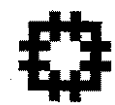
Fifty Years of Public Housing in Hong Kong

A Golden Jubilee Review and Appraisal

Edited by

Y. M. Yeung
and
Timothy K. Y. Wong



Hong Kong Housing Authority

Hong Kong Institute of Asia-Pacific Studies

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ISBN 962–441–558–7

Published by
The Chinese University Press

For the
Hong Kong Housing Authority
Hong Kong Institute of Asia-Pacific Studies

THE CHINESE UNIVERSITY PRESS
The Chinese University of Hong Kong
SHA TIN, N.T., HONG KONG
Fax: +852 2603 6692
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E-mail: cup@cuhk.edu.hk
Web-site: www.chineseupress.com

Printed in Hong Kong

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Richard Y. C. Wong

Introduction

The policy to sell part of the existing stock of public rental housing (PRH) units was first announced by the Chief Executive of the Hong Kong Special Administrative Region (HKSAR) government in his Policy Address in October 1997. On Monday, 8 December 1997, the Hong Kong Housing Authority (HA) proposed a Tenants Purchase Scheme (TPS) to sell 250,000 units over a 10-year period.

The onset of the Asian financial turmoil in 1997 and the subsequent world economic recession of 2001 led to a double-dip economic recession in Hong Kong. This sent property prices plunging by more than 65% from their peak in 1997. The accumulated consumer price deflation of the past four years is over 12%, of which about 57% is due to the decline in property prices. With a public languishing in negative net worth after the collapse of property prices, widespread concern emerged over the large supply of PRH and Home Ownership Scheme (HOS) units that were being produced and brought into the market.

The TPS was blamed for being one factor contributing to the fall in property prices. On 13 November 2002, the Secretary for Housing, Planning and Lands announced nine new housing policy measures that re-emphasized a diminished role for the government in the housing market and a return to free-market principles. Included in those nine measures was the decision to terminate the TPS, four years after it had been introduced.

While most of these nine measures are appropriate, the decision to halt

the TPS is debatable. There were many good reasons for introducing the TPS in the first place. From an economic perspective, the most important reason is the inefficiency and inequity of the PRH programme. Did the TPS contribute to the decline of property prices in 1997? If so, in what way?

Private property in Hong Kong is far more affordable than it has been at any time during the past two decades, and instalment payments on mortgage loans are now lower than rents. Nevertheless, market sentiment remains weak. Why has confidence in the property market evaporated so dramatically? The blame for the depressed state of the property market has been laid in many directions. Wong (2002) argued that one factor that has been largely neglected in most public discussions — the creation of the HOS secondary market in 1997 — has caused a great deal of damage.

The emergence of the HOS or HOS/TPS secondary market has undermined the functioning of the private property market. The creation of two separate markets, one subsidized and the other unsubsidized, has altered the foundations of the property market and severely depressed market sentiment over the longer term. The structural malaise in the property market today stems from decisions made by the HA with the best of intentions but without a full appreciation of the consequences.

This chapter provides an analysis of the case for introducing the TPS initiative, its shortcomings, its role in contributing to the depressed state of the private property market, and suggestions on how the TPS initiative can and should be revived in a modified form in the future.

Failures of Public Housing Policy

There are 640,000 rental units and 356,000 home-ownership units in Hong Kong's public sector. Together they constitute 50% of the entire housing stock. Approximately 60% of the total annual supply of new housing units in the past 10 years has been supplied by the public sector. This massive public housing sector is the greatest source of economic inefficiency and inequity in the community.

The PRH programme in Hong Kong provides an in-kind transfer to eligible households. A subsidy-in-kind does not allow the household to select a housing unit on the open market. Such a choice would only be available if the subsidy were in the form of a cash grant made through an income subsidy or a housing voucher. Under the PRH programme, a household is allocated a flat on the basis of the HA's assessment of its

housing requirements. The household is charged a rent that is about a quarter to a third of the market level. Tenants are given little choice with respect to location, size and other characteristics of the housing unit that they are assigned. The typical unit is built according to a standard set of designs that offer a limited range of choices. The flat provides the household with a range of housing services.

