RESTRUCTURING HOUSING ASSISTANCE: BENEFITS FOR HOUSING, BUDGET AND ECONOMY*

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1. Introduction

1.1 Housing policy is in transition. Up until 2002, housing assistance in Hong Kong comprised mainly public rental housing (PRH) – home to some 30% of the population – plus aid for home ownership through the Home Ownership Scheme (HOS), the subsidized sales of PRH units to tenants, and the subsidized home loan scheme. Also, home mortgage interest has been deductible from taxable income. All the above benefits, however, embodied substantial inefficiencies in the use of resources.

1.2 Since 2003, on grounds that home prices had fallen sharply, the programmes for assisted home ownership have been discontinued. This is coupled with efforts to make the PRH system more efficient.

1.3 As an alternative, these authors have proposed replacing *all* forms of housing assistance to date with a system of allowances, matching actual income shortfalls, for households to rent or buy homes at their option from the market. There would be substantial benefits for housing and welfare, the property market, public finance, and the economy.

* *This paper has been revised periodically since first written in February 2002. Any future updates would be posted to the website* www.hongkongbetter.com*, as are related articles by these authors.*

2. *Mismatched resources, curtailed option*

2.1.1 Subsidized housing, i.e. the government-built HOS and PRH, with their perceived lower quality and apparent zero land cost, might have given the impression of being money-savers for the public purse. The fact is, in subsidized housing as well as all other forms of housing assistance to date, resources were, and are, "mismatched", i.e. their purposes could be achieved with less resources by other means Five types of mismatch are identified below.

2.1.2 Disparaging incidents reported from time to time about subsidized housing, including instances of major defects in construction, suggest that the private sector could do a better job. In general, subsidized housing give the impression of being lesser in quality, design, choice and social standing relative to private housing. Hence the public appears to place a significantly lower valuation on them, e.g. when prices fetched by HOS flats are compared with private sector units nearby. Operation-wise, one would also suspect public sector housing to be less efficient than private sector housing, e.g. PRH are said to have high operating costs.

2.1.3 Secondly, there were cases of allocation of luxury-class land for subsidized housing that could be located more cheaply elsewhere. More generally, mismatch between land value and land use inevitably arises where government, rather than the market, performs the allocation.

2.1.4 The third and most prominent type of mismatch is that, in all the above forms of housing assistance, stipulated benefits as a whole exceeded actual needs. This arose mainly out of what might be called the "single income ceiling" principle, viz. that all households below a certain income limit receive the same measure of aid[1]. Actual need differs widely, however, between the recipient household which is, say, just $1 short of being able to fully afford private housing, and the household which truly needs every dollar of aid. On average, therefore, the extent of mismatch of resources should be close to one-half.

2.1.5 In the case of PRH, though, this "50%" mismatch applies only to those not-so-low income tenants, as many do need every dollar of the benefit. Currently, for PRH overall, the extent of this category of mismatch appears to be less than one-quarter[2]. A look at Appendix A would make this clear.

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[1] For example, the income limit for PRH units for 4-person households is $14,300 monthly. The inference is that those with incomes above this level are considered able to afford to rent private housing after paying for non-housing expenditures.

[2] The percentage of mismatched resources in respect of PRH benefits has been low recently because housing costs have been low relative to other prices and incomes generally, so that DA in Appendix A is modest relative to OD. Upon DA increasing relative to OD, the proportion of mismatched benefits would rise, but would in any case be under 50%.

2.1.6 In reality, mismatch has exceeded the proportions mentioned in the last two paragraphs, because better-off families can afford to opt for larger flats and as a result receive higher amounts of benefit for them to do so[3]. That benefit might be, taking the HOS as example, a discount that historically ranged between 30% and 60% of the price of the flat.

2.1.7 For concessionary PRH sales the mismatch between actual needs and stipulated benefits was due also, eminently, to the simple fact that prices and terms of sale were so favourable. The units, no down payment required, would be fully paid for by affordable installments over 7-10 years, instead of the usual 15-25 for other homebuyers. Prior to 2002 the number of units sold in this way had been in the same order as new PRH units built.

2.1.8 The deductibility of home mortgage interest from taxable income was not meant to be assistance for the needy, but has been disbursed irrespective of need. Richer beneficiaries receive the same, or greater financial benefit (because they buy more expensive flats), than less well-to-do ones. Moreover there is no upper income limit

2.1.9 The fourth type of mismatch arose because, with the HOS, subsidized loans and concessionary PRH sales, the buyers were only means-tested once, at the time of purchase. They then receive the full benefit, even though incomes usually rise over time, often substantially as careers progress. There has been a policy to make well-to-do existing PRH tenants pay more, however.

2.1.10 The fifth type of mismatch became prominent in the 1997-2003 period when housing costs fell sharply – down over 80% for mortgage costs as both home prices and interest rates fell – whilst qualifying income limits for housing benefits (and the benefits themselves, in the case of the HOS) were not correspondingly curtailed. This meant many families could fully afford private housing and yet chose PRH and HOS units. Qualifying incomes for housing benefits have now been lowered, albeit belatedly as always, and, given the understandable resistance, less than fully reflecting the drop in housing costs.

2.1.11 A pilot scheme was briefly introduced in 2002-03 to provide the elderly with, instead of PRH, monetary rental subsidies, equal to 60% of rents, for beneficiaries to rent private housing. Like the subsidized loan scheme, it embodied mainly the 3rd type of mismatch of resources.

2.1.12 The table below reviews which of the 5 types of mismatch of resources are present in each of the main housing benefits. Roughly, the rate of efficiency

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[3] A distinction should be made. In order that effort and merit are rewarded, welfare benefits should be structured so that higher-income beneficiaries can enjoy higher standards of living. However, as income rises, need (i.e. shortfall) would decrease, and hence the amount of benefit should decrease, not increase.

of deployment of public resources is probably around 65% for PRH, and, for the various home ownership benefits, under 40%.

	Type of mismatch of resources				
	1st	2nd	3rd	4th	5th
Public rental housing (PRH)	x	x	x		x
Home Ownership Scheme (HOS)	x	x	x	x	x
Subsidized PRH sales	x	x	x	x	
Subsidized home loan scheme			x	x	x
Tax relief for mortgage interest			x	x	x

2.2.1 *Post-2002: home ownership assistance curtailed* In November 2002, the Government enunciated a number of policy changes. It noted that property prices had fallen, and stated the objective of withdrawing as far as possible from housing assistance programmes other than PRH, in order to minimize intervention in the market. As a result, the HOS and the PRH subsidized sales scheme were discontinued during 2003. The last batch of PRH subsidized sales took place in August 2005.

2.2.2 The mortgage interest tax benefit was also due to end in the 2003/04 fiscal year but later extended to 2005/06. An end to the subsidized home loan scheme, which at one time was thought of as a replacement for the HOS was announced in early 2004. At a time when home prices were cheapest historically, these steps apparently ended, at least temporarily, 26 years of public assistance for the less well off to own homes. Thus the traditional approach, which sees the need for housing assistance as varying directly with home prices, is wasteful of opportunities to help low-income families buy homes when prices are low.

2.2.3 On the side of rental assistance, the pilot 60% rental subsidies scheme (Para. 2.1.11 above) was short-lived. Regarding PRH, the only remaining form of housing assistance, the Government has taken steps, within the existing framework, to match aid more closely with need. In this it has met with understandable resistance and hence limited success[4]. Meanwhile, other difficulties with the PRH system kept surfacing[5]..

2.2.4 Recently, in September 2005, the inflexibility of the PRH scheme, due to indivisibility of benefits but also time lags in planning and construction, resulted in another instance of its inability to meet housing needs. The waiting list for PRH became such that the Housing Authority decided to resort to rationing against younger and single-person applicants. Some very needy young or single persons would not any aid at all while some older/married persons only marginally meeting the income ceiling would receive full benefit.

2.3.1 *Intervention in the market.* Housing assistance, a transfer payment to the needy from the rest of society, in itself is an important construct of, and should not be regarded as interference with, the working of the free market. Intervention occurs, however, when benefit exceeds need, i.e. the amount by which income falls short of meeting basic living requirements. This happens under the above-mentioned 3rd to 5th types of mismatch of resources.

2.3.2 This has meant, in repect of the "brick-and-mortar" programmes, that people have been over-subsidized to buy or rent subsidized housing, i.e. HOS and PRH units, thereby impeding the shift of demand to private sector housing, especially when market property prices fell but public housing benefits and qualifying income levels are slow to follow suit. Market prices and turnover are adversely affected.

