words, speculation takes place only when monopoly power, even if it exists, is not exercised.

The puzzling issue that has to be explained is why do developers choose to sell their units the way they do? Why do they choose to place some of their units with property agents and speculators in advance of the public sale? Why do they choose to make prospective buyers wait in queues? Why don't they use auctions to maximize their expected gains?

One explanation is that while developers can make a reasonably accurate forecast of the average market price, it is impossible for them to know the highest bid for every unit. If developers are less efficient at searching out the highest bid for every unit, then one would expect property agents and speculators who are more efficient in this type of search activity to perform such a function. But such an explanation fails to explain why developers are keen to sell many of their units to property agents and speculators often in advance. Since developers cannot gain from a better matching of units to final users, why do they care whether the units are sold to property agents, speculators, or final users. The explanation is also unconvincing because unless auctions are too costly to administer, developers will have an incentive to use it to force buyers to reveal their bids for every unit and capture the gains that would otherwise accrue to property agents and speculators.

The selling of new residential units in advance of their completion date is in principle no different from the selling of a futures contract. Like all futures markets it is not always easy to distinguish between speculators and final users. But housing futures have two important distinguishing features. First, residential units are necessarily heterogeneous. Second, the final users are typically home owners or small landlords. These two elements imply that there is a non-trivial problem of matching units to final users. Consequently, speculation in housing involves not only the spreading of risk but also the matching of the units to final users. Property agents and speculators who trade in housing futures perform dual functions.

These unique characteristics create the need for a special set of arrangements in order for the market in housing futures to function. It is important to establish at the very outset the incentive for developers to sell some of their units to property agents and speculators rather than to final users.

Developers often choose to sell the units in a single development in a number of stages. Clearly the price one is willing to bid for a unit depends to a large extent on its expected future value. This value will change over time as more information becomes available and the price

that one is willing to bid for a unit will be changed either upwards or downwards. A developer would try to pick the best time to sell his units, but he can never be completely certain when that is. An optimal strategy would be to space out his sales over time so as to balance risk against expected return, but there is a limit dictated by relevant cost-benefit considerations on the frequency of conducting such sales.

Property agents and speculators have a comparative advantage over developers in searching for a prospective buyer for a unit because they are in a better position to fine tune both the price and the timing of each sale. This advantage allows property agents and speculators to be comfortable with bearing more risk than the developer is willing to. It also means that the price of acquiring a unit from property agents and speculators will be higher because they have to bear more risk.

Property agents and speculators will prefer to acquire prime units from developers. Since they have to sell the units to final users at prices above the initial sales prices set by developers, it would not be in their interest to acquire non-prime units from the developers and sell them to final users at prices that will not be very different from some of the prime units available directly from developers.

This explains why in the period following the initial sale of new units by developers, the increase in prices on different units occurs at an uneven rate. The prices of prime units tend to rise proportionately more than non-prime units in the same development. Incidentally, this explanation also makes it clear that developers are not systematically making poor forecasts of housing prices as their pricing strategy would superficially suggest.

The final user is faced with three choices: (a) to purchase a prime unit from a property agent immediately, (b) to purchase a non-prime unit from the developer, or (c) to postpone his purchase until some future date. In making his choice he is aware that many prime units are held by property agents and speculators who would not sell unless a premium is paid now. This information alters his assessment of the value of the non-prime units available from the developer. It induces him to increase his bid for these units, which will raise the probability that the non-prime units will be taken up.

By selling the prime units to property agents and speculators, the developer has increased the probability that all of the units will be sold within a short period of time. He is able to do this because by selling some of the units to property agents and speculators he has temporarily withheld some of the units from the final users. The developer has created a situation in which property agents and speculators will help him space out the sale of the units to final users. The risk of picking the right time to sell the right number of units has been partly shifted to property agents and speculators who are in a better position to fine tune that decision.

Sometimes developers sell a large block of units to a single investor at a discount with a provision that the investor will not resell the units in smaller parcels for a pre-determined period of time. The discount represents a compensation to the investor for taking higher risks. The restriction on reselling these units in smaller parcels ensures that the investor will be taking higher risks for otherwise there will be no reason to give the discount in the first place. The

discount is clearly given with the view that the units would not end up in the hands of individual final users too quickly.

By selling some of the units to property agents and speculators in advance, the developer has induced others to take on the risk of picking the right time to sell. Property agents and speculators may be more willing to bear such risk than developers not necessarily because they are less risk averse, but because they are better searchers for final users than the developers. The most subtle aspect of the arrangement is that the developer is able to capture part of the gains from allowing others to help him space out his sales more efficiently over time. This occurs because the probability that all the units can be sold quickly has been increased. This translates into a higher expected revenue after adjusting for risk. Note also that the developer would have little incentive to sell to property agents and speculators if it were not possible for him to improve his own situation.

