Public Housing Reform and Its Effects on the Private Housing Market

Y. C. Richard Wong
The University of Hong Kong

Introduction

Ever since the onset of the Asian financial turmoil, Hong Kong's public housing policy has come under considerable criticism. At the heart of the matter is the depressed state of the private property market. With a public still languishing in negative net worth after the collapse of property prices, it is not surprising that there is widespread concern over the large supply of public housing units in the pipeline. The Chief Secretary announced on October the decision to suspend the sale of Homeownership Scheme (HOS) units for 10 months. Meanwhile a review of the long-term policy on public housing is being conducted.

Many factors have been blamed for the current state of affairs. First, the negative wealth effect from the collapse of property prices has continued to exercise a dampening effect and to sap confidence. Second, the success of the Housing Authority since 1995 to build up land reserves to develop Home Ownership Scheme (HOS) units received fresh impetus from official policy announced in 1997 to provide 85,000 units each year. The large supply of Home Ownership Scheme (HOS) units is clearly crowding out private housing demand in a slow property market. Third, the recent slowdown of the global economy and the shocks of the terrorist attacks in the United States have further weakened sentiments despite declining interest rates. Fourth, the perceived structural adjustments required in the labor market to maintain Hong Kong's competitiveness in the global marketplace have added to fears of cyclical unemployment. Fifth, cheaper housing available across the border in Shenzhen may provide homeowners with another choice.

Today home ownership is far more affordable than at anytime in the past two decades and it is cheaper to pay mortgage loans than rentals. Nevertheless market sentiments remain weak. It appears that long-term considerations are depressing market sentiment to an extreme extent. Why has confidence evaporated so totally? Can it be due solely to the five factors listed above?

Nobody really knows, but I believe a neglected factor in the entire discussion is probably as important as all those factors that have been put forward, if not more so. The creation of the HOS secondary market in 1997 played a critical role to undermine the operation of the private property market. The creation of two separate markets, one subsidized and the other not, altered the foundations of the property market in the most damaging way.

The structural malaise in the property market today stemmed from decisions taken with the best of intentions, but without fully appreciating their combined consequences.

The Failures of Public Housing Policy

There are 645,000 rental and 300,000 homeownership units in the public sector. Together they constitute 50 percent of the entire housing stock. Some 60 percent of the total annual supply of new units in the past 10 years are in the public sector. This massive public housing sector is the greatest source of economic inefficiency in the community. In previous studies, I had estimated the annual efficiency loss to be between 0.5-1.0 percent of GDP. I also found that the population would on average consume more housing services had the subsidies been provided through cash subsidies rather than through a bricks and mortar program.

Even worse this massive redistribution of housing resources has not improved inequality in any significant way. The following two figures compare the income distributions of households in the public and. private sectors, respectively, for tenants and homeowners in 2001 (courtesy of Dr. Alan Siu). 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 the failure of our public sector housing policy to target scarce public resources at the lowest income segments of our society. Instead they are apparently spread to large segments of society with outcomes that appear to be random.

Figures 1 & 2

Retreating from Bricks and Mortar

Recent public housing policy emphases have gradually shifted away from the direct provision of housing units as the only means to subsidize housing consumption. Various loan schemes and the partial easing of transfer restrictions on public sector housing units were introduced to enhance efficiency and equity **within** the public housing sector. I emphasize **within** the public housing sector because those were the primary considerations of the new policies. The measures were taken with no consideration for or understanding of their possible effects on the wider market. They have given rise to unintended consequences and have significantly increased uncertainty in the property market. Let me know provide three concrete illustrations of these changes and explain how they have affected the private property market.

1. The Emergence of the HOS Secondary Market

The first example is the partial relaxation of the transfer restrictions of HOS units. In 1997, the secondary market for HOS units was introduced for units that had been occupied for three years. Eligible households, constituting some 50-60% of all households, could trade in this market. In the HOS secondary market units could be traded without having to return the subsidized portion of land premiums to the Housing Authority (HA). After five years, HOS units could be traded on the open market, but any gains from subsidized land premiums had to be returned to the HA. With such a restriction, there was little incentive for owners of HOS units to sell their units on the open market and they seldom did. The HOS secondary market, however, provided them with an opportunity to trade their units at a discounted price that they could easily afford. This increased the attractiveness of HOS units enormously to existing and prospective owners. A fairly active HOS secondary market was soon created. Over time the size of this market will grow as more HOS units are built and existing units become eligible for transfer.

The HOS secondary market was a well-intended policy to provide a means for a partial freeing up of "locked-in" landed resources among eligible households. These households were therefore provided with an alternative market 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. The differences, however, narrowed considerably after the collapse of the private property market and the improving quality of many HOS units. The dampening effect on the private housing market became increasingly obvious. The problem will be further exacerbated as old sites in the urban areas under the Housing Authority will be redeveloped into new HOS estates. The locations of these HOS units are extremely attractive. The supply of new land on highly desirable sites to build HOS estates in the future will create a further overhang.

Table 1 (SHKP statistics)

2. The Introduction of the Tenant Purchase Scheme

The second example is the Tenant Purchase Scheme introduced in 1998, which called for the sale of 250,000 public rental units over a ten-year period. The sale of public housing at highly discounted prices creates wealth and should increase the demand for housing, including the demand for private housing. Unfortunately, the opposite happened because other measures and restrictions were introduced at the same time.

First, sitting tenants who acquired TPS units at a considerable discount were allowed to apply for HOS units within ten years as a White Form applicant. This meant that at least 250,000 households in public rental housing units were enticed to wait for their turn in the ten-year period to acquire, firstly, their TPS units, and then subsequently to apply for an HOS unit. The TPS was clearly a success as judged by the high take up rates, however, in failing to cut the production of HOS units at the same time, it created a serious indirect knock-on effect on the private housing market. The number of successful Green Form applications for HOS units in the ensuing years dropped dramatically. In 1997, about two-thirds of the new HOS units were sold to Green Form applicants, but in 1999-2000, White Form applicants took up some 60 percent of these units. Given the large supply of new HOS units coming onto the market, the HA was effectively competing with the private housing market for buyers.

Table 2: Statistics on Green & White Form Applicants for HOS 1990-2001

Second, the TPS units could only be transferred on the open market after five years, but the owners must return to the Housing Authority any gains from the discounted land premium. Like the HOS owners there is really no incentive for TPS owners to sell the units onto the open market. Had the Housing Authority sold all 250,000 units with immediate transferability on the open market and without requiring the owners to return the gains from the discounted land premium then it would have produced a stimulating effect rather than a dampening effect on the housing market.

Although the sale of public rental housing might have worsened the property market slump, but the real point is that it need not had been so. The issue is not the sale of public rental units, but that its transfer on the open market was restricted and the HOS building program was not reduced commensurately.

3. Applicability of the Home Purchase Loan Scheme

The third example is the decision in 1998 by the Housing Authority to permit the Home Purchase Loan Scheme (HPLS) to be applied to the purchase of units in the HOS secondary market. Prior to that decision HPLS loans could only be used for the purchase of private housing units. Almost immediately the number of HPLS loans granted jumped from 2742 in 1997/98 to 9482 in the period from 1 April 1998 to 31 July 1999. Moreover in the period from 1 August 1999 to 31 March 2001 some 55 percent of the HPLS loans among Green Form applicants were used to purchase units in the HOS secondary market.

Table 3 Use of HPLS among Green & White Form Applicants

Simple Economics of Two Housing Markets

Under the bricks and mortar approach, public sector housing units were non-transferable, therefore, a market for public housing sector units did not exist. Households in the public sector could not trade their units in anyway. Every household in that sector was locked into their original unit. Only private sector housing units could be transferred and this constituted the only housing market in the system. Without transferability, the effect of the public program on the private housing market was limited to the supply side, i.e., the annual flow supply of public sector units. With transferability, a huge stock of units in the public housing sector was liberated with enormous impact on the private housing market. The scale of the effect is many times bigger than that due to changes in the annual supply .

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

Table 4 Stock of Units in the HOS Secondary Market

We have shown that the distribution of household income of tenants and homeowners are not significantly different between the private and public housing sector. This guarantees that the demand for private and public units will overlap almost totally. Economics tell us that when there are two markets - one subsidized and the other not – and they overlap considerably with each other on either the demand or the supply side then the subsidized market will certainly drive out most of the activities in the non-subsidized market.

The HOS secondary market have awkward and perverse incentive effects. First, financial subsidies are provided on the demand side. Second, the market has a monopolist developer that collects sales revenues on the supply side to provide financial subsidies on the demand side. Moreover, this developer is an avowed non-profit maximizer. How should this monopolist developer set prices and determine output? If it does not seek to set sales prices to maximize profits, how should prices be set? How should it set financial subsidies for loans and determine the quantity of loans? How should it set rents for public rental housing? Obviously this creates a great deal of uncertainty in the housing market. Clearly the decisions taken by the HA with respect to the public sector will have consequences for the private housing market. The HOS/TPS market makes it certain that the effects will be amplified many times. But where is the mechanism to ensure that the decisions taken by the HA will be the right ones for the entire housing market? In their absence, many decisions will lead to unintended outcomes that would not have been foreseen at the very beginning.

As the HOS secondary market continues to grow, these units will become increasingly attractive as an alternative to private housing units because of its transferability in the secondary market. This creates 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 severed to a considerable extent. It is important at this point to recall that the income distribution of tenant and homeowners between the public and private housing sector are almost identical. This 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 into the public sector.

In this new situation, the public and private housing sectors are now linked not only through the annual supply flows, but on the supply and demand sides in terms of both annual flows and a large proportion of the total stocks. 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.

New Section Title

The creation of a separate market for public sector housing units made it possible for many public housing tenants and homeowners to address one their most pressing housing aspirations, i.e., to change their residential location within the territory. The demand for private housing units was immediately negatively impacted as a consequence. While the objective of creating a market mechanism for facilitating the transfer of public housing units is an improvement over the earlier situation, it brings the curse of having created two separate markets with inevitable spillover effects. The current lack of activity in the secondary market for private housing is primarily a reflection of the breakdown of the trading up effect created by the secondary market of public sector housing units.

The reforms should have been designed to create a single housing market rather than two separate markets. It is an extremely important policy matter to unify the two markets as soon as possible. To do so would require a simple act. Enhance the incentive for HOS and TPS units to be transferred on the open market. This can be done by reducing the amount of the subsidized land premium that has to be returned to government. If only 10 or 20 percent of the land premium has to be returned then there will be good incentives for the two markets to become fully united.

I believe that households should be allowed to pocket the full amount of the subsidized premium. Given the considerable reserves that our government has today they can well afford to give up this possible future income stream and allow some of our citizens to capitalize on it. If public sector homeowners never sold their units on the open market, the government would never be able to collect this future income stream. Since the land has no alternative use in its present arrangement, the net loss to the government may be very limited and even reversed if the land can later be redeveloped through the private market to a higher valued use in the future.

The question that this is unfair to other citizens is beside the point given that the benefits of using the unit have already been transferred to the household. The household is merely provided with the freedom and opportunity to realize it at a time and in a form it chooses rather than to be compelled to consume its value over a very long horizon and in-kind. **Moreover, it would also allow society to realize as much as $100 billion dollars in wealth**

for our society, if not more. This would go a long way to recapitalizing our economy at a time when feeling prosperous will be good for our confidence, our entrepreneurial propensities, and our future development. It would take place at no real cost to society given that the occupied land has little alternative use.

The HOS program should be halted. Land made available for the development of new HOS units should be transferred to the private domain. Revenue derived from these land sales would be adequate to provide subsidies to help the population finance property purchases and can fully replace the construction of planned HOS units by the Housing Authority. This is the best time to do it given the considerably deflated prices in the private housing market.

There is a defensible case for continuing to provide subsidized public rental housing units to the genuinely poor. As these tenants become better off economically they should either be required to leave, to pay market rents, or provided with an option to purchase their existing units.