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"Housing in the 21st Century: Challenges and Commitments"**

**PERMANENCE AND CHANGE,
EAST ASIAN HOUSING POLICIES AFTER FIFTY YEARS.**

By

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I. INTRODUCTION

This conference celebrates the 30th anniversary of the Hong Kong Housing Authority and the 50th anniversary of public housing in Hong Kong. As every one who is here knows well, the history of public housing in Hong Kong began as a Christmas tale. On Christmas Eve 1953, the disastrous fire that devastated the Shek Kip Mei squatter living conditions were harsh for many. Hong Kong was being swamped by a flood of refugees from the Chinese mainland who were struggling to survive "on borrowed time, in a borrowed place."

The Shek Kip Mei disaster catalyzed a growing public awareness that the housing situation was running out of control in Hong Kong. The stories of the period tell us that the government reacted quickly in a very emotional atmosphere. There was no preset plan to follow, but out of the solutions that were adopted grew a housing policy that went far beyond the initial goal of a resettlement program, and kept growing with time until Hong Kong had become an impressive high-income economy after 50 years... only to face very different housing challenges after 1997 with the Asian financial crisis, the reconnection of the Hong Kong metropolis with its regional hinterland and a shared new future with booming mainland Chinese cities.

The story of Hong Kong's housing policy and of its unique urban development has been told often, and in many different ways.¹ In 1953, Hong Kong's success was very

¹ A few books could be mentioned. There is a heartfelt pictorial history by Peter K.W. FONG and Chan CHIK, *Home of Yesterday* [1993]. The Housing Authority offers an official history in *The First Two Million* [1979]. An important analysis of housing in the economic development strategy of Hong Kong is offered by Manuel CASTELLS, L.GOH, and Reginald Yin-Wang KWOK [1990], *The Shek Kip Mei Syndrome, Economic Development and Public Housing in Hong Kong and Singapore*, London: Pion Ltd. For the road avoided in Hong Kong and one perspective on the hardships of the past, there is the story of daily life in Hak Nam before its clearance in 1992, in *City of Darkness, Life in Kowloon Walled City*, by Greg GIRARD and Ian LAMBOT [1993].

far from obvious. Yet, over the past decades, every student of urban development who could do so has come to Hong Kong to see, study, and think more clearly about the possibilities and many dimensions of urban growth management as this unique metropolis kept reinventing itself. Today, we are all very happy to offer our sincere congratulations to the Housing Authority and all those who have contributed to making Hong Kong such a special metropolis.

Given the occasion it seems appropriate to examine the legacy of the housing policies that were pursued across the countries of East Asia during the second half of the 20th Century and then to consider the outlook at the start of this new century. Housing policies and urbanization are intimately linked. The first part of this presentation looks at the take-off of East Asian urbanization during the 20th century and then at the awesome outlook for urban growth in Asia and in particular in China during the first half of the 21st century.

How did it begin? What were the housing policy choices made in East Asia during the second half of the 20th century? In the second part, we will compare the four strikingly different types of housing strategies that East Asian governments initially chose in the 1950s to manage their urbanization take-off. In many ways, the legacy of these strategic choices continues to affect today's policy choices.

Faced with the need to choose among these contrasting East Asian experiences, the third part of this presentation focuses on China's housing policies. There are at least two major reasons. First, almost all of the new urbanization in East Asia during the 21st Century will take place in China. Second, in order to manage successfully the huge scale of urban growth that still lies ahead, the Chinese government has made a fundamental change in housing strategy away from the central planning strategy that had been adopted in 1949. This historical yet very pragmatic U-turn in housing strategy has been completed over the last two decades. However, on the ground level of cities the development of a market-based system remains a work in progress. We shall look at the main features of the strategic U-turn first, and consider the challenges ahead. The aim in this third section is to highlight the major institutional challenges that China faces for the continuing development of its housing system.

But housing is far from the full story for China and for the rest of Asia. We already know that the present century is the first truly urban century for the global economy. We also know that this will be primarily an Asian urban century in terms of scale and of global scale. In closing we shall need to mention new challenges facing Asian metropolitan governments in this era of mega-cities and growing metropolitan competition at the regional and global levels.