Consider the difference between auctions and the present method from the point of view of the developer and the final user. Auctions have the advantage of extracting the highest revenue for the developer given the information available to all parties at the time of the auction. The disadvantage is that many of the units that are put up for auctioning are likely to end up with final users. This means that the extent to which the sale to final users can be spaced out over time is limited. The developer therefore has to assume a higher risk of picking the right moment to conduct the auction.

Naturally developers will want to be compensated for taking on more risk than they prefer if they are compelled to adopt auctioning as the mechanism for selling the units. In a sense, developers can expect to get a higher total revenue through auctioning because they have to take higher risks. Since the present method has been chosen by developers over auctioning, it represents a superior arrangement not because it brings in more expected revenue, but because it optimizes between return and risk.

From the final users point of view, they are not worse off either under the present method. If search activity is highly efficient, then the expected amount they have to pay the developer under auctioning may not be significantly different from what they have to pay now, which includes payments to both the developer and property agents and speculators. They may be better off if the developer picked a bad time to conduct the auctioning and worse off if the developer picked a good time. The risk to the final user and to the developer are both increased under auctioning. Under auctioning the final user has less scope to decide when to buy the unit because fewer such units will be available from property agents and speculators.

An alternative to auctioning is to operate a lottery so that whoever comes first will have the first pick of the units offered by the developer. This may reduce the probability that the prime units will end up in the hands of property agents and speculators if all units have to be sold by lottery. Lotteries will reduce the amount of speculation only if more units end up in the hands of final users, but this need not be the case. The element of randomness inherent in lotteries make speculative activities less costly for large numbers of people who would otherwise be unwilling to wait in queues. If developers are not prevented from placing their

units with property agents and speculators in advance of the lottery, then lotteries will have very little fundamental difference from the queuing method.

The important point about the market for housing futures is that it exists in order to diversify risks for both developers and final users. This is beneficial to developers because it reduces the risk of selling most of the units to final users at a bad time. It also benefits users because it protects them from having to buy most of the units at a good time. For this to work a significant number of units has to be held by property agents and speculators, who perform the dual function of assuming risk and searching for the final user.

Attempts to restrict the internal placement of units would, however, fundamentally affect the process of selling new units. The act of picking the right time to conduct public sales and the correct mix of units to place on the market will become very important for the developer. The risk borne by the developer will increase and as compensation he will demand a higher price for the units. In the long run the supply of units will also be reduced. Measures to curb speculation in housing futures is basically a contradiction in terms. If all the units can be placed directly with final users then why bother with a futures market. It is natural for final users to complain that they are often unable to purchase the units directly from developers when the sentiments are bullish, but then they have no obligation to buy the units from developers when the sentiments are bearish.

Town Planning and Development

In July 1991 the government released an important consultative document entitled Comprehensive Review of the Town Planning Ordinance. The document represents a broad-based government review of and a set of recommendations for planning and land-use regulation. It highlighted several areas of planning and land-use control to be incorporated into replacement legislation for the original Town Planning Ordinance passed in 1939. The proposed changes represent the first comprehensive review of town planning in Hong Kong. The review highlights several important problems with current planning practice and lays important ground-work for developing revised town planning legislation. Yet, if the proposals are adopted, they will also have potentially significant impacts on the economy in general and housing development in particular.

The distinguishing feature of the Hong Kong planning and land development system is that virtually all land in Hong Kong is legally owned and managed by the Crown. Private developers and other users gain use of the land by purchasing leases issued by the government, most often (but not exclusively) at public auction. In booming economic times, government revenues from land sales can be significant. Revenues from these auctions and other land transactions can account for a substantial portion of government revenues, varying from less than 1 percent to 35 percent in any given year.

Leases sold at auction include a variety of restrictions, or lease conditions. To promote the optimum use of land as well as to control the development in order that the environment is not adversely affected, lease conditions often contain restrictions that control development

through specifications over site coverage, plot ratio, building height, and minimum floor area to be constructed.

The leasehold system and the nature of planning in Hong Kong has created a unique system of land-use and development control. One of the most unique features is the relationship between leaseholders and the government. For property developers, leases are considered a contract between the government and the owner of the lease. The nature of the contract is implicit since the terms are not legally enforceable at least with respect to planning and development control.

The informal contractual nature of land development is not purely abstract and theoretical. Since leases are purchased with the intention of developing land, and land premia and bids are based on the full development value of the land, developers have viewed the lease purchase as the "point of commitment" for development between the government and property developers. Similarly, a private individual purchases a lease from another private individual with the expectation of assuming the conditions of the lease and the right to develop the land in accordance with the lease's stipulations and existing zoning plans.