2.3.3 On the other hand, in respect of those monetary aid programmes mentioned above, such as the subsidized housing loans and the mortgage interest tax benefit, such over-subsidy has tended to exert the opposite effect, viz. an artificial boosting of the private housing market. The problem is that such over-subsidy is usually greatest and most attractive during a property boom, when

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[4] Apart from trying to lower qualifying income limits, the Government has attempted, mostly in 2003-4: to make wealthy or undeserving PRH tenants give up their flats or pay market rent. For some time now, it has planned to charge PRH rents that reflect the relative desirability of the positions of individual flats, and to limit recipients of Comprehensive Social Security Assistance to less well-situated flats. Also mooted plans for consultations apparently to make PRH tenants pay rents that vary with their individual income levels.

[5] Whilst the Government was having difficulty lowering benefits and qualifying income thresholds, it was embroiled, on the other hand, in litigation by residents demanding lower PRH rents in line with deflation, given guidelines to keep rents within a certain percentage of the median income. Fresh issues of building safety on PRH estates also continued to capture public attention from time to time. All these and other difficulties would be obviated under a system of allowances that match actual need.

interest rates are high, and least attractive during a property slump as interest rates fell.

2.3.4 Also, in respect of the HOS, it was difficult for both the price discount and number of units built to be cut quickly enough in a falling property market, and in the meantime the market was being undercut. Furthermore, due to construction time lag, by the time the programme was cut, the HOS completions then coming on stream became a supply overhang, exacerbating and prolonging market weakness.

2.3.5 Market-destabilizing distortions aside, the modes of housing assistance to date fail to freely allow aid resources to be deployed by recipients for home ownership purpose. Yet most families aspire to own their homes. In general, in order to own a home, people are prepared to scrimp on their non-housing expenses, and/or live in smaller flats.

2.3.6 The main reason is that, by paying rent, a household gets only the use of a property, but paying mortgage gives it also eventual ownership of an asset worth at least the value of the land element of the flat. Thus many countries have policies that foster home-ownership, because it serves also to provide social security for the aged. .

2.4 Looking forward, should property prices again run up strongly, then, once again, the middle class would not be able to buy their homes and there would be renewed demand for the HOS, subsidized loans, etc. to be re-instituted, along with their inherent defects. There needs to be a replacement system that avoids all the above shortcomings..

3. A mismatch-free and asset-endowing system

3.1.1 Proposed below is a simple, market-oriented system that is free of mismatch of resources. It also endows the less well off with home-ownership. The way forward, which is already an international trend, is to replace the various existing forms of housing assistance with an allowance that matches individual need. Recipients would be free to rent or buy a home from the market. The principles are outlined in this section, whilst numerical illustrations are given in Appendix B.

3.1.2 A household would be entitled to an allowance, referred to below as Comprehensive Allowance (CA), equal to whatever amount by which its own income (if any) falls short of the amount of total expenditure – i.e. housing plus non-housing expenditures – that society deems equitable for such a household given such factors as household size and amount of income by one’s own means. The “deemed” housing expenditure is calculated on the basis that the household rents its home from the market.

3.1.3 Realistically, and to encourage upward mobility, society would deem as equitable, for households earning successively higher-incomes, correspondingly higher standards of living as measured by deemed total expenditure. For each dollar of increase in income by own means, deemed total expenditure might be scheduled to increase by, say, 33 cents. The amount of CA, which meets the shortfall between own income and deemed expenditure, thus falls by 67 cents – until CA eventually reduces to zero[6]

3.1.4 When, due to higher home prices and/or interest rates, housing costs climb relative to the general income and price levels, successively higher-income households who previously were self-sufficient would find themselves in need and thus become eligible for CA.

3.1.5 For the purpose of calculating its CA, a household's "income[7] by own means" would be determined by tests of financial means, not only at the time of initial application for aid but also annually thereafter. As at present, such tests would consist of declarations, subject to random checks by the authorities and backed up by the muscle of criminal prosecution for cheating.

3.1.6 To ensure that a basic standard of housing is met, CA would be applied firstly toward housing, with payment made directly to the landlord or bank concerned. Any balance left would be paid over to the household itself. Also, the rented premises should meet certain stipulated housing standards. An alternative or additional requirement might be that the amount a CA recipient spends on housing must not be less than 90%, say, of the lowest (i.e. subsistence-level) deemed housing expenditure on the prescribed scale.[8]

3.1.7 To recapitulate, the basic relationships are:

Deemed non-housing expenditure + deemed housing expenditure
= Deemed total expenditure, socially guaranteed
= (met by) Own income + Comprehensive Allowance

3.2 *Socially guaranteed income* The existing Comprehensive Social Security Assistance (CSSA) is a cash allowance covering non-housing needs only. CA may be regarded as the product of extending CSSA to housing. As such, CA provides a social security assistance that is truly comprehensive. It also improves upon CSSA by rewarding earning of income by one's own means. Another

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[6] When a household's income falls, its CA entitlement would increase, though only partially offsetting the drop in income. In other words, households in financial adversity would, as always, face the likelihood of having to move to lower-levels of accommodation. Upon a total loss of income due to unemployment or retirement, a household might receive the maximum CA entitlement.

[7] Included would be not only income from employment but also an imputed return on assets owned.

[8] Sanctions would no doubt be available to prevent cheating by collusion between a CA recipient and its landlord/seller/bank. As a last resort, the authorities might be authorized to place the household in a residential accommodation mandatorily.

improvement is that benefits are adjusted more responsively.[9] CA can be administered as a policy of minimum or socially guaranteed income[10]. The latter would be preferable to a minimum wage policy, which reduces employment overall – more specifically, in industries that employ low-skilled workers.

3.3.1 *PRH replaced* All existing PRH – and unsold HOS stock – would be for rent or sale at market rentals/prices. Those considered ripe for redevelopment might be set aside for sale *en bloc* instead of by individual units. Empowered by CA, existing PRH tenants would freely rent or buy housing from the market, including the units they were occupying.

3.3.2 All those who qualify for aid (e.g. meeting the residency requirement) would receive CA right away, instead of having to spend years on the waiting list for PRH before their equitable needs could be met.

3.3.3 There may no longer be much demand or need for buildings comprised solely of small rental units[11]. The supply of small rental units by the private sector should not be a problem under the allowance system. The housing portions of CA entitlements would be payable directly by Government to landlords. This provides the latter with assurance of payment. As in some Western countries, the authorities should encourage and facilitate private investment in rental housing by introducing mortgage insurance for that purpose, of up to 85% and covering even second mortgages[12].

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[9] For instance, in past years, as the annual inflation adjustment of CSSA benefits was based on forecast inflation, this sometimes resulted in significant overpayment of benefits after a couple of years of larger-than-expected deflation, and efforts to correct the excess encountered difficulties. Here it is proposed – see Appendix B – that adjustment be based an actual recent inflation. If necessary, adjustment can be made as frequently as every month.

[10] An employer would pay a worker's wages into a bank account. Based on the wage level and the data it has on the worker's family composition etc., the government would pay the pertinent amount of CA into the same account. The worker then finds his account credited with the total amount of the socially guaranteed income, and would not have to swallow his pride to claim the "welfare cheque".

It should be noted that CA is not a government subsidy to increase Hong Kong's competitiveness internationally, no more than is CSSA or its equivalents abroad.

[11] One advantage of the allowance system is that economic and social segregation would be reduced, with aid recipients being financially empowered to live in the same buildings as others.

[12] Tax incentives can also be offered if warranted. The Canadian experience (see Appendix F) is instructive in this regard. The experience in Canada and the U.S. also suggests, for example, that insurance companies and provident/pension funds might play an expanded role by investing in or directly financing housing projects, particularly if reforms help to raise confidence in a more stable property market.

3.4.1 *Assisted home ownership, with safeguards*. The household that opts to buy its home would get the same amount of CA as if it rents its home, i.e. the amount is calculated as if it is a tenant[13]. However, of that total CA amount, the homebuyer would be allowed to spend, on housing, a larger proportion of the household's total budget (i.e. own income, if any, plus CA), to the extent that outlays for home-ownership are usually higher than outlays for renting

3.4.2 Since allowing CA to be used for home purchase in this way involves no extra cost to the public purse, there is no need, from the cost perspective, to exclude low- or even zerio-income households from being so empowered. The issue is rather what safeguards would prevent low-income families from plunging into CA-assisted purchases at times of speculative fervour, thus exacerbating market excesses, to the detriment of themselves and others[14]. Such concern might partly arise from the fact that any increase in housing costs – viz. rents, prices and/or interest rates – would not deter prospective CA-assisted tenants and homebuyers, to the extent that their CA entitlements would increase responsively.

3.4.3 The market itself provides some restraint. Lending banks will, as always, impose terms that reflect the risks they perceive.[15] For lenders, the risk on CA-

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[13] Given the benefits of home-ownership as mentioned in Paragraph 2.3.6 above, governments often provide more aid to homebuyers than to tenants. This approach was adopted in a previous version of this paper. A system that gives equal aid to both homebuyers and tenants is proposed in the present version, however, as such a system would not interfere with consumer choice or market behaviour.

[14] An earlier version of this paper provided for means and income thresholds, viz. requirements that the household put up a down payment of at least 3% of the value of the flat, and that it must have sufficient income of its own to cover, say, its deemed non-housing expenses plus at least 20%, say, of its deemed housing expenditure, i.e., CA entitlement would be, at most, 80% of deemed housing expenditure. However, in the light of the various safeguards mentioned in this section, such measures should be unnecessary, except perhaps in times of exceptionally wild speculative fervour

[15] The actual total amount, size of down payment, term to maturity (and amortization period, if different) etc. of the mortgage loan would, as previously, be proposed by the borrower and subject to agreement by the lending bank. Banks would no doubt take into account such factors as the length of the remaining working life of household members, size of down payment put up, and expected stream of CA pursuant to the standard scale.

For mortgage lenders and insurers, it appears that the risk of default upon a general fall in property prices is reduced under the allowance system, insofar as the price of a flat would have to fall by more than the proportion of the loan borne by the housing portion of the CA before the borrower would be tempted to default. The risk of borrowers defaulting upon loss of income is also reduced, given the prescribed increases in CA as income declines. Given also the fixed interest rate requirement, on balance, the overall risk for banks and mortgage insurers would appear to be quite limited under the allowance system. In turn, this should reduce interest margins and mortgage insurance premia.

Banks would not really require down payments. The latter are useful to banks mainly supported loans should be lower than for other loans, insofar as monthly repayments on the former would in effect be guaranteed by the government up to the amount of the housing portion of the CA. Lenders should therefore be content to offer CA-assisted loans with amortization periods of up to 30 years so that low-income families can buy homes with monthly payments similar in amount to rents[16]. .

3.4.4 Although the CA-assisted homebuyer may be using little or no money of his own to buy his home, yet the profit-seeking/loss-avoiding motive would ensure that he tries to be prudent by seeking out the best price and refraining from buying near perceived market peaks.

3.4.5 Other safeguards against property bubbles are built into the CA system. In one feature, aid would become more stringent as housing costs escalate. For instance, in Appendix B, CA for zero-income, 4-person households would pay for a subsistence-level flat 660 sq.ft. in area – at mid-2003 price levels, but, should housing costs ever rise with rentals climbing some 150% to around their 1997 levels, the assumption becomes that CA would only pay for a 500 sq.ft. flat.

3.4.6 Another safeguard is that, unlike for CA-assisted tenants, for whom there would be no upper limit to how much they can spend each month on housing, a CA-assisted homebuyer should be limited to paying no more than, say, 110% of the deemed home-ownership expenditure as described in Paragraph 3.4.1.

3.4.7 At times of speculative fervour, property prices are usually high relative to rents. As total CA entitlement is calculated on the basis of households renting their homes, prospective CA-assisted homebuyers would very much feel the pinch. Constraints like these would help prevent government-funded purchases of low-end homes from fuelling an overheated market.

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as cushions to reduce the risk from depreciation in asset value. However, CA provides an additional, more important cushion, which is largest at low income levels, where it covers a large proportion or even all of the mortgage payment. Conversely, monetary authority guidelines should allow, and indeed call for banks to set higher down payment requirements both at higher income levels and as home prices rise relative to incomes.

[16] In the US, 30-year fixed rate home loans are common. Over the decades Hong Kong also seems to be moving in this direction. Also, age of the building has become less of a deterrent to lenders. Still, to require 30-year amortization periods for CA-assisted loans is to venture into uncharted territory, as the subsistence-level flat qualifying for CA might be a PRH unit built 15 to 20 years ago. However, the market prices of such units would already be fairly close to their underlying land value. The loans might be amortized over 30 years but with terms of, say, 12 years leaving “balloons” to be refinanced upon maturity, as is common in many Western countries. After all, borrowers’ rising earning power over time, together with inflation, means that entry-level residences are often not held for very long..

3.4.8 Furthermore, interest on the CA-assisted mortgage should be required to be of the fixed rate variety for, say, at least the first 12 years, and fixed at the same rate for, say, at least the first 8. Mortgage insurance on the loan should be mandatory. Ninety-five per cent mortgage insurance is already available in Hong Kong, and should be readily extendable to 100% for CA-assisted mortgages. Insured mortgages would be securitized and sold in the capital market. The new demand would open up a market for long-term fixed-rate instruments – a welcome addition to the portfolios of investors and institutions locally and abroad[17].

3.4.9 A main purpose of the above home-ownership assistance system is to provide nest eggs for the population when they retire. Hence any positive equity (i.e. excess of sale proceeds over outstanding loan) resulting from the disposal of a CA-assisted residence should, to the extent of the proportion of past CA funding to total past mortgage payments, be kept in what might be a collective investment account, to be spent only for the purchase of the next residence or after reaching retirement age. For similar reasons, a CA-assisted home-owner normally should not be allowed to increase his borrowing on the residence.

3.4.10 The Government should also stand by a price stabilization policy as discussed in Paragraphs 4.2.1 and 4.2.2 below. With all the above commonsense safeguards in place, CA-assisted home-owners would be more protected against property and financial market volatilities than most other homebuyers.

4. Implications for property demand and prices

4.1.1 Over the years 1997-2003, home prices, relative to incomes and other prices generally, deflated sharply, reaching depressed, historical lows before bottoming out during the 3rd quarter of 2003. Main causes of the downturn included overshooting during the previous run-up, an oversupply in the near term, and low confidence in the competitiveness of Hong Kong over the long term. The current recovery appears to be still subject to at least some potential oversupply in the mass market, given the unsold HOS stock and the housing developments along mass transit lines that have been held back.

4.1.2 The CA system, along with a competitiveness-enhancing programme proposed by these authors, should improve long-term fundamentals in respect of the Budget and the economy (see Sections 5 and 6 below) and thus raise underlying confidence.

4.1.3 In respect of the oversupply situation, introducing the CA system would generate a one-time increase in the demand for small private flats as about 30% of the territory's population, the current occupants of some 700,000 PRH units, become empowered by CA to rent or buy private sector units. Many would just

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[17] Remarks by senior Chinese officials suggested that the Chinese government and investors could be among buyers of these instruments.

rent or buy their former PRH units. But others would switch upon finding that they are no longer over-subsidized to stay in PRH, but would be subsidized to freely buy or rent from the market. Still others, such as those previously on the waiting list for PRH, would find themselves in immediate receipt of CA. The resultant wave of demand would help absorb the remaining overhang of unsold HOS flats.

4.1.4 Also, the Government should exercise flexibility and care in determining the pace and price/rent levels at which it offers its PRH and HOS stock, to avoid untimely flooding and undercutting of the market[18].. The bulk of PRH stock, though, consists of low-end units that would add a new stratum to the market, extending, rather than overlapping with, the grades of housing currently available.

4.1.5 As a result of the above improvements to demand and supply, the housing market should witness a strong increase in transaction volume. Property prices may also receive a modest but solidly based boost

4.2.1 *Stabilizing property prices.* Property prices should then be held broadly stable, at an appropriate level relative to income. This would be accomplished mainly through a policy of flexible land supply. See Appendix C: *Flexible land supply: policy and mechanism*. Under the CA system, the Government would be selling more land than presently, as PRH would be replaced by private housing. .

4.2.2 Against any possible runaway property price increases, the authorities should also stand ready to impose, if necessary, down payment and income thresholds (Footnote 14 above). A modest 15% property gains tax would also help prevent excesses[19]. Moreover, there are market constraints (Paras. 3.4.3 and 3.4.4 above), as well as constraints built into the CA system (Paras. 3.4.5 to 3.4.9). For instance, the fixed rate loan requirement means that, should interest rates rise, a smaller fraction of the number of homeowners than at present would be immediately affected. Also, factors under the old system that exacerbated property market volatilities (Paras. 2.3.1 to 2.3.4) would no longer exist. All in all, greater property market stability should prevail under the CA system.