The rent charged for PRH units is lower than the market-level rent, hence the subsidy. The difference between the market rent and the rent charged by the HA is the gross subsidy provided to households. The gross subsidy is the cost society has to pay for the PRH programme. From an economic point-of-view, the gross subsidy is the opportunity cost to society of not using the land to develop housing that can be sold or rented out at market rates. If the subsidized rent is one-third of the market rent, then society is providing the remaining two-thirds as a subsidy. In other words, the subsidy provided by society is twice the subsidized rent.

Contrary to what many people think, the cost of the PRH programme is far more than the sum of the construction cost of the buildings, the land formation cost, the interest cost, and the administrative and management cost, minus the rent charged by the HA.

Under the PRH programme, a household must stay in the flat that the HA has assigned it in order to secure the subsidy. Suppose the household were given an income or rental subsidy equivalent in value to the gross subsidy spent on the public housing programme. Would the household choose a private unit on the open market similar to the flat assigned by the HA? Most likely not. The private unit the household would choose could be either a better or a worse unit than the one provided by the HA. This difference in choice reflects an underlying economic inefficiency. That is why the net subsidy received by the household may be different from the gross subsidy provided by the public housing programme. In other words, given that society has decided to provide a housing subsidy, it would be better for the recipient if he or she could have the freedom to choose his or her preferred unit. To the extent that households have different preferences, it is inefficient to force them to consume exactly the same housing bundle. This is why economists believe that transfers-in-kind are inferior to cash transfers.

Empirical studies conducted in numerous countries demonstrate that public housing programmes of the kinds that exist in Hong Kong are enormously inefficient and wasteful (see Aaron and Furstenberg, 1971; DeSalvo, 1971; Olsen and Barton, 1983; Clemmer, 1984). Such programmes

result in a significant misallocation of resources and cause a distortion in consumption patterns, and may sometimes even worsen income distributions. In a previous study, Wong (1998) estimated the annual efficiency loss to be between 0.5% and 1% of gross domestic product. He also found that the population would on average consume more housing services if the subsidies were in the form of cash rather than bricks and mortar.

Inefficiency of the Public Rental Housing Programme

Wong and Liu (1988), Wong (1998) and Yan (2000) have estimated the level of gross subsidies provided by the government per household and the level of net benefits enjoyed by the PRH tenant household. The degree of efficiency of the public housing programme can then be calculated. Yan (2000) estimated these figures from the Population Censuses for the period 1976–1996; they are reported here for interest. Table 13.1 also presents estimates of average household income, gross subsidy, net benefit and the efficiency ratio of the programme.

The gap between the gross subsidy granted and the net benefit received is enormous. The efficiency of the programme can be assessed with reference to the efficiency ratio defined as the ratio of net benefit to gross subsidy. A fully efficient programme will have an efficiency ratio of 1. Yan (2000) found that the efficiency ratio varied between 0.6098 and 0.7480 in the period 1976–1996. These estimates mean that for each dollar the taxpayer spent on the PRH programme, the tenants deemed only 61 to 75 cents worth of housing services valuable. The remaining 25 to 39 cents were deemed wasted because of resource misallocation. In other words, an enormous amount of resources was wasted. The efficiency of the programme improved

Table 13.1 Gross Subsidy and Net Benefit per Household, and the Efficiency Ratio of the PRH Programme, 1976–1996

	Average Household Income ($)	Gross Subsidy per Household ($)	Net Benefit per Household ($)	Efficiency Ratio
1976	1,559.86	398.93	243.25	0.6098
1981	3,374.17	558.51	351.24	0.6289
1986	5,679.78	1,166.95	872.91	0.7480
1991	10,072.19	1,695.86	1,231.20	0.7260
1996	16,547.25	2,970.72	2,089.34	0.7033

Source: Yan (2000).