Despite the lack of a formal contract allowing maximum development, the system of land development operates as if these formal arrangements existed and were respected by all parties involved in the contract, especially the government which exacts land premia based on the value of the anticipated development. Moreover, procedures exist for developers to modify the lease or change the land-use requirements specified in the lease. If the change results in increasing the value of the property or its development potential, the developer compensates the government by paying a premium on the land.

Importantly, the lease purchase is not a legal point of commitment, or a legal contract between the government and property developers specifying the extent of development control over land use. Rather, this interpretation of the role and rights of leaseholders has emerged as a product of the evolution and practice of planning and land-use control in Hong Kong. While not legally binding, with respect to planning and development control, this element of the leasehold system has been the cornerstone of property development in Hong Kong, allowing land markets to work efficiently and effectively to meet the changing demands of consumers and producers in the local economy.

The existence of this implicit contract has been instrumental in reducing uncertainty within the property market because, historically, the government has been reluctant to alter the development potential of land stipulated through the lease conditions or changes in zoning plans. From an economic perspective, significant changes to informal rules that govern or regulate property markets can be as important as the formal or legal rules. As long as the government honours the lease, a high degree of certainty is implicit in development process, facilitating smoothly functioning land markets. This certainty allows developers to estimate future income from these developments with greater certainty and increase the price they are willing to pay in land sales.

In keeping with the evolutionary nature of planning in Hong Kong, land-use regulation has rarely been influenced by radical change. The most recent change occurred when the Town Planning Amendment Ordinance was passed in 1991 to allow for more control over development, particularly in the New Territories. Before the 1991 Amendment, the most important change to land-use regulation occurred in 1973 when the courts invalidated the government's power to use notes developed by the Town Planning Office on zoning plans as guidelines for development. Legislation was passed in 1974 to give statutory authority to these notes.

This amendment, however, represented an attempt to codify existing practice into law and did not represent a significant break with the administration of planning in Hong Kong. Before this, the Buildings Ordinance of 1955 gave the government the power to refuse permission to approve planning applications that were inconsistent with official zoning plans. In this context, any major change to the existing planning laws is considered important.

Planning and the Market

Publicly, Hong Kong's planning department has the same goals as planning departments throughout the industrialized world. In the introduction to the Comprehensive Review of Town Planning Ordinance, the consultative document describes planning as an attempt to promote the right development in the right place and at the right time, so as to bring about a better organized, more efficient and more pleasant place in which to live and to work. The planner's mission requires assessing the requirements for and designation of land for all types of uses.

In principle, planners attempt to supplant market allocations of land-use, determined by market prices, with allocations considered rational and efficient from the perspective of the planner. Market allocations of land, according to standard planning theory, tend to be haphazard and disorderly, lacking an underlying rationale. Thus, planners in many industrialized countries consider mixed uses of commercial and residential property inefficient. In Hong Kong, planners and others have argued that the juxtaposition of industrial and residential areas, or the location of industrial facilities, such as auto repair shops, on the lower floors of apartment buildings, was inappropriate and inefficient. To protect the interests of the public, according to this view, intervention in land use, is essential to promote economic efficiency and social harmony.

The economic perspective of land-use questions challenges many of the traditional views of planners toward land development. While the physical supply of land is fixed, the supply of land to a particular activity can vary significantly with price and will be used for that purpose which yields the higher rent. Opportunity costs determine how land will be used at any given point in time. Whether land will be developed, redeveloped, or undeveloped will be determined by expected yields given market conditions, the value land-owners place on the existing use of the land, and the levels of uncertainty in the development process. Land development, then, is fundamentally a future-directed economic activity. While existing allocations may seem disorderly or incongruent, these allocations may in fact reflect orderly development within the context of a dynamic, intertemporal market for development. Thus, some land may not be developed at a current date since it may be more suitable for development at a future date.

Anything that disrupts market prices for land also changes future revenue streams and the opportunity costs of developing land at a particular moment in time. An increase in uncertainty over the development potential of land may widen the number of potential uses in the future, encouraging developers to delay development. Uncertainty, in this case, will discourage development, ultimately reducing the supply of new units, and, in the long run, increase prices and rents.

In addition, prices for land reflect market signals concerning the highest and best use at any given moment. While a planner may consider an auto repair shop in a residential building a nuisance or inappropriate use, that repair shop may in fact provide valuable services to residents of the building and the neighbourhood. The repair shop exists because it is able to generate the revenues necessary to pay the lease for that property. In addition, the existence of the auto repair shop, to the extent it generates negative externalities, may also contribute to lower housing prices within the building, allowing rents to remain affordable for existing residents.

The differences between the economist's and planner's approaches to land-use development are important because they reflect how different world views of the market process will interpret the reforms proposed in the recent consultative document on town planning. From the perspective of the planner, more control over land-use development will allow for a more efficient allocation of resources since the planner will be more able to determine the appropriate pattern and pace of development. The economic perspective tends to view the planner's interventions as inefficient since they increase uncertainty into the development process and interfere with market signals concerning the optimal use of land implicit in market prices.

The current system of land-use planning in Hong Kong is a product of decades of evolution and economic development. Current practice is grounded in the 1939 Town Planning Ordinance which permits the Governor-in-Council, with the advice of the Town Planning Board, to "promote the health, safety, convenience and general welfare of the community by making provision for the systematic preparation and approval of plans for the future lay-out of existing and potential urban areas as well as the types of building suitable for erection therein." But the government and planners have been reluctant to exercise the full authority of the ordinance. In large part, this resulted from the widely held belief that the leasehold system worked well and facilitated economic development.

The Demand for Control

Hong Kong's economic growth has been accompanied by problems that are by-products of successful economic development. In essence, as Hong Kong's wealth and income has grown, its politicians and planners has become more sensitive to the social costs of growth. Minimizing these social costs, some believe, requires the abandonment of positive non-interventionism, particularly with respect to planning and land-use regulation.

For example, some claim a casualty of economic growth has been the environment. Extensive pollution in Victoria and Tolo Harbours has raised questions concerning the viability of the environment when industrial waste is dumped haphazardly and untreated. Unfortunately, the attempt to regulate environmental damage has been largely unsuccessful, especially since

many existing factories have been exempted from meeting the new, more strict requirements. These concerns led to reducing plot ratios in the old industrial area of Kwai Chung. Similarly, concern over air and noise pollution has put additional pressure on authorities to control development more tightly. Thus, the consultative document specifically points to the need for environmental impact statements to accompany new applications for development in environmentally sensitive areas.

Interest groups have already emerged to intercede in the policy making process for political reasons. The local environmental group Friends of the Earth challenged the government's recent plans to sell 30 hectares of public park land to developers attempting to build a resort of over 300 homes and an 18-hole golf course. Friends of the Earth argued that the golf course was an example of creeping urbanization and the valley should remain unspoilt. The development was stopped after a judicial challenge that argued the public was improperly consulted in the development process.

Similarly, concern over congestion resulted in downgrading residential developments in the Mid-levels on Hong Kong Island. Public officials and planners questioned whether the existing infrastructure -- roads, water, sewers, etc. -- could handle more intensive residential development. Some officials have specifically highlighted the inability of emergency vehicles to climb the narrow roads into the Mid-levels during rush hour.

Land-use incompatibility has also become an important planning issue. Cement factories, for example, are found next to residential areas, creating problems from unwanted dust. Automobile repair shops are located underneath residential buildings, creating noise throughout the night. Better planning, advocates of the proposals argue, will enable these inefficiencies to be eliminated.

To cope with these changing circumstances, planners have become more and more willing to intervene in the development process to direct or influence the pace and pattern of development. In some cases, these changes have been clear and open. The moratorium on development in Pokfulam and plot ratio reductions in the Mid-levels and Tsuen Wan serve as examples. Even before the 1991 Amendment and current proposals for planning reform were issued, planners were anticipating a substantial increase in planning-related activity. The most ambitious manifestation of the new activism may be represented by the Metroplan which, according to Graham Barnes, former Secretary for Planning, Environment and Lands, "provides a framework which will guide the selection of projects and the priority given to them, so as to restructure and develop the city in a cost-effective way."

Moreover, planners have recently argued that the current land-use planning system is inefficient and, in some cases, ineffective given the lack of development control and the inflexibility of the leasehold system. Development control is exercised largely through the Buildings Ordinance and lease conditions that effectively limit planning input to the front-end of development. Any planning change that might affect the lease condition requires mutual consent of the leaser and the lessee, restricting the discretion of planners. If, for example, planners believed that the plot ratio for a residential area should be reduced to limit the impact of the development on congestion, the change would require the consent of both the developer and

the government if the plot ratio is stipulated in the lease. The developer is unlikely to consent to such a change if it entails a financial loss.

This lack of comprehensive planning control over development, and the apparent conflict between land development and planning principles, led the consultative document to identify several areas for improvement in the existing planning system. The 1939 Town Planning Ordinance, the review observes, ignores many contemporary issues in modern planning such as environmental impact, civic design, conservation, and non-conforming uses. Enforcement through leases is extremely inflexible since planning requirements can only be imposed when the lease expires. Even when the lease expires, planners may have little impact on future land-use if the lease includes a clause allowing for automatic lease renewal. These issues have become particularly important on Hong Kong Island and Kowloon where long-term leases have few restrictions on land development.

Planning Certificates

To ameliorate these problems, the proposals call for centralizing development control and enforcement in a Planning Authority. Through the use of a planning certificate, the Planning Authority would ensure that development conformed to existing Outline Zoning Plans (OZPs) before work even began. The Planning Authority will also be permitted to stop work (or levy fines) on a construction site if the development is considered in violation of the existing plan or if a planning certificate has not been issued.

In concept and in practice, this reform represents a significant break with the past. The planning certificate can be used to require development to conform to plans that are in the draft and objection stages of consideration. The planning certificate would be issued after the public exhibition period for draft plans or, if an objection is raised on the site for development, after the objection review procedure (which could take up to nine months). The current system allows development to proceed as new drafts of statutory plans are being considered by the Town Planning Board. The planning certificate would be used to ensure the developer complies with any draft or approved statutory plan or restrictions imposed by the Planning Board. By not issuing a planning certificate, planners could also prevent development if the site was under public objection and ensure the development satisfied the Planning Authority's concerns over density, plot ratio, site coverage, etc.

A developer would normally apply for a planning certificate before submission of detailed building plans to the Building Authority to ensure compliance with all planning requirements so as to avoid abortive work in the preparation of detailed building plans. While the reforms call for a statutory limit on the approval of the planning certificate approval process (sixty days), discretionary power over density control and other planning-related provisions would be transferred to the Planning Authority from the Building Authority. The introduction of the planning certificate entails a substantive shift in the development approval process from a system that emphasizes processing building applications to one that determines the suitability of development for planning purposes. The planning certificate will also give formal control over the development process to planners. Under the current system, planners exert informal control through their consultative role in the plan application process through the Buildings Department.

A second issue identified, but not explicitly addressed in the recommendations, is compensation. Currently, the government is required to pay compensation to property owners only if their land is resumed for public purposes. In this case, compensation is determined by the fair market value of the land. Section 5 of The Town Planning Ordinance specifies that no compensation will be paid property owners for changes that occur through planning decisions. In principle, since the government is acting in the best interest of the public, changes in plans are technically not considered takings despite the fact that changes in land-use restrictions can have a dramatic impact on the value of developable lands. Thus, even if the planners decided to reduce plot ratios or restrict other types of development on property, legally these planning-oriented actions would not require the government to pay compensation even though they may be considered as a break in the implicit contract over the right to development land.

The issue is complicated by the fact that the government exacts land premia from developers who want to upgrade their land to capture the economic benefits of more intensive development. To maintain consistency, given the contractual nature of development in Hong Kong, the government should pay compensation to developers if the value of their property is downgraded through planning decisions. Even though the government is not legally required to pay compensation, the economic development in Hong Kong hinges in large part on the contractual nature of land development and the mutual respect implicit in that arrangement. If the government pursues planning objectives that significantly and negatively impact property developer interests, uncertainty would be introduced into property markets with potentially significant economic and revenue-raising impacts.

The consultative document also identified the lack of public participation in the planning system as a weakness of the current system. In order to ensure that the planning and development process more fully reflects the interests of the community, the review suggested that the planning process allow more public input. While the final decision still rests with the Governor-in-Council (avoiding direct public involvement through referenda on land development), opening the process will entail delays in the plan making and plan application process.

Delays and Uncertainty

These proposals if adopted are likely to have significant impacts on property markets in Hong Kong. The economic impacts will emerge from two fundamental changes in the way planning is practised in HongKong: (1) delays that will result from public participation in the development process, and (2) the break-down of the contractual nature of development under the leasehold system.

The delays that are implicit in the expanded role of the public in the development process will manifest themselves in financial burdens on developers that arise from delaying construction and the completion of projects. These impacts also have important implications for the government since a large portion of revenues are raised through property-related economic transactions.

The more fundamental challenge the new system poses is to the stability and security of property rights in Hong Kong. By injecting more variability into the plan making and plan application process, the proposed reforms will increase uncertainty since special interests and public administrators have more discretion over determining the type, pace, and pattern of development on the district level. Uncertainty then, entails much more than the simple delays in the development process, it will also increase risk associated with future investment. The proposed changes introduce uncertainty on several different levels, all of which may significantly impact economic growth and development. Uncertainty is a result of the random component of the development process and is largely associated with the process of obtaining planning and development approval.

One type of uncertainty that will be introduced into the planning system involves the procedural uncertainty that results from adopting a new planning framework. This uncertainty may be the easiest to quantify since the design of the new planning system places boundaries on processing planning applications. The proposed system, for example, limits the planning application to between three and nine months. The average length of time, of course, will depend on how often objections are raised to new developments or redevelopments, but the proposed reforms increase the opportunity and likelihood that plan applications will result in a rejection or the imposition of conditions. Clearly, developments that are controversial and stir public sentiment will be subjected to longer application approvals than those that face little public opposition.

Unfortunately, unpredictable delays are difficult to cope with and the increased uncertainty will impact the expected profitability of developments. The market will discount the expected value of new developments accordingly. An increase in uncertainty will provide incentives for leaseholders and developers to delay land development until they have more information concerning permissible leases and the plan application/approval procedures have become more established. Since a substantial component of the process involves an increase in a random element of the development approval process, the impact is likely to be larger than simply the delay in the approval process. These impacts occur as a result of the procedural uncertainty that is inherent in the reform proposals that allow more discretion on the part of the Planning Board, public participation and planners involved in the plan making and plan application process.

Another type of uncertainty is somewhat more abstract and more difficult to estimate. With a new planning and regulatory system, informal procedures will also change. In addition to changing the procedures for approving and implementing plans, the process of negotiating with private developers and interpreting the powers of the planning authorities will also evolve. Developers will be less likely to commit to new developments unless they receive a clear sign of support from within the government, or from major interests that could delay development. Similarly, since the legal framework for enforcing the new system will be untested, the court system will be responsible for defining its boundaries. For example, the notes attached to OZPs (Section 16) were not given statutory authority until after the Town Planning Amendment (1974) was passed, allowing these plans to be used as general guidelines for land development. Given the common law framework in which the Hong Kong system has developed, these new procedures will take time to identify.

The third type of uncertainty likely to have the most important economic impact the philosophical shift in planning practice that may take place under the new system of planning. Not only is the current system well known, it is also fundamentally non-interventionist. Since the new system is intended to give planners more discretion over development, this implies that less flexibility will be given to developers. To the extent the new system facilitates more interventionist planning, the current system of property rights will be significantly affected. Thus, those investing in Hong Kong's property market will be unclear about the stability and respect for property rights under the new system. Just as developers bid on leases assuming that they will be able to build to the maximum developable potential of the site, one would expect they would anticipate maximum delays into their calculations until new rules evolve concerning the objection process and more experience is gained with respect to actual (rather than potential) delays in the development process.

In sum, the implementation of the new system will inevitably infuse uncertainty into the existing planning process and property markets will respond accordingly. The costs are not simply delays that can be anticipated by the private market since there will be significant random elements. How the market reacts to these new uncertainties is difficult to estimate or project. One possible response is that the market will make a one-time adjustment as the new system is implemented: property markets will discount the market value of properties according to expectations about delays in the development process. Another response is that delays may grow over time as planners avoid substantive changes in the beginning so that property market does not fully discount the changes at the outset.

One potentially significant impact of the new planning procedures will be on the building cycle in Hong Kong. The building cycle occurs because new residential or commercial units typically take up to two years to develop, requiring property developers to make decisions based on future demand forecasts. Their inability to accurately predict movements in market conditions creates lags in their ability to match changes in the demand for new units with a perfectly offsetting supply, providing the basis for a building cycle. The introduction of the new planning system will likely exaggerate this cycle by lengthening the supply lag for new units due to delays in the plan application and approval process and uncertainty surrounding development, resulting in significant swings in the price of new commercial and residential units. The impact will also entail larger variations in prices and leases for existing property.

Compensation and Betterment

The issue of compensation and betterment, which has the most significant impact on property rights were addressed by a Special Committee on Compensation and Betterment which released its recommendations in March, 1992. Generally, the Special Committee recommended that compensation for adverse planning decisions if these decisions deprived developers of reasonably beneficial use. However, the special committee represented a legal perspective on the status of compensation and betterment in other countries and its applicability in Hong Kong. The economic ramifications of compensation were not a major focus of the analysis or the committee's deliberations.

The issue of compensation lies at the very heart of economic development in Hong Kong because of the peculiar nature of property development under the leasehold system. When leases are sold at auction, or the government requires payment of land premia for redeveloping land, land values are calculated based on expected market conditions and assume that land can be developed to the maximum permissible under existing OZPs and Development Permission Areas (DPAs). By specifying lease conditions and auctioning off property, the government has transferred a development right to leaseholders that can be used until the expiration of the lease.

On the other hand, if the owner of the lease wants to modify the lease to allow for more intensive development, he(or she) must pay the government a premium that reflects the value of that land. Historically, the "point of commitment" for development has occurred at the time of the sale. This system has provided a tremendous amount of certainty in an economy subject to extreme external shocks.

The contractual nature of land development in Hong Kong is currently being weakened by a more activist approach in setting planning priorities and restricting the scope and pace of land development. Legally, the government is only required to pay compensation to private developers if their land is resumed under the Crown Lands Resumption Ordinance. The Town Planning Ordinance states unequivocally that the government is not required to pay compensation when the value of land is diminished as a result of planning decisions. But, the compensation issue is central to the problem of government accountability in its willingness to use the discretionary authority outlined in the Town Planning Ordinance.

Moreover, the economic impact of weakening property rights can be significant. As planners and the planning authority use their discretionary powers to restrict development, the expected values from development will fall, lowering lease prices. This will be particularly important if the government continues to sell leases under one set of conditions only to be varied (often reducing the value of the lease) by another division of the government. These impacts may be mitigated by the allowance of grace periods. But, grace periods are not a consistent part of government policy.

The issue of compensation for adverse planning decisions is a historically contentious one in Hong Kong, but has been largely muted in recent history since the government encouraged rapid development. But, the stability of land development system has been compromised and, with the proposals for reform introduced in the Consultative Document, the issue of compensation has emerged as one of the most salient concerns in the development community. Many see the reforms in the planning system as another step in the weakening of property rights and a move away from a market-orientation in land use development. In at least three cases -- Kwai Chung, Tsuen Wan, and the Mid-levels -- the government has exercised its discretionary power of land use without heed to the financial and economic burdens that resulted from those decisions.

In the case of the Mid-levels, the government allowed a grace period in which developers could submit building plans and develop land according to the old planning guidelines (at a plot ratio of 8 instead of the newly imposed limit of 5). Most developers were

able to submit their building plans and obtain approval for construction within the grace period, making the issue of compensation moot.

The case of Tsuen Wan, however, raises more disturbing issues. The government negotiated land sales and collected premia on land for redevelopment allowing plot ratios up to 15. Within weeks, the planning department, acting independently of the government's land sales department, reduced the plot ratio to 9.5 (almost a 40 percent reduction in development potential). Legally, the government cannot be compelled to compensate the landowners even though the negotiations over land premia occurred at the same time the planning department was considering the plot ratio reduction.

Indeed, some government officials believe planning changes that affect the market value of property should be evaluated by property developers in the same way developers anticipate changes in the market. Property values rise and fall according to trends in regional and world-wide economic trends, producing uncertainty in the property market. Changes in land-use restrictions should be viewed simply as another element of uncertainty in an uncertain investment climate.

Yet, planning restrictions impose permanent costs on private developers while markets typically rebound after a period of contraction. Thus, planning restrictions constitute a permanent restriction on permissible development. Many developers view the trend toward more liberal use of planning guidelines (in OZPs and DPAs) to restrict development as a break-down of the contractual nature of development. While the government will require developers to pay land premia to redevelop land, the government is not required to uphold its side of the implied contract.

Moreover, restrictions on land use can be extremely costly to developers. These losses will be reflected in future market prices for land as the government pursues a more discretionary and interventionist planning policy. Moreover, these losses will be magnified if developers believe the government is working at cross-purposes: one branch negotiating the sale of leases without knowledge of another branch's impending restrictions on future development. Inconsistency in government policy will further increase the randomness of the planning process, reducing the value of land in Hong Kong for developers and lowering the overall level of investment by property developers.

The losses that can occur from land-use regulation can be substantial for property markets. In fact, the economic burden of losses due to regulatory changes can be substantially higher than the costs associated with delays in the plan application process that result from citizen participation and increased public involvement. This is why a solution to the issue of compensation is crucial to maintaining stability in property markets. If planners exercise their authority over land development and impose substantial costs on property developers, property markets will react adversely. This discretion will be interpreted as an erosion of property rights since developers will be less certain about the potential uses their property can be used for and will be subject to the whims of land-use planners. This, in turn, could substantially compromise confidence in Hong Kong property markets.

Compensation is an important element of the land development process since it holds the public sector accountable for the economic impacts of adverse decisions. If the public sector is released from any obligation to calculate the costs of its decisions, public officials and planners will be more inclined to use their regulatory authority to impinge on property markets, redirect investment, and disrupt the development process. In essence, without compensation, an important instrument of political and government accountability would be destroyed in Hong Kong and, if the government exercised its powers to alter land-uses according to planning principles without regard to the resultant economic costs, the certainty and the stability of the local property market may be significantly compromised.

The potential impact of the proposed changes to Hong Kong's town planning ordinance are not trivial. While many believe several benefits will accrue to the territory through the adoption of the proposals in the consultative document, the impacts will reverberate beyond the offices of planners, planning consultants, government officials, and developers. For this reason, it is imperative that the government should take into account the following considerations when considering changes to the Town Planning Ordinance:

1. Design a development application process that avoids unnecessary delays. This can be achieved by designing a plan application system that presumes development is beneficial to the economy and Hong Kong society by limiting the time the planning board can deliberate on an application and refuse it. Rather than introduce a system (e.g., as in Australia or the United Kingdom) where the application is presumed refused if the planning authority does not act on it, Hong Kong should implement a system where the plan application is automatically approved unless the planning board explicitly rejects the application. This would shift the presumption in favour of development and provide incentives for the planning board (and other public officials) to avoid unnecessary delays in processing applications.

2. Clearly define the scope and interests of objections to planning applications. The system as it is currently outlined in the Consultative Document is vague and extremely open. Objections should be limited to parties directly affected by the development and limited to a well-defined list of bad neighbours identified by the Town Planning Board and Planning Authority. This would substantially reduce the random nature of the uncertainty implied in the proposed reforms.

3. Limit objections to the plan making process. Public involvement is most likely to be productive in the early stages of planning. Citizen participation in the plan application process will create costly delays that could be pre-empted in the plan-making stage of developing OZPs and DPAs. This would allow planners to provide more certainty in property markets by maintaining much of the stability in the current plan application process.

4. Adopt a system of compensation that preserves the contractual nature of property development in Hong Kong. The success of the Hong Kong system depends on the stability and security of a system that is a product of evolutionary, rather than radical, change. A system of compensation and betterment anchored to a clear recognition of property rights and the economic costs imposed by regulation is an important element of this relationship.

Compensating property owners for adverse planning decision would reinforce property rights and provide a formal mechanism for their protection in the development and planning process.

5. Subject planning decisions to an economic impact analysis. While the consultative document acknowledges the importance of environmental impact statements, it overlooks the economic costs that may be imposed by regulation. Many decisions, such as reducing plot ratios in areas experiencing high demand, may be too costly to implement given the trade-offs and alternative means for achieving intended goals. This report is, in part, an attempt to subject planning decisions and recommendations to more rigorous analysis that incorporates economic issues and problems. This perspective should become a routine element of plan analysis and development.

6. Eliminate or substantially revise the planning certificate procedures. Diversity, flexibility, and adaptability are essential in Hong Kong's economy and will be compromised if the planning certificate is used its purpose should be to force developers to conform to narrow planning concerns with respect to design, aesthetics, shape of accommodation, or other subjectively determined criteria. In essence, the planning certificate should be used merely to indicate compliance with the OZP or DPA existing at the time of development. To the extent the planning certificate is used to delay development, the economic costs will be significant while producing few clear benefits.

Conclusion

It has often been alleged that housing markets are characterized by market failures arising from neighbourhood effects. The nature of housing is such that the value of a property depends not only on its own attributes, but also on the characteristics of the neighbourhood it is located in. Since anyone who invests in housing development will generate benefits that would accrue to others, there is a presumption that the free market will not provide adequate housing. Economists call this the problem of negative externalities.

This is the classic justification as to why governments should intervene in housing and land markets. The case is further strengthened by moral concerns that in a civilized society no one should be deprived of basic shelter. Those who live in a society that fails to house all its population adequately is unlikely to find it a safe place to be in. For this reason, governments all over the world have been heavily involved in the controlling, regulating, and providing housing and land.

Hong Kong's experience has demonstrated that the failures of government can be just as bad, and often with even more damaging consequences. The enormous waste and injustices of the public housing program is alarming, and is especially so when one considers that it did not even succeed in providing more housing for the Hong Kong population than the free market alternative. Rent control have exacerbated building cycles by alternately delaying or advancing development leading to untold miseries.

On the other hand, the absence of an interventionist approach to planning and land use have allowed Hong Kong's land and property development to keep up with its rapid economic

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Published in *The Other Hong Kong Report* : 1992, Chinese University Press, Hong Kong 1992 pp. 309-350

growth and changing economic structure. The security of contractual arrangements have made it possible for developers to build massive private residential developments with some 8000 units, containing community facilities, transportation services, and commercial areas. These massive developments are able to create a controlled environment and minimize neighbourhood effects. The fact that units in such developments can command a much higher price than those in stand alone structures is clear evidence that market failures can be overcome through voluntary private initiatives. Economists have a fancy name for this phenomenon - the Coase Theorem - named after the recent Nobel laureate in economics Professor Ronald Coase.

Market failures may have been exaggerated, but government failures have not. Recent policy initiatives in housing and land development should be received with Hong Kong's past experience in mind.