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[18] Similarly, the Government has already reacted quickly to dissuade any uncoordinated sales of flats by the mass transit companies, who are eager to finance new railway lines by exercising the development rights granted to them. Likewise, urban renewal should be sensitive to market conditions, to avoid a general over-supply.

[19] In Hong Kong, personal investments are generally not taxed. However, a case can be made for taxing property gains given the importance of maintaining stable property prices. Consideration can be given to taxing inflation-adjusted price gains only. By itself, a 15% property gains tax is not a major deterrent of property speculation, and actual proceeds from the tax is unlikely to be substantial. However, it is one more arrow in the quiver to prevent speculative property price rises.

5. Implications for the Budget

5.1.1 Compared to other places, Hong Kong derives relatively more of its public revenues from property. The Government collects premia on sales of leasehold land and modifications of existing leases; taxes property transactions and ownership by way of stamp duty, rates and rent, and property-related income and profits taxes; and has derived receipts from PRH and the HOS. These revenues are broadly based (see Para. 5.4.1 below), and have relatively low collection costs The large surplus of property-related receipts over property-related expenditures goes to finance other public spending. The system has made possible low taxes on income and consumption. This ia a cornerstone of Hong Kong's economic competitiveness, as well as of its social stability notwithstanding wide income disparity.

5.1.2 For decades this system yielded a healthy budget balance.. However, property prices went up to stratospheric levels during the run-up to 1997, and then dropped abysmally. Property transactions also dwindled. Amid deflation, both property- and non-property-related revenues fell[20]. The two main housing aid programmes, PRH and HOS, exacerbated the weakness in property prices (see Paras. 2.3.2 and 2.3.4), hurting property-related public revenues. Meanwhile, government expenditure had expanded during the property-led boom. The Budget registered a record surplus of $87bn in 1997/98, but by 2001/02, a deficit of $66bn, or 27% of total government expenditure[21].

5.1.3 A recovery in the economy and the property market since late 2003 has now restored the budget to balance. However, concerns remain about how to ensure long-term fiscal health. New or increased taxes would not be very helpful, given their drag on spending, profitability, incentive and social harmony, and the need to maintain a competitive tax regime. Selling off assets or issuing bonds would not resolve underlying deficiencies and may destabilize the currency and interest rates.

5.1.4 It is clear from Paragraph 5.1.2 above that the basic problem is, not over-dependence on property-related revenues, but the out-of-control excess of the property market during the cycle of 1985-2003. This paper proposes, firstly to

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[20] Land premia, for instance, after reaching 34.4% of total government expenditure in fiscal 1996/97, fell to 3.6% in 2001/02.

[21] The Budget deficit grew to $70bn in 2003/04. These numbers, which do not take into account the Housing Authority, which is off Budget, may appear grimmer if they did. Public sector housing expenditure, mainly through the Housing Authority, notwithstanding sharp falls in property prices and interest rates, first continued to grow rapidly and then only fell belatedly starting in 1999/2000. In 2001/02 that expenditure was still 36% above its 1996/97 level. The main reason is that these figures do not include land cost, but reflected the construction costs of the public housing programme. Meanwhile, the Housing Authority's main income, revenue from HOS sales, declined sharply.

stabilize property prices with the flexible land supply mechanism discussed in Appendix C. Elements of the proposed CA regime (see Para. 4.2.2 above), such as the fostering of long-term fixed rate loans, are also conducive to milder property cycles.

5.1.5 Secondly, annual provisions would be made in the Budget using the same yardsticks as described in Appendix C, that measure how much the property market, and hence property-related revenues, have cyclically outpaced the economy's productivity. That is, funds are set aside during the "good times", when both property prices and transaction volumes exceed their equilibrium levels, for the "lean years".

5.1.6 Thirdly, efficiency gains in housing assistance resulting from the CA system would amount to some 13% of total public expenditure. This would obviate any need for a goods and services tax, asset sales, or debt issues. Using 2001/02 as a point of reference, that year's $66bn fiscal deficit would be eliminated as follows.

5.1.7 The Government would pay CA in amounts that correspond to actual needs and are therefore mismatch-free. It would receive additional land premia for housing to replace PRH, as well as recurrent revenue derived from the former PRH and HOS stock (see below). There would be net efficiency savings of some $28bn compared with the old "PRH plus HOS" model,(see Appendix D)[22].

5.1.8 Next, a return to healthy property transactions on mildly firmer prices would – again relative to 2001/02 economic conditions, (a) increase land premia (excluding premia upon land sales for replacing PRH and HOS) by about $7bn, to some $15bn or a historically modest 1.2% of Gross Domestic Product[23], and (b) increase other property-related revenues, viz. stamp duty, land rent and rates, and property-related profits and income taxes, by, say, $8n.

5.1.9 The Budget should also benefit from higher non-property-related revenues and lower social welfare spending generally, as near- and long-term economic prospects improve – see Section 6 below, particularly the programme for long-term competitiveness mentioned in Para. 6.3

[22] When PRH/HOS is replaced by monetary aid – be it CA or subsidized loans – for people to move to private sector housing, an additional cost that has to be borne by the Budget is the return to private sector developers. Hence, were, say, the HOS to be replaced by subsidized loans (provided in such quantity that the level of satisfaction to aid recipients stays the same), the cost to the Budget would likely increase – despite an offsetting factor, viz. the observed willingness of people to accept a smaller benefit in dollar terms when they are given the funds for them to freely choose from private sector products. (See Notes 2 and 3 in Appendix C.)

[23] Land premia averaged about 0.9% of Gross Domestic Product in the 1960s, 1.5% in the 1970s, 2.9% in the 1980s and 3.2% in the 1990s, and were about 0.7% in 2001/02.

5.1.10 Against the above improvements to the Budget have to be deducted the costs of the said competitiveness-enhancing programme, assumed to comprise mainly a 2% tax cut, stepped-up infrastructure construction, and some $10bn annually of direct incentives for new engines of economic growth.

5.1.11 On balance, a Budget gap of some $25bn may remain[24].. This should be closed mainly by more efficiency savings in public expenditure, through rationalizations[25] and privatizations (see Appendix E). These may entail restructuring and trimming of services and programmes, closer alignment of civil service pay with market, and improved mechanisms at all levels for decision-making that targets long-run benefits**.**

5.2.1 *Housing fund.* Sales over time of the stock of some 630,000 (as of 2002) former PRH units at market prices would bring in some $400bn. Of this, $80bn, say, might be booked near the outset if it is assumed that 20% of the units are bought up by households just after the introduction of CA. In a subsequent year, if 20% of new aid recipients (i.e. some 8,400 households, under the assumptions of Appendix D) choose to buy existing PRH flats, some $6bn would be realized. There would also be sales *en bloc* to developers for redevelopment.

5.2.2 Proceeds from sales of former PRH and unsold HOS units should not be credited directly as gains for the Budget. The stock of those units, together with their accumulated realization proceeds, should become reserve assets and constitute a Housing Fund. The fund would generate recurrent revenue – put at just $10bn or 2.5% annually in Appendix D – consisting of net market rents received plus the investment returns on accumulated proceeds. The investments should include ones that generate interest earnings, to the extent that CA payouts are partly interest rate-sensitive.

5.2.3 Into this housing fund should also be credited a proportion of the land premia as residential sites are sold. Payments out of the fund would consist of the estimated housing portion of CA disbursements. The purpose is to earmark revenues for related expenditures where both rise and fall mainly in response to the same variables viz. changes in the levels of property prices and rentals and interest rates.

5.3.1 *Effect of rise/fall in property prices.* Implementing the CA system would tend to reduce volatility for the Budget, since, for reasons mentioned above, the property market should be more stable, and because CA payouts, compared with

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[24] Closing this gap should not be too difficult. With an operating budget of over $200bn in fiscal 2002/3, the Government already directed its departments to cut spending 20% by 2006.

[25] One possible rationalization to raise revenue in the area of housing is to treat sales of property-holding companies as real estate transactions. As in Ontario, Canada, if all the company owns is real estate, its transactions are real estate transactions, and so would be subject to stamp duty and other relevant taxes.

PRH and HOS expenditures, would rise and fall more closely in step with the revenues that fund them.

5.3.2 Whenever property prices rise, both the number of new CA recipients and the respective amounts they receive would increase. In respect of existing CA recipients, however, entitlements would increase in the case of tenants, but stay the same for mortgagees. Overall, the rise in CA payments upon a rise in property prices would appear to be well covered by the contemporaneous rise in land sales premia and other property-related revenues.

5.3.3 Conversely, when property prices fall, CA payouts for existing mortgages do not fall, causing some pressure for the Budget as property-related revenues fall across the board.

5.3.4 Similarly, when interest rates rise, the resultant rise in CA payouts would likely be more than offset by gains in the Government's interest-sensitive earnings (including those from the Exchange Fund as well as the Housing Fund itself), because CA payouts on existing fixed rate mortgages stay the same. Conversely, some pressure on the Budget may be caused by a drop in interest rates. Unlike in the case of rises/falls in property prices, instruments for hedging against interest rate movements are quite readily available.

5.3.5 The implications are firstly that, with property prices and interest rates still not far from historically low levels and hence posing relatively little downside risk, now is still an opportune time to implement the allowances system, and, secondly, that after the system is launched, the Government should take steps to prevent large increases in property prices (it has no control over interest rates) to safeguard against the adverse effects of their subsequent falling back.

5.4.1 *More broadly-based revenues.* Property-related revenues are broadly based. When the government sells land, every citizen is contributing his/her stake to pay for public spending. And one result of economic growth, to which all workers contribute, is the appreciation of property values over time as productivity increases, at the rate of "real" productivity gain plus inflation. Property-buyers reap the benefit but pay stamp duty, rates and land rent and, for corporations, profits tax. With grassroots families joining the ranks of home-owners under the CA system, public revenues would become more broadly-based.

5.4.2 Upon the stabilization of property cycles as proposed, consideration might be given to broadening the tax base by introducing more property-related revenues such as a capital gains tax – see Para. 4.2.2 and the relevant footnote.

6. Economic implications

6.1 Near-term, upon implementation of CA, recoveries of the housing market and of the domestic economy would go hand in hand. The group of housing-related sectors such as construction, banking, real estate and home furnishing typically constitute a powerful engine for both employment and consumption[26].

6.2 Ultimately, general confidence, home prices, domestic demand and public revenues etc. are all chiefly determined by the economy's productivity relative to the rest of the world. While an economic recovery has set in largely due – as always in Hong Kong – to external factors such as a lifting of tourism and trade restrictions by China and a weaker US$-linked currency, concern may re-surface at some point about a weakening of demand for Hong Kong's services, longer term, as China opens up and advances further.

6.3 Recent improvements in the economy and in public finances thus provide an opportunity to build long-term capabilities. Savings under the CA system would help underwrite a programme[27] to raise competitiveness that includes a 2% general tax cut, stepped-up construction of productive infrastructure, and, to take advantage of hitherto unexploited externalities and long-term perspective, $10bn p.a. of direct pecuniary incentives for new engines of economic growth, and government participation in long-term investments and loans. These would build on and complement Hong Kong's traditional strengths.

6.4 One of those strengths is that Hong Kong has had a more advanced market economy than China's. Under the CA system, property cycles would be smaller in amplitude. Contentment and social solidarity would increase, as the working poor and the elderly are better provided for. There would be less expectations of "pork" or "free lunch", and more of reward for productiveness. People would choose freely and live in better-quality homes closer to work. With housing, the one major non-market segment of its economy finally opened up, Hong Kong can truly contend to be a model market economy. It would show itself to be a dynamic and knowledge-based society able to make pragmatic changes beneficial to itself in the longer term. A new confidence would be built.

7. Conclusions

7.1 *Housing assistance.* Despite popular notions, PRH is not cheap while assisted home-ownership does not have to be expensive and interventionist. This paper proposes the payment of allowances that match actual income shortfalls, for recipients to freely rent or buy homes in the market. Those who choose to buy would possess a valuable asset years later – at no extra cost to society and yet relieving its future burden from an aging population. Should housing costs escalate, the CA safety net would extend to progressively higher income families.

7.3 *Overall social assistance.* CA is not only a broadened. but also improved. version of CSSA. The main improvements, in efficacy and equity, are the

[26] See, for example, Appendix F for the North American experience.

[27] See the paper *Government's role in enhancing competitiveness* by the same authors, on *www.hongkongbetter.com*.

endowment of assets so that grassroots families can share in the appreciation of property values, and an increase in the guaranteed living standard as one’s earned income rises. “Minimum wage” reduces employment of low-skilled worker. Socially guaranteed income enhances it.

7.4 *Property market.* The market would receive a boost in demand needed to absorb the persisting overhang in supply of homes. Longer term, the market would be more stable than before, due to safeguards built into the CA system, as well as a flexible land supply mechanism as the. Government sells more residential land directly to the market.

7.5 *Fiscal budget.* Housing expenditure, in the form of CA payouts, would be mismatch-free. Revenues would include additional land sales to replace public housing, and the entire former PRH and HOS stock would generate recurrent revenue at market rates of return. The resultant savings would obviate any need for new or higher taxes sales of valued assets, or debt issues. Equally important for long-term fiscal health are, firstly, the stabilization of property cycles using the quantitative yardstick in the proposed flexible land supply mechanism, and the making of Budgetary provisions using the same yardstick, and, secondly, the empowerment of grassroots families to own homes relieving the looming welfare burden from an aging population and low grassroots wages.

7.6 *Economy.* Empowering families with CA would give a boost to housing-related sectors of the economy. Restored fiscal health would make it possible to step up competitiveness-enhancing programmes such as tax cuts, infrastructure construction and incentives as well as long-term loans and investments for new engines of economic growth. Adjustments in property cycles and hence the relevant economic cycles would be milder. Hong Kong would strengthen its lead and attractiveness as a flexible and efficient market economy.

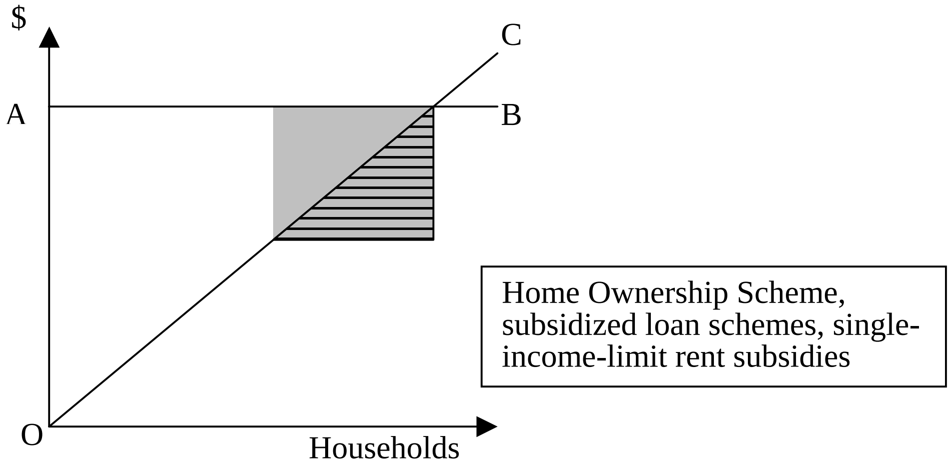
Appendix A. Graphical illustrations of mismatch of housing resources

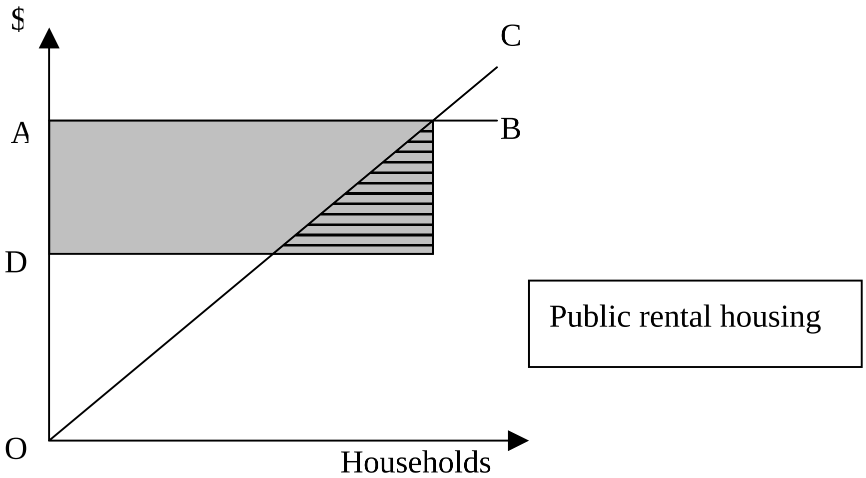
(Charts illustrate certain basic notions only, and are not to scale.)

OC Income distribution of households

AB Income just sufficient to cover basic housing and non-housing expenses

Government subsidies Mismatched portion





Appendix B. How housing assistance might be calculated

1. Shown below are basic principles, assumptions and parameters – which can be refined and varied – for calculating Comprehensive Allowance (CA). The latter would replace all existing forms of housing assistance as well as the non-housing, Comprehensive Social Security Assistance (CSSA). CA is, in effect, CSSA modified and extended to housing. It provides a monetary allowance that matches actual need, i.e. the amount by which a household's income falls short of meeting the socially equitable living standard.

2. The property prices and rents referred to below pertain to what these authors estimated to be around their mid-2003 levels – near their historical lows relative to incomes. Take the household of 4 persons:

(a) For non-housing needs, experts first determine – at the outset and, say, every 2 or 3 years thereafter – a package of goods and services other than housing, of such quantities and qualities as deemed to be necessary to sustain the socially acceptable subsistence standard of living. The value of that package (at mid-2003 prices) is taken to be $4,500 a month.

(b) Similarly, the subsistence-level accommodation for such a household, given mid-2003 price levels, is determined to be the equivalent of, say, a public rental housing (PRH) flat 660 sq.ft. in construction area built 15-20 years ago in the New Territories with a market rental cost, including management fee, of $3,284 a month ($4.98 per square foot).

(c) Total subsistence expenditure is therefore $(4,500 + 3,284) or $7,784 a month. This would be the amount of CA receivable by a 4-person household with zero income of its own from employment or investments.

(d) To provide incentive for self-reliance and -advancement, the amount of CA falls off only partially – not dollar for dollar as in CSSA – as "income by own means" increases. The assumption here is that aid would fall off evenly (i.e. on a "straight-line" basis), by $667 for every $1,000 rise in income by own means, as shown in Columns A-E of Table 1 below, so that the living standard supported (Column B), met by the household's own income plus CA, rises by $333. Eventually CA becomes zero when own income reaches $11,676 (equal to, in this case, 1.5 times $7,784).

3. Columns C and D split the total expenditure supported (Column B) in the ratio of the aforesaid 4,500:3,284 into deemed non-housing expenditure and deemed housing expenditure respectively. CA recipients would be required to spend on housing not less than 90%, say, of the minimum prescribed deemed housing expenditure ($3,284). Alternatively (or additionally), the premises must meet certain physical standards. There would be no upper limit on the amount spent on rent..

Effect of higher housing costs

4. When housing costs rise – due to higher home prices and/or interest rates – relative to other prices, there is pressure on families to accept lower standards of housing, chiefly in terms of unit size. In Columns J-M, housing costs have, hypothetically, multiplied by 2-1/2 times to around the 1997 peak levels. At $13.68 a sq.ft. in rental costs, the subsistence-level flat is now taken to be only 500 sq.ft., giving a deemed subsistence-level housing expenditure of $6,842.

5. Assuming that the subsistence-level non-housing expenditure in Column K is still $4,500, this gives a subsistence-level deemed total expenditure of $11,342 (i.e. 4,500 + 6,842). This would be the amount of CA for zero-income households. Aid then falls progressively as own income increases, becoming zero when own income reaches $17,013.

6. It is assumed that the subsistence-level flat size at any other level of housing costs is determined by linear extrapolation through the two points, 660 sq.ft. when rent is $4.98/sq.ft., and 500 sq.ft. when it is $13.68/sq.ft.

Purchasing a home

7. A household that buys its home is only entitled to the same amount of deemed total expenditure as if it rents its home. It also gets the same amount of CA, since CA is any excess of deemed total expenditure over the household's income-by-own-means. Moreover, to discourage property speculation, the homebuyer's actual monthly housing expenditure, unlike in the case of tenants, is required to not exceed 110%, say, of its deemed housing expenditure. On the other hand, the latter would likely be a larger proportion of the said deemed total expenditure than in the case of a tenant, simply because home-ownership costs are frequently higher than rental costs.

8. The prospective homebuyer first refers to the columns that reflect current rental costs (say, Columns B-E in Table 1) and reads, against the amount of its income-by-own-means in Column A, its deemed total expenditure in Column B. For how this sum is to be allocated between housing and non-housing, he refers to another set of columns – F-I in this example – where housing cost reflects the level of current home-ownership costs. It would read off, against that same amount of deemed total expenditure in Column F, the corresponding deemed housing expenditure in Column H.

9. In our example, the current home-ownership cost is determined to be, for a flat of about subsistence level, $6.08/sq.ft./month. Included are mortgage payment on a loan for the full price of the flat amortized over 30 years at 5.75%[1] fixed rate of interest, government "rates", and management fee. At $6.08/sq.ft./month the

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[1] As 30-year fixed rate loans have not been available in Hong Kong and as mid-2003 might be a period of exceptionally low interest rates, a high rate of 5.75% is used in these calculations, compared with about 2.875% for probably the bulk of new floating rate loans around mid-2003. If a rate of 4.0%, say, is used, home-ownership cost would almost be the same as rental cost in these calculations.

subsistence-level rental flat size extrapolated as per Paragraph 6 above is 640 sq.ft., yielding a housing expenditure in Column H of $3,891 (= $6.08 x 640). The ratio of 4,500:3,891 is applied to apportion between the rest of Columns G and H.

10. For the household with zero income of its own and entitled to $7,784 of CA as mentioned in Paragraph 2(b) above, applying the 4,500:3,891 ratio would accord it a deemed housing expenditure of $3,609 if it chooses to buy instead of rent its home. It can spend up to 110% of that amount on actual home-ownership expenses.

Table 1. Relationship between income-by-own-means, deemed equitable expenditure and Comprehensive Allowance (CA)

Income by own means	Subsistence housing cost is $4.98/sq.ft.				Subsistence housing cost is $6.48/sq.ft.				Subsistence housing cost is $13.68/sq.ft.			
	Deemed equitable expenditure			CA	Deemed equitable expenditure			CA	Deemed equitable expenditure			CA
	Total	Non-housing	Housing		Total	Non-housing	Housing		Total	Non-housing	Housing	
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)	(M)
	(B) =(C)+(D): (E)=(B)-(A)				(F)=(G)+(H); (I)=(F)-(A)				(J)=(K)+(L); (M)=(J)-(A)			
0	7,784	4,500	3,284	7,784	8,391	4,500	3,891	8,391	11,342	4,500	6,842	12,600
1,000	8,117	4,693	3,425	7,117	8,724	4,679	4,045	7,724	11,675	4,632	7,043	10,675
2,000	8,451	4,885	3,565	6,451	9,057	4,858	4,200	7,057	12,008	4,765	7,244	10,008
3,000	8,784	5,078	3,706	5,784	9,391	5,036	4,354	6,391	12,342	4,897	7,445	9,342
4,000	9,117	5,271	3,847	5,117	9,724	5,215	4,509	5,724	12,675	5,029	7,646	8,675
5,000	9,451	5,464	3,987	4,451	10,057	5,394	4,663	5,057	13,008	5,161	7,847	8,008
6,000	9,784	5,656	4,128	3,784	10,391	5,573	4,818	4,391	13,342	5,294	8,048	7,342
7,000	10,117	5,849	4,268	3,117	10,724	5,751	4,973	3,724	13,675	5,426	8,249	6,675
8,000	10,451	6,042	4,409	2,451	11,057	5,930	5,127	3,057	14,008	5,558	8,450	6,008
9,000	10,784	6,234	4,550	1,784	11,391	6,109	5,282	2,391	14,342	5,690	8,651	5,342
10,000	11,117	6,427	4,690	1,117	11,724	6,288	5,436	1,724	14,675	5,823	8,852	4,675
11,000	11,451	6,620	4,831	451	12,057	6,466	5,591	1,057	15,008	5,955	9,054	4,008
12,000	12,000	6,937	5,063	0	12,391	6,645	5,745	391	15,342	6,087	9,255	3,342
13,000	13,000	7,515	5,485	0	13,000	6,972	6,028	0	15,675	6,219	9,456	2,675
14,000	14,000	8,094	5,906	0	14,000	7,508	6,492	0	16,008	6,352	9,657	2,008
15,000	15,000	8,672	6,328	0	15,000	8,045	6,955	0	16,342	6,484	9,858	1,342
16,000	16,000	9,250	6,750	0	16,000	8,581	7,419	0	16,675	6,616	10,059	675
17,000	17,000	9,828	7,172	0	17,000	9,117	7,883	0	17,008	6,748	10,260	8
18,000	18,000	10,406	7,594	0	18,000	9,654	8,346	0	18,000	7,142	10,858	0

Appendix C. Flexible land supply: policy and mechanism

1. Land is scarce in Hong Kong, which has a population density a little higher than that of Singapore, but the terrain here is very mountainous. Land cost is therefore expensive, and thus a major cost in production and livelihood. Property features prominently in the income statements and balance sheets of households, businesses, banks and the government.

2. Hence problems associated with the inherent volatility of the property market are magnified. Because property is a leveraged valuable investment, property prices and transactions and hence their related economic activities vacillate on expectations about, but in sharper swings than the economy itself. Property market excesses may, in turn, exacerbate economic cycles. Economic, financial and fiscal stability are affected.

3. There is thus a strong need to limit such volatility. Fortunately, the Hong Kong government has the unique capability to do so. Of course, in the longer term, the course of property prices reflects productivity growth. Any policy – other than measures to increase productivity – that results in driving property prices up or down other than in keeping with Hong Kong's international competitiveness will not be sustainable and will only result in damaging volatility.

4. However, in the shorter term, as the government is effectively the sole supplier of land, it is, like it or not, the only domestic independent determinant of land price. The other independent determinants, viz. economic demand and interest rates, are basically decided abroad, Hong Kong being a small and open externally-dependent economy.

5. The government cannot possibly adopt a neutral position and be a market-follower, because whatever quantity of land it currently supplies to the market and/or whatever price it sets will decide market price levels. To make its role in the market a constructive one, the government would conduct land policy that purports to move prices neither up nor down, but to keep them stable near their equilibrium level, which is explained below.

6. As in all cyclical behaviour, the cyclical excesses of the property market mentioned above are inevitably corrected over time, often by moves of similar proportions in the opposite direction. Thus there is an equilibrium level about which the market vacillates.

7. Take the ratio between the price of a basic 600-sq.ft. flat, and economic output per person (Gross Domestic Product per capita). Its average value over the past 26 years, 1980-2005, at about 10.6, provides an indicator of this equilibrium level[28]. Property

[28] This indicator of the equilibrium level can be further refined, as it can be affected by factors such as change in the scarcity of land as population increases (see the last two

prices above this level would make Hong Kong uncompetitive internationally, and so would eventually fall back. Prices below that level would be bid up.

8. The role of government is to stabilize property prices, i.e. keep prices as close to the equilibrium level as possible. This means that, as the economy grows, the general property price level should grow at about the same rate as per capita income or output, i.e. productivity, viz. at the rate of real per capita GDP growth plus rate of inflation. Property cycles would then become milder but not eradicated, since economic cycles will likely continue to exist.

9. Stabilizing property prices would be mainly by the policy of flexible land supply: the government would sell as much or as little land as is required to keep property prices stable. This means it has to sell more land when prices are on the high side of equilibrium, and less on the low side. For instance, upon any threat of excessive rise in home prices, it can readily sell a large quantity of land. It can stipulate that buyers complete the buildings within a short period. The market would be dampened quickly.

10. (It was argued that the Home Ownership Scheme should be retained so that the Government can increase the supply of HOS flats when it needs to dampen an overheating market. The reality is that, because of lags in planning and construction time, such salutary impact was never noted during the run-up of property prices leading up to their 1997 peak. Instead, when the increased supply did come on stream, the resultant over-supply worsened the property slump that had set in.)

11. Currently (in 1st quarter 2006), the above price-to-GDP ratio, at about 9.7, is below the equilibrium level. This suggests that target prices for land sales should be on the high side, pending absorption of the existing supply overhang, which includes unsold Home Ownership Scheme stock as well as projects by the mass transit companies ready for launching.

12. Upon implementation of the Comprehensive Allowance system, the ranks of home mortgagees would swell by the number of those low-income families choosing to

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paragraphs of this appendix), and changes affecting the efficiency of land use (e.g. as buildings get taller). For instance, on the basis that as population increases land should be getting more expensive relative to all other costs, then the targeted equilibrium level as measured by this indicator should be increasing over time.

An alternative indicator to use might be the ratio between the price of a standard- sized flat and median household income. One might have to allow for change in average household size.

What is sometimes called an index of affordability, i.e. the ratio of a typical mortgage payment to median household income, would probably not be a suitable indicator for this purpose, since it measures the combined impact of the property price and interest rate levels.

own homes. The amount of land sold by the government would also increase, by the quantity of land sold to replace subsidized housing (PRH and HOS). Both the need for and the capability of the government to stabilize land prices would therefore be increased.

13. The government should make known to the public what indicators it uses: say one simple, measurable and transparent indicator for each major type of property. It should make known how each indicator is calculated, but with the understanding that a range in terms of percentage points is allowed for.

14. At the same time, the authorities need not reveal their target price for each piece of land put up for sale. However, objective criteria should be laid down for the purpose of deriving from that ratio the target prices for individual sites. The actual price for each individual site will only be determined by the market through the auction process. The current Application List system, where a site will be put up for auction once there is a confirmed offer to pay at least 80% of the undisclosed target price, is an integral part of the flexible alnd supply mechanism.

15. The authorities would have to allow for overshooting. For instance, during a cyclical upswing it may find that the current price-to-output/income ratio has risen beyond a reasonable discounting of likely economic prospects, and also that the inventory in the hands of the private sector will likely become excessive relative to forecast demand. To dampen the market by increasing land supply alone might then require an overshooting of land supply, exacerbating any impending market reversal. This would be the time to take additional steps such as: verbal reminders to the market, sharply increasing the amount of land placed on the Application List, requiring developers to complete and sell buildings within a shorter time, introducing or increasing down payment and/or income thresholds for assisted home ownership, introducing or increasing property gains tax and stamp duty, etc. .

16. The flexible land supply mechanism and the government's role thereby are analogous to those under the linked exchange rate system. Both are for the purpose of obviating unnecessary and excessive volatility, so that the outcome better reflects the economy's fundamentals. Such actions, to fulfill a key role in the market mechanism, do not constitute intervention in the free market. Governments should only be guided by basic market economic principles, and the unique set of local circumstances.

17. *Long-term cost of land* The quantity of land in Hong Kong can, in fact, be expanded through reclamation, subject to cost and environmental considerations as well as some ultimate geographical constraint. For better planning and to properly take into account the increasing scarcity and cost of land in its budgeting, the Government should draw up a long-term comprehensive plan for the supply of land, estimating the rise in future costs of land formation.

18. Provision for the long-term cost of land thus estimated would then be made annually by earmarking, say, a proportion of the revenue from land sales, for crediting to what might be called a Land Development Fund. Actual costs of land production might then be charged to the fund. The balance of the fund would be invested.

Appendix D. Public expenditure on housing under 3 policy alternatives

Model 1: Public rental housing (PRH) + Home Ownership Scheme (HOS) + concessionary PRH sales + mortgage interest deductible
Model 2: Same as Model 1 except that HOS is replaced by subsidized loans
Model 3: Comprehensive Allowance (CA), meeting both housing and non-housing needs

		Estimated expenditure in HK$ billions					
Expenditure category	Basis of estimation	Model 1		Model 2		Model 3	
		Actual	Book	Actual	Book	Actual	Book
PRH: Opportunity cost of land	Market value of land for 24,000 units [Note 1]	10		10			
Construction cost	Construction cost for 24,000 units	12	12	12	12		
Less: Net rental income	Rental income less running costs	(1)	(1)	(1)	(1)		
HOS: Opportunity cost of land	Market value of land for 18,000 units	7					
Construction cost	Construction cost for 18,000 units	9	9				
Sales revenue	Revenue from sales of 18,000 units [Note 2]	(14)	(14)				
Concessionary sales of PRH flats	Residual value of land for 22,000 units if not sold	9	9	9	9		
	Less: Excess of purchase installments over usual PRH rent	(1)	(1)	(1)	(1)		
Mortgage interest tax deductible	Tax revenue foregone	2	2	2	2		
Subsidized loans: Subsidies worth	Equals 30% discount on HOS flats, 80% valuation [Note 3]			5	5		
Land sales revenue	Market value of land for 18,000 units			(7)	(7)		
Opportunity cost of land	Market value of land for 18,000 units			7			
CA: Part of CA replacing PRH	65% of value of PRH programme [Note 4]					14	14
Part of CA replacing HOS	40% of value of HOS programme [Note 5]					2	2
Returns on PRH, HOS stock	2.5% of $400bn					(10)	(10)
Land sales revenue	Market value of land for 42,000 units					(17)	(17)
Opportunity cost of land	Market value of land for 42,000 units					17	
Other housing expenditure	Other recurrent expenditure	5	5	5	5	5	5
	Other capital expenditure	2	2	2	2	2	2
Net housing expenditure	Sum of the above [Note 6]	40	24	43	26	12	(4)

Notes to table of Appendix D:

The figures above of 24,000, 18,000 and 22,000 units a year for PRH, HOS and concessionary PRH sales respectively are based on averages of annual output/sales seen during the decade 1992-2001. This table was first prepared when all three kinds of housing assistance were in existence, which provides a useful point of reference.