II. THE WORLD AT A MAJOR URBANIZATION THRESHOLD

On a world scale, urbanization is a new story. The 20th century is the story of the urbanization take-off.² All the demographic and economic data show that the 21st century will be the story of Asian urbanization, and massively so in China and in India.

The world population is passing through a major urban inflexion point during the present decade. And China itself is approaching this point very rapidly.

Andy Grove, the founder of computer chip maker Intel, once stated in an interview on corporate governance that the most important strategic question for the success of a company is to identify on time what he calls "major inflexion points" in the industry. When passing through an inflexion point, the operating environment changes at an accelerating pace. Successful approaches from the past cannot be extrapolated further without great risk to the competitiveness of the company.

The world population is crossing the 50% urbanization threshold around 2007

Not only figuratively, but in actual fact, the world population is crossing such an inflexion point: Sometime around year 2007, we shall be crossing the 50% urbanization threshold.³ The impact for the housing sector will be major in many countries, especially in Asia. What are the features of this important demographic threshold? Here are a few key findings:

- In 1950, only 30% of the world population lived in urban areas
- In 2000, 47% of the population was urban
- In year 2007, the number of urban dwellers is projected to equal rural dwellers
- By the year 2030, the urban share will reach 60%
- In 2000 the world urban population was 2.9 billion. It will rise to 5 billion in 2030.
- Most importantly, virtually all the population growth expected at the world level during 2000-2030 will be concentrated in urban areas.
- The 20th Century has been a critical demographic century when the world population nearly quadrupled in size to reach 6.3 billion in 2000
- Such massive growth will not happen again, the world will grow more slowly and will probably take 300 years to grow from 6.3 billion today to 9 billion in 2300.⁴

Urbanization has now become predominantly an emerging markets experience

The other component of this urban transition is that pressures on the cities of the developing world have been enormous over the last 50 years. Table 1 shows that during the second half of the 20th Century, the distribution of world population has shifted massively to the less developed regions of the world. By now, 95% of the annual urban

² To measure the analytical and psychological distance we have now traveled, it is interesting to refer back to the 1954 special issue of the *Scientific American* edited by Kingsley Davis on "Cities, Their Origin, Growth and Human Impact", or a decade later to Norton S. GINZBURG [1965] "Urban Geography and 'Non-Western' Areas" in HAUSER and SCHNORE eds. *The Study of Urbanization*, John Wiley, 1965.

³ United Nations Population Division, *World Urbanization Prospects*, 2001 edition. Posted at: <http://www.un.org/esa/population/publications/wup2001/WUP2001report.htm>

⁴ United Nations Population Division, *World Population 2300*, 8 December 2003.

population increments are in cities of the developing world.

TABLE 1: Distribution of the World Population, 1950-2030					
		Percentage of the World Population			
		1950	1975	2000	2030
<i>Total population</i>					
	More developed regions	32.3	25.8	19.7	14.7
	Less developed regions	67.7	74.2	80.3	85.3
<i>Urban population</i>					
	More developed regions	59.5	47.6	31.4	20.2
	Less developed regions	40.5	52.4	68.6	79.8
<i>Rural Population</i>					
	More developed regions	20.8	12.5	9.2	6.4
	Less developed regions	79.2	87.5	90.8	93.6
Source: United Nations Population Division, <i>World Urbanization Prospects</i> , 2001, p.15					

The 1950s were just the take-off of urbanization in the less developed regions of the world. The export of Western urban development theory, methods, standards and regulations which were the only thing we had in the early 1950s has made way to more appropriate approaches and technologies over the last 25 years. The countries of East Asia have taken their own road.