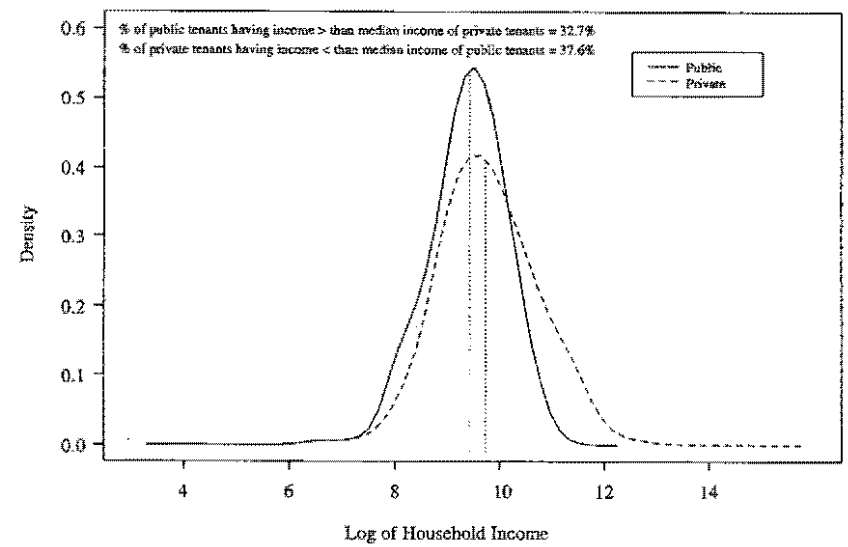
considerably over the period 1976–1996, after the government reduced PRH subsidies by lowering the discount on public sector rents.

Inequity of the Public Rental Housing Programme

Unfortunately, this massive redistribution of housing resources has not improved equity in any significant way. Figures 13.1 to 13.4 compare the income distributions of households in the public and private sectors, respectively, for tenants and homeowners in 2001Q2 and 2002Q1. These figures show that the income distributions of households in the public and private sectors are essentially similar, except for the extreme end of the upper tail.

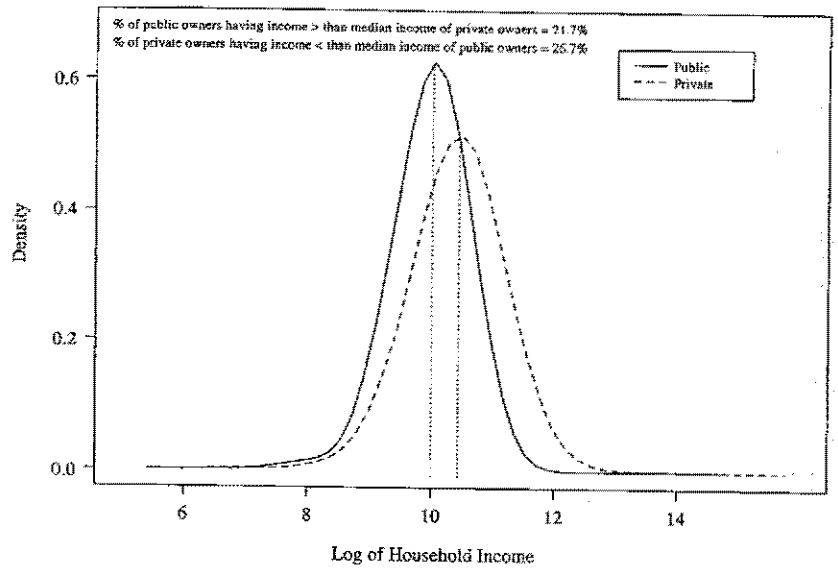
This is a serious indictment of our public housing policy — that it fails to target scarce public resources at the lowest-income segments of our society. These resources are apparently redistributed to broad segments of society, resulting in seemingly random outcomes. One consequence of such a distribution is that the demand for housing among households in the public sector and those in the private sector are likely to be quite similar (Figures 13.1 to 13.4).

Figure 13.1 Income Distributions: Public vs. Private Tenants, 2001Q2



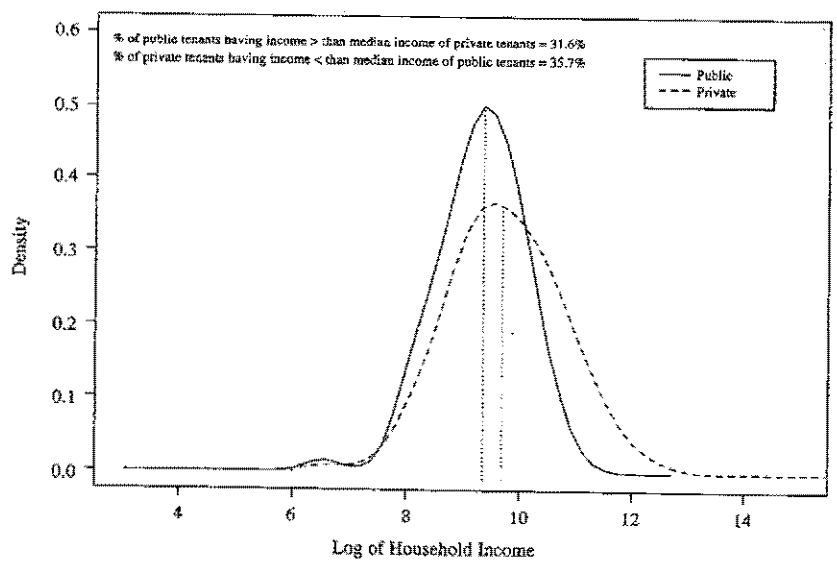
Source: General Household Survey data.

Figure 13.2 Income Distributions: Public vs. Private Owners, 2001Q2



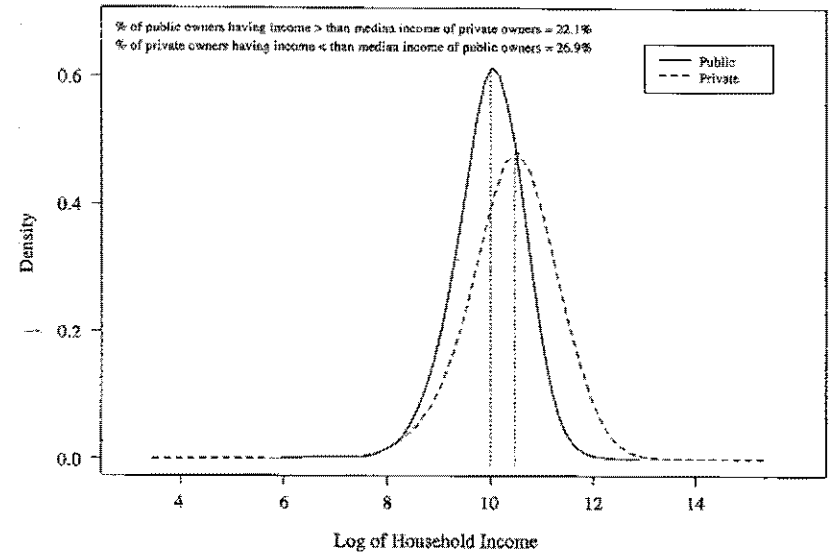
Source: General Household Survey data.

Figure 13.3 Income Distributions: Public vs. Private Tenants, 2002Q1



Source: General Household Survey data.

Figure 13.4 Income Distributions: Public vs. Private Owners, 2002Q1



Source: General Household Survey data.

Consequences of Incomplete Public Housing Reform

The public is now better aware of the inefficiencies and inequities of the PRH programme. Numerous attempts to reform the sector have been made. The double-rent policy, the tightening of asset and income eligibility criteria for existing tenants, the provision of loan schemes as alternatives to the direct provision of housing units, measures to relax transfer restrictions, and numerous other measures have been introduced to enhance efficiency and equity within the public housing sector. The word "within" should be stressed because these policies focused on the interests of the HA's own constituencies, and do not take into consideration their impact on efficiency and equity for society as a whole.

Consequently, these measures were undertaken with no consideration for or understanding of their possible effects on the wider market. Among all of these measures, the creation of a secondary market in HOS/TPS units has had serious unintended consequences that have significantly increased uncertainty in the private property market. It has also distorted the effects of the TPS initiative.

Home Ownership Scheme Secondary Market

Prior to 1997, HOS units could be traded on the open market,[1] but any gains from subsidized land premiums had to be returned to the HA. With this restriction in place, there was little incentive for owners of HOS units to sell their units on the open market, and they seldom did. In 1997, a secondary market for HOS units was created as a result of the partial relaxation of transfer restrictions on HOS units. The secondary market allowed owners of HOS units to sell their units without having to repay the subsidized portion of the land premium to the HA. This increased the attractiveness of HOS units enormously for existing and prospective owners, as it provided them with a previously unavailable opportunity to trade their units at a discounted price that they could easily afford. Eligible households, constituting approximately 50% of all households in the population, could trade in this market. A fairly active HOS secondary market was soon created. The size of this market will grow over time as more existing HOS units become eligible for transfer. The creation of the HOS secondary market has made HOS and private housing units closer substitutes for each other, and most likely has had a significant effect on the decline in demand for private housing units.

Recent attempts to tighten income and asset eligibility criteria for applicants of HOS units will only affect prospective owners, not existing owners. Since the latter are far more numerous than the former, the negative effect on the private market will remain substantial. The problem will be further exacerbated if old sites in the urban areas under the HA are redeveloped into new HOS estates. The locations of these estates are extremely attractive. The supply of new HOS units in desirable sites will further augment the quality of the units in the HOS secondary market, and these units will compete with private housing units in the future.

The HOS secondary market was a well-intended policy to provide a means to partially free up "locked-in" land resources among eligible households. These households were, therefore, provided with an alternative market in which to trade units at a discount. Units in the HOS secondary market and those in the private housing market may not be perfect substitutes for each other because of differences in quality and discounts on land premium. These differences, however, have narrowed considerably after the collapse of prices in the private property market and the overall improvements in quality of HOS units.

Tenants Purchase Scheme

The TPS called for the sale of PRH units at highly discounted prices. In principle, it should have had a positive effect on wealth and increased the demand for housing, including private housing. The TPS was, therefore, a potentially market-boosting policy. Unfortunately, the opposite occurred largely because other measures were introduced with the Scheme at the same time.

First, sitting tenants who had acquired TPS units at a considerable discount were allowed to apply for HOS units within 10 years, as White Form applicants. This meant that at least 250,000 households in PRH units were enticed to wait out the 10-year period to acquire, first, their TPS units, and then to apply for an HOS unit. The creation of the HOS secondary market in 1997 transformed HOS units into an attractive market commodity. These measures together killed off any incentive for prospective TPS beneficiaries to plan future home purchases in the private market. The TPS was clearly a success, as judged by the high take-up rates, but it led to a serious negative knock-on effect on the private housing market. The real damage to the private housing market was not the immediate loss of buyers from among the ranks of prospective TPS households but the fact that these buyers were expected to leave the private housing market more or less permanently.

The change in behaviour was reflected in the dramatic drop in the number of successful Green Form applications for HOS units in the years following 1997. In 1997, about 74% of new HOS units were sold to Green Form applicants; in 2001, however, White Form applicants took ownership of approximately 68% of these units (Table 13.2). Given the large supply of new HOS units coming onto the market, the HA was effectively competing with the private housing market for buyers.

The sale of PRH units at a discount would not have resulted in the negative knock-on effect that has just been described had it not been for two measures: (1) the option to allow TPS buyers to re-apply for HOS units as White Form applicants within 10 years, and (2) the creation of an HOS/TPS secondary market. The sale of PRH units could, in fact, have created a positive wealth effect.

TPS units can only be transferred on the open market after five years, but the owners must return to the HA any gains from the discounted land premium. As with owners of HOS units, there is really no incentive for owners of TPS units to sell their units on the open market. Had the HA sold

Table 13.2 Green Form and White Form Applicants to the HOS, 1978–2002

	HOS/PSPS Units Sold			Successful Green Form Buyers (%)	Subscription Rate[1] (times)
	Total	White Form	Green Form		
1978	8,373	4,552	3,821	46	4.3
1979	1,506	753	753	50	38.4
1980	3,574	1,784	1,790	50	22.9
1981	3,859	2,082	1,777	46	12.2
1982	6,612	4,548	2,064	31	10.8
1983	9,460	7,015	2,445	26	4.3
1984	14,789	9,041	5,748	39	4.1
1985	19,634	9,104	10,530	54	5.8
1986	9,588	4,375	5,213	54	18.1
1987	12,242	5,863	6,379	52	15.0
1988	15,903	6,191	9,712	61	13.2
1989	17,361	7,349	10,012	58	13.8
1990	17,646	6,083	11,563	66	8.2
1991	18,620	6,232	12,388	67	11.0
1992	20,792	7,246	13,546	65	10.7
1993	15,798	6,799	8,999	57	14.1
1994	13,462	4,434	9,028	67	14.6
1995	13,026	4,351	8,675	67	10.1
1996	10,564	3,010	7,554	72	9.9
1997	27,259	6,995	20,264	74	10.6
1998	17,087	7,812	9,275	54	7.0
1999	17,687	8,575	9,112	52	4.8
2000	3,954	2,782	1,172	30	7.3
2001	16,193	11,145	5,048	31	2.9
2002	1,361	830	531	39	2.1

Note: 1. From 1999, White Form applications from single people are being accepted for HOS and Private Sector Participation Scheme (PSPS). Excluding single people, the subscription rates in 1999, 2000, 2001 and 2002 are 4.2 times, 3.3 times, 1.6 times and 1.4 times, respectively.

Source: Statistics Section, HA.

all 250,000 units with immediate transferability on the open market, and had it not required owners to return the gains from the discounted land premium, this would have produced a huge stimulating effect rather than a dampening effect on the private housing market.

It is not the sale of PRH units as such, but rather the specific provisions of the TPS design and, crucially, the creation of the HOS/TPS secondary market that produced the negative knock-on effect. To make matters worse, the HOS building programme was not reduced commensurately with the introduction of the TPS and the creation of the HOS/TPS secondary market.

The Simple Economics of Two Housing Markets

Before the introduction of the HOS/TPS secondary market, public sector housing units were non-transferable; therefore, a market for public sector housing units did not exist. Households in the public housing sector could not trade their units in any way. Every household in that sector was basically locked into its original unit. Only private sector housing units could be transferred, and the private housing market constituted the only housing market in the system. Without transferability, the effect of the public housing programme on the private housing market was limited to the supply side (i.e., the annual supply of public sector units). With transferability, a huge stock of units in the public housing sector was liberated, and the result was an enormous impact on the private housing market. The scale of the stock effect is many times larger than the changes in the annual supply.

The HA reforms created a new secondary market that is distinct and separate from the existing private housing market. The introduction of various financial subsidies and the partial easing of transfer restrictions has meant that a large proportion of the entire stock of housing units in the public sector is now transferable on the new HOS/TPS secondary market among eligible households. The introduction of the TPS in 1998 will further increase the future supply of units on the HOS/TPS secondary market. Over time, this secondary market will continue to grow as new HOS units are constructed, more existing HOS units become transferable, and more TPS units are sold and become transferable (Table 13.3).

The distribution of the household income of tenants and homeowners in the private housing sector is not significantly different from the public housing sector. This guarantees that the demand for private and public units will overlap almost totally. Economics tells us that when there are two

Table 13.3 Estimated Stock of Units in the HOS Secondary Market, 2000–2004F

	2000	2001	2002	2003F	2004F
Total	244,789	262,109	305,242	336,389	355,339
HOS/PSPS/FFSS	226,197	230,151	245,617	260,782	262,233
TPS	18,592	31,958	59,625	75,607	93,106
Units sold for over 2 years but less than 5 years	80,625	70,686	96,732	91,600	93,230
Units sold for over 5 years	164,164	191,423	208,510	244,789	262,109

Note: FFSS: Flat for Sale Scheme.

Sources: HA; Rating and Valuation Department (2001).

markets — one subsidized and the other unsubsidized — that overlap considerably on either the demand or the supply side, the subsidized market will drive out most of the activity in the unsubsidized market.

The HOS/TPS secondary market has created awkward and perverse incentives. First, financial subsidies are provided on the demand side. Second, the market has a monopolistic-like developer that collects sales revenues on the supply side to provide financial subsidies on the demand side. Moreover, this developer operates under all sorts of constraints and non-market considerations in setting prices and determining output. Similar considerations are present when it sets financial subsidies for loans and determines the quantity of loans, as well as when it sets rents for PRH units. Decisions are, therefore, likely to be highly political. Clearly, the decisions made by the HA with respect to the public housing sector will have consequences for the private housing market. The HOS/TPS secondary market guarantees that the effects will be amplified many times. This means considerably more uncertainty for the housing market.

As the HOS/TPS secondary market continues to grow, HOS and TPS units will become increasingly attractive as an alternative to private housing units because of their transferability in the secondary market. This will create a powerful disincentive for households to exit the public sector and enter the private sector. The trading-up ladder that was previously present has now been largely eliminated. It is important at this point to recall that the income distribution of private-housing-sector tenants and homeowners is virtually identical to that of tenants and homeowners in the public housing sector. This similarity not only kills any incentive to move from the public sector to the private sector but also provides powerful incentives for those in the private sector to move to the public sector.

Under this new situation, the public and private housing sectors are linked not only through annual supply flows, but also on the supply and demand sides in terms of both annual flows and a large proportion of the total stock. When such broad stock and flow linkages on both the demand and supply sides are permitted, it will no longer be possible to keep these two sectors separate.

On Recreating a Single Housing Market

The creation of a separate market for public sector housing units made it possible for many public housing tenants and homeowners to address one of their most pressing housing aspirations — to change their residential

location within the territory. But the demand for private housing units was immediately negatively impacted as a consequence. While the creation of a market mechanism for facilitating the transfer of public housing units constitutes an improvement over the earlier situation, it has inevitably had spillover effects. The current lack of activity in the private housing secondary market is primarily a reflection of the breakdown of the trading-up effect created by the HOS/TPS secondary market. It is, therefore, not surprising that the private housing market is so inactive even though prices are low and yields are high. The only significant activity is that in the primary market for new units.

Public housing reforms must be designed to create a single housing market rather than two separate markets. Unifying the two markets as soon as possible is a policy matter of the utmost importance. It will, moreover, be relatively simple to achieve. Two things have to take place to make it happen. First, the TPS must be reinstated. It is desirable that the scope should be enlarged to embrace more than the originally planned 250,000 units to the entire PRH stock, if at all possible. Work on preparing the documentation could be made well ahead of time so that the entire stock could be transferred within a short period of time, rather than over a protracted period of 10 years as in the past.

Second, a critical issue is to enhance the incentive for owners of HOS and TPS units to trade on the open market. This can be accomplished by reducing the amount of the subsidized land premium that has to be returned to government when a unit is sold. If half of the discounted land premium has to be returned, there will be a strong incentive for HOS and TPS households to pay back the land premium and the two markets will then become unified. Once such a measure is announced, prices in the HOS/TPS secondary market will immediately reflect the enhanced value of HOS and TPS units, as households will no longer be willing to trade units at prices that fail to reflect the reduced land premium.

It is in the interest of all parties to offer such discounts to HOS and TPS homeowners. Doing so is a simple way to stimulate consumption and investment activity through an injection of property wealth. Moreover, the decision to unify the two housing markets would eliminate an important source of uncertainty in the marketplace. If public sector homeowners never sell their units on the open market, the government will never be able to collect this future income stream. Since the land has no alternative use under the present arrangement, the net loss to the government may be very limited and may even be positive if the land can later be redeveloped through the private market for a higher valued use.

The notion that such a measure would be unfair to citizens who have never benefited from any form of public housing support is a mistaken one, because the benefits of using the units have already been transferred to the owners (and also to the renters). The owners would merely have the added freedom and opportunity to realize these benefits at a time and in a form they chose, rather than being compelled to consume their value in kind and over a very long time horizon. This will also make it possible for the HA to collect part of the subsidized land premium, which they would otherwise be unable to realize more or less permanently.

If all HOS and TPS units could be sold on the open market, then a total of 996,000 units would be integrated within a single housing market. Such a measure would allow society to realize an estimated $250 billion in wealth. These new homeowners would capture half of this wealth, and the other half would go to the government in the form of paid-up land premium. This would go a long way towards recapitalizing our economy and helping the growing fiscal deficit. The measure would cost society virtually nothing, given that the occupied land has little alternative use under present regulations.

Such measures will not affect the continuation of public policies aimed at assisting qualified households to become homeowners. With the suspension of the HOS programme, the continuation of a public policy to subsidize home-ownership can be achieved through the more cost-effective loan subsidy scheme rather than via a bricks-and-mortar approach. The PRH programme may still continue to exist to help society's truly needy. However, wherever possible, a subsidized rental scheme should be relied upon to provide qualified households with better choices. A thriving private rental market is a better solution for restoring long-term stability to the housing market.

Note

1. The 10-year resale restriction period was shortened to five years in June 1999.

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