Note 1. To maintain its PRH programme, the Government builds some 24,000 PRH units a year. The land and construction costs for these 24,000 units, plus the net current expenditure in respect of all units, together make up the annual spending on the PRH programme.

Note 2. For both PRH and HOS, the Government has played the role of the developer but has not charged a developer's margin for return on investment and development risk. A 20% developer's return is added here to the sum of land and construction costs for HOS flats. Those flats are then assumed to be sold at a discount, taken here to be 30%, to the resultant total value.

Note 3. Here the subsidized loan schemes are assumed to replace the HOS with an amount of benefit exactly equal to the 30% price discount on HOS flats (see Note 2) after the latter amount is multiplied by a valuation factor of 80% reflecting the assumption that, for every $100 worth of benefit of residing in public housing, families would just as soon accept a cash equivalent of $80 that they can use to freely buy or rent private sector housing.

Note 4. This is the housing component of the CA that meets those needs catered to by the PRH programme. The market value of the quantity of housing provided by the PRH programme is the cost of the programme (see Note 1) plus a 20% developer's margin (see Note 2) and then valued at 80% (see Note 3). There is a 35% savings to that value when CA replaces PRH, as the 1st, 2nd, 3rd and 5th types of mismatch of resources (Section 2 in the main text) are eliminated. Note that the percentage of savings would increase when housing costs rise (Footnote 2 in the main text).

Note 5. This is the housing component of the CA that meets those actual needs catered to by the HOS. With the elimination of the 1st through 5th types of mismatch of resources, 60% is saved as compared with the HOS-equivalent cost estimated as per Note 3 above. (Alternatively, the amounts of housing expenditure under the CA system as per Notes 4 and 5 can be estimated along the lines of the calculations in Appendix B, with similar results.)

Note 6. The savings under Model 3 above do not include proceeds from any property gains tax. Also, there should be administrative efficiency gains from the merging of CSSA and housing assistance into one, but this may be offset by extra administrative requirements of the more responsive CA system. Loss of the stamp duty originally receivable on HOS sales is assumed to be roughly offset by additional stamp duty from home purchases with CA; so neither is itemized.

Appendix E. Note on privatization and rationalization

1. Subject to what might be called the principles of privatization and rationalization, governments should do whatever would make the population better off, i.e. show a net benefit on an economy-wide cost-benefit analysis. This is entirely in keeping with a free market economy.

2. Rationalization here refers to restructuring government programmes in closer adherence to market economic principles, so that there is more or better output relative to the resources used. True rationalization means more effective and transparent government, and so should win public support.

3. Take social assistance, a topic in this paper. In the past, especially in housing, the Government often granted benefits that did not match actual needs and so are not "assistance" but merely "benefits" – if one defines assistance as benefits that match actual needs. As time went on the negative effects of such "pork" or "free lunch" in respect of efficiency, incentive, fairness, fiscal health and economic adaptability etc. began to be felt, particularly at bleaker economic times. The benefits then need to be rationalized so that they match actual needs Though some constituents may receive less than before in the short term, over the longer term everyone would gain.

4. Privatization here refers to letting the private sector do whatever it can do more cost-effectively than government. (The quality of service should be carefully examined, though.) Hence privatization is one form of rationalization. Thus government should do both as much (see Paragraph 1 above) and as little as possible. The linked exchange rate mechanism is a clear instance where there is cogent need for government to fulfill a role in the market that only it can fill; this paper outlines other instances, such as the flexible land supply policy.

5. Privatization in this sense may or may not involve the sale of public assets. In any case, the objective of privatization is efficiency gains, not deficit reduction. Proceeds from any asset sales should preferably be credited to reserves and invested in assets to earn recurrent revenue.

6. The introduction of cogent mechanisms should minimize future intervention or involvemment by the government. One example is the flexible adjustment mechanism (可加可減機制) like the ones being proposed for transport fares, utility charges, and even PRH rents. A similar mechanism in the CA arrangement is that for adjusting benefits to inflation.

7. Once such a mechanism is in place, wrangles between the parties concerned – examples are politically costly battles in the legislature – to adjust prices, benefits, qualifying income levels etc. would be obviated, and the adjustments would be timely instead of lagged. There would also be less need for administrative measures, which are prone to controversy, errors, mishaps and complications. Rationalization and privatization thus enhance not only economic but also political efficiency.

Appendix F. The North American housing experience

1. Real estate has been very much the underpinning for the North American economy since the economic recovery of the '90s. Construction creates more jobs for bankers, professionals and labourers. The activities in housing construction and sales have spilled over into consumer sales of furniture, appliances and other household goods. The increase in home value has made people feel good and bolstered consumer confidence. If the economy gets going, so do house prices.

2. Canada has modeled some of its housing programmes on the United States. Since the 1980s, the government has adopted a policy to encourage home ownership. Central to the Canadian or US solution is the mortgage insurance and low down payment programme. In Canada, this is done through the government's housing agency, the Canada Mortgage and Housing Corporation. Down payments are as low as 5%, and the upper price limit on homes that can be insured has recently been abolished. Insured mortgages securitized and sold to the market have opened up the market for bonds.

3. Furthermore, to encourage construction activity during hard times, there have been interest-free loans, income tax deductions, and low-interest second mortgages to developers to encourage real estate developments.

4. Homebuyers can receive some income tax credits. Individuals can fund their home mortgages from their own registered pension plans. They can take money out from the plans to buy homes without having to pay income taxes.

5. There are some rental subsidies. Mortgage insurance was also extended to investors in rental housing, who can get 85% financing. For developing and investing in rental housing, tax and other incentives are made available. Recently, the CMHC would also insure second mortgages on investment properties, so that investors can take out their equities in existing properties and invest them in new building.

6. Pension funds have invested directly in housing. For example, the British Columbia government employees pension plan has 1/3 of its investments in stocks and securities, 1/3 in real estate, such as rental apartments, and 1/3 in mortgages and bonds.

7. Productivity is the key to growth in income and real estate prices. In recent years economic boom has led to a jump in real estate prices in the United States, especially in cities where there is a concentration of high-tech industries. The price of an average house in Bellevue, Washington was half of that in Honolulu a decade ago, but now it is considerably more.

8. Since 2005 house prices have gone up 35% in the US, and 28% in Toronto. Unlike the 1980 housing boom, there has been no demographic change in the US. Rather, the recent US experience has been largely interest rate driven. With the economic boom since 2001, low rates have made possible a switching from renting to home ownership. The home ownership ratio has gone from 63.5% in 1995 to

68.5% in 2004. As most renters have bought now, house prices in the US may stop going up from here. Meanwhile the threat from a debt bubble is a real one, with people buying $700,000 homes with 100% financing

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Note on authors.

James Lee, writing as an independent observer in Hong Kong, and Lawrence Lau, a Chartered Accountant resident in North America, have published various articles concerning the Hong Kong economy, some of which are posted to *www.hongkongbetter.com*. Comments/queries are welcome at *jlee.hkbetter@gmail.com*. This paper may freely be made available to interested persons.

[2006.3.25]

PostScript, August 2010

In an article being prepared by James Lee, some different nomenclature is used. “Comprehensive Allowance” is replaced by “income supplements”, and “deemed housing expenditure” by “housing consumption entitlement”.

Also, Para. 3.1.3 above posits, “For each dollar of increase in income by own means, deemed total expenditure (i.e. “housing consumption entitlement” by the new nomenclature) might be scheduled to increase by, say, 33 cents.” The latter figure might be increased to 50 or 66 cents, to provide more incentive, and so that more people would be benefited.