Industrialization and urbanization: avoiding the worst of over-urbanization in East Asia

The great cities of ancient times such as Xi'an in China under the Tang Dynasty were not engaged in the export of goods but in the export of "order" in the form of security, law, and a system of communication. In exchanges for these services, the city collected taxes from the countryside, with various degrees of fairness depending on the ruler. These tax revenues in turn became the means of paying for agricultural imports. In the pre-industrial era the share of urban population was seldom, if ever, as high as 5% of the total population of a country. For instance, this ratio was still 4.4% in China in 1890.⁵

The industrial revolution that started in the United Kingdom in the final years of the 18th century was the trigger for a powerful but steady urbanization in Western countries. There were three major dimensions: a manufacturing revolution, a transportation revolution, and an agricultural revolution. It is noteworthy that the only country in the world that was more than 50% urban in 1900 was Britain. Today, the entire world has reached this threshold.⁶

Two factors distinguish the slow and relatively steady urban growth experience of Western countries, and also Japan, from the massive experience of emerging economies

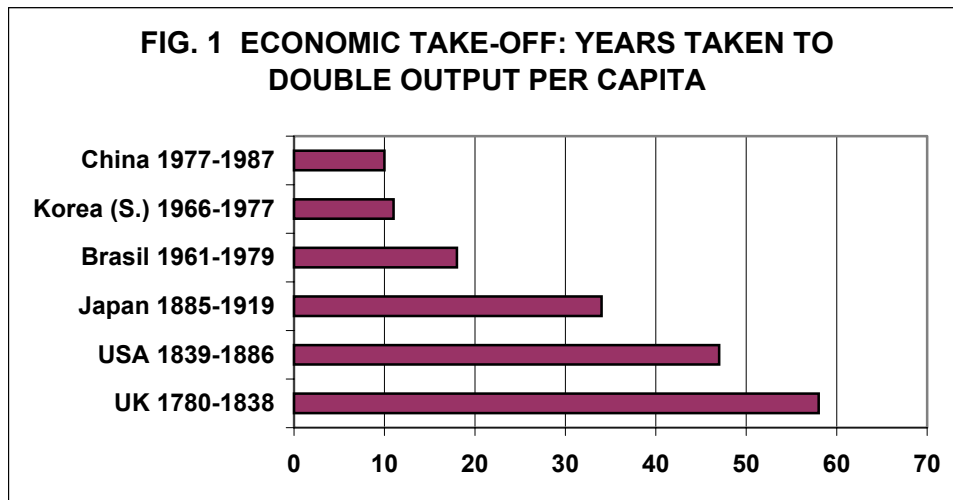
⁵ Angus Maddison [2001], *The World Economy: A Millennial Perspective*, Paris, OECD, Table 1-8c, page 40.

⁶ Why did the Industrial Revolution start in Europe and not in East Asia considering that China remained ahead of Europe until the 14th century? (Maddison, Figure 1-4, p.42). Kenneth Pomeranz provides an intriguing answer in *The Great Divergence, China, Europe and the Making of the Modern World Economy, 2000*. Princeton U. Press. Yet, Pomeranz underestimates some key differences in institutional development paths; see for instance Rajan and Zingales, 2003, Chapter 6.

in the last 50 years. One is the speed in the adoption of innovation and the other is the strength of the demographic transition when health improvements abruptly lowered death rates faster than shifts in cultural expectations in desired family size, which did not reduce birth rate at the same pace.

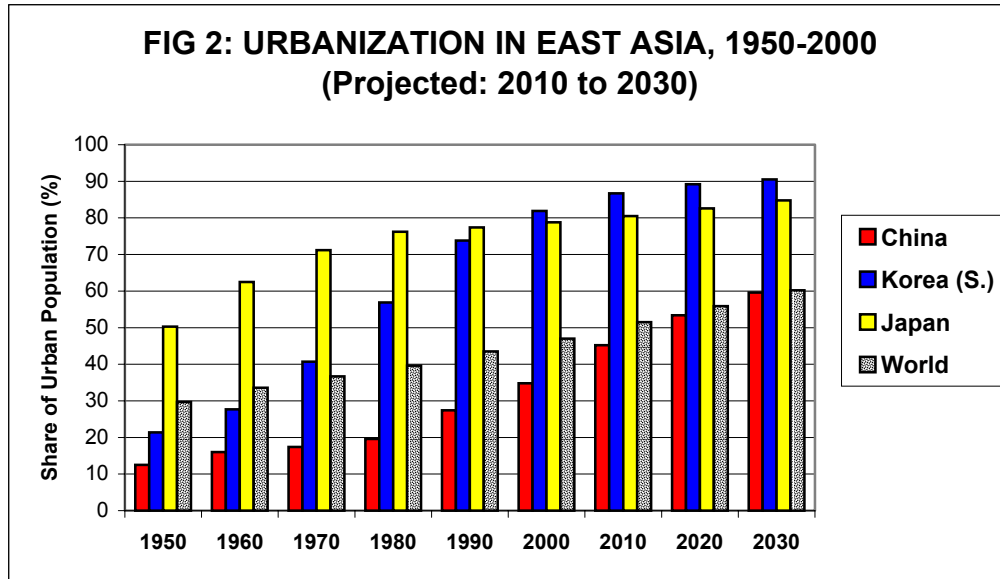
In East Asia, a powerful force behind the great renaissance of China and Korea since the 1970s – and their ability to avoid the worse ills of over-urbanization in the form of an ever-larger informal sector compared to Latin America or Africa– has been the ability of these two countries to industrialize rapidly and to engage in successful family planning. Their economic take-off has been very fast: it took both countries only a fraction of the number of years that Britain had needed 150 years ago to double the output per head as shown in Figure 1, below. Accordingly, their urban system has grown fast.

Countries like those of Asia that have succeeded in adapting industrial innovations at a pace commensurate with their demographic growth have also maintained the ability to manage their cities. Countries where the population boom caused by the demographic transition was not matched by the capacity to educate that population and to industrialize suffer from over-urbanization of various degrees of severity. The implications for the nature and scope of housing and urban development policies under these different scenarios are major.



Source: World Bank Development Report 1991, page 12.

Presently, China dominates world urbanization with its 456 million urban population, or 16% of the urban world total, and a national population of 1,285 million in 2000, or 20% of the world. Yet, as seen in Figure 2, over the last 50 years, China's share of urban population has been lagging significantly behind the world average. Now, the country it is approaching very fast the inflexion point level of 50% urbanization, which it will cross within the next quarter century.



Source: UN Population Division, World Urbanization Prospects 2001, Table A.2

It could be argued that the pressures on housing and urban development will be moderate since the national urban population growth rate is projected to moderate from 3.75% per year to about 2.2%. However, the challenges for China are that it is urbanizing with high population densities in both rural and urban areas; its level of per capita natural resources is below average; and industrialization and urbanization have been attracted to the subset of cities located in the coastal provinces causing constant worries for the government about maintaining social instability across provinces.

China's fifth census of 2000 showed that 36% of people live in cities and towns, which is 9.86 percentage points higher than in 1990. However, the natural population growth rate is decreasing. Nationwide, the natural growth rate was 1.2% per annum in 1978, but fell to 0.88% in 1999. Although the cities' natural population growth rate is going down, rapid urbanization has made the total urban population grow rapidly, especially in large cities. The data available shows that the urban population is expected to continue to grow at a faster pace in large cities than in medium-sized cities in the years to come. Hence the need for urban growth management policies suited to the full urban hierarchy.

In these large cities, there is another group of people officially categorized as "temporary population", referring to those who live in those cities for less than half a year. The size of this "floating population" in Beijing officially amounted to 1.5 million in 1999 – an increase of nearly 167% in the ten years since 1989. The urban floating population nationwide ranged from an official figure of 130 million to informal estimates of order of 200 million in year 2000. In Gwangdong Province alone, one estimate for 2000 was 21 million. China is faced with the difficult task of maintaining high economic growth rates for the foreseeable future, a challenge that it is met even during the global recession of the last three years.

Urbanization, patterns of housing investment and growth in urban assets

Figure 3 show the links between the level of urbanization, the share of annual housing investment in GDP, and the growth of urban real state assets in the national economy of countries at various stages of urban development.⁷

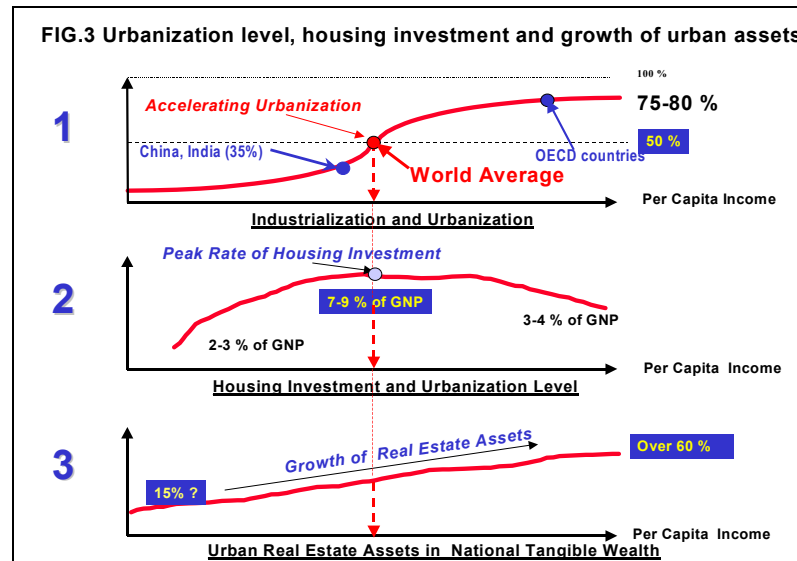


Figure 3 should be read from the top down. At the top, graph 3-1 shows the share of urban population in a country as it industrializes and its per capita income rises over time. The general pattern of urbanization follows a logistic curve. As already noted, in the pre-industrial era less than 5% of the population of a country lived in cities. There is an inflexion point around the 50% level when the rate of population growth of cities is the fastest because it combines a substantial rate of rural-urban migration with a significant rate of endogenous population growth. Moreover the in-migrant population tends to be younger than in the out-migration staging rural areas. In most countries, the urban saturation level tends to be reached somewhere between 75% and 85%, when the net flow of rural-urban migration has stopped.⁸

In the middle, graph 3-2 shows that the share of annual housing investment in annual GDP will rise as more and more people move to city. That share tends to peak at the 50% inflexion point as the highest rates of urban population growth has to be accommodated. As a country's system of cities goes through the 50% inflexion point, the share of housing in total output peaks between 7% and 9% of GDP. In some special cases such as Singapore as a city-state, the housing investment ratio has climbed above 10%, but this is unusual in time and around the world.⁹ At high levels of urbanization the annual rate of housing investment tends to slow down, but in absolute numbers the value of housing investment is large because of the overall size of the economy and high per capita income levels.

⁷ Borrowed from RENAUD "The Financing of Social Housing in Integrating Financial Markets: A View from Developing Countries", *Urban Studies*, Special Issue, Vol. 36, no 4. 1999.

⁸ Reported urban population shares can go beyond 90%, as is the case in Argentina. Such very high ratios depend on the administrative definition of what minimum population concentration is considered urban. In Latin America, the threshold is often set at a low figure of 500 people, while in most East Asia countries a population concentration under 20,000 people is still considered rural.

⁹ Very high housing investment ratios of the order of 10% have also been experienced by China in the 1980s, and early 1990s. These high housing investment ratios had several causes. In particular, a large stock adjustment process made up for several decades on deliberate under-investment in cities under central planning; and, also for the period of the Cultural Revolution 1966-1976 when little investment took place and the national urbanization rate actually turned negative, as shown later.

The lower graph 3-3 shows that due to the long-economic life of housing assets and other real estate assets, their share keeps increasing in national tangible wealth. This relation has not been tested on cross-country data in the same manner that Figures 3-1 and 3-2 have been tested because of the scarcity of national wealth data even among OECD countries. For instance in the US in the early 1990s, total real estate was 68% of total tangible assets, and the share of residential structures alone was 29%.

The point that Figure 3 aims to emphasize is that the main thrust of housing policies has to be quite different in orientation and emphasis before, during, and after the urbanization inflexion point. During that transition, the most massive phase of urban investment and city building is taking place. Housing policies have to focus on expanding the supply of new housing for all social groups, especially for the lower half of the income distribution.

Later, different urban contexts require different solutions. Once an economy has passed the urbanization inflexion point and the urban ratio is approaching saturation, the absolute growth of the urban population may continue. However, a dual shift in social housing policy is quite visible. There is a shift from quantity to quality: political euphemisms change from 'low cost housing' to 'affordable housing'. There is also a parallel shift from supply-side subsidies to demand-side subsidies in choosing tools out of our housing policy toolbox. One might add that concerns about social segregation and social exclusion within large metropolitan regions become a high priority agenda.

The housing policy debates in Hong Kong, especially since 1997, about how to modernize housing policies and privatize public housing in spite the impressive results that grew out the Shek Kip Mei disaster are one example of the shift in policy direction in response to a changed urban environment.¹⁰ A similar shift in policy emphasis has taken place in Singapore. But the terms of comparisons between these two traditional competitors have permanently changed after 1997, and close housing policy parallels will become more difficult to make. In contrast with Singapore, the housing and social policies of Hong Kong have entered a new era discontinuous from the past.¹¹ Certainly an important element of the new housing policy debate is the shift from supply to demand side subsidies for social housing.

When do housing policy shifts from the supply-side to the demand-side?

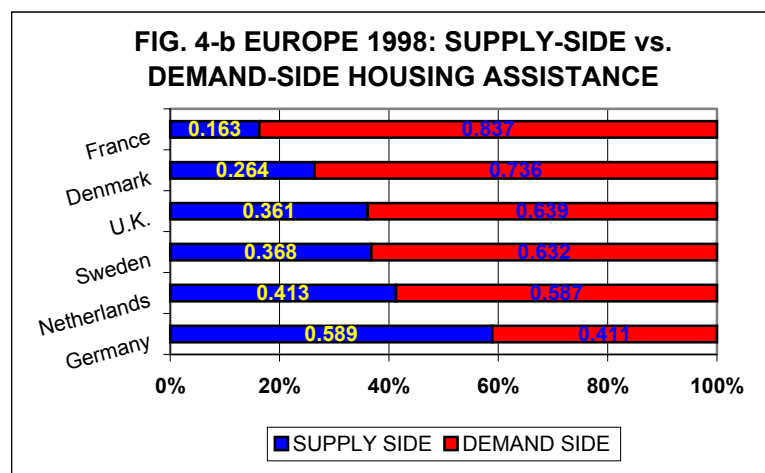
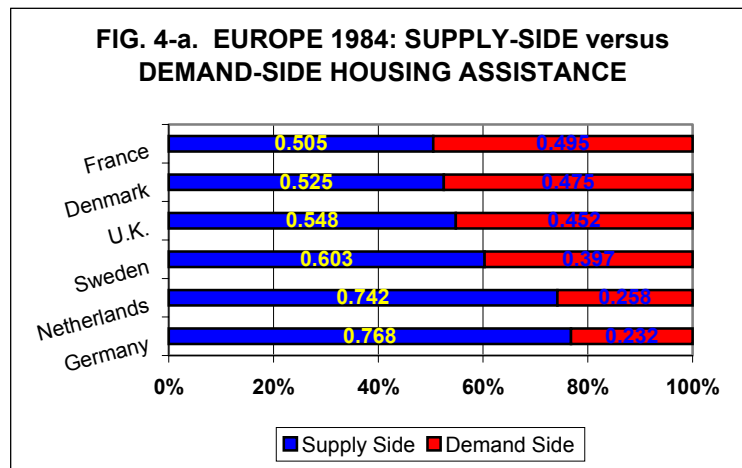
The policy shift from supply-side to demand-side subsidies is always favored by economists as more efficient economically and socially better targeted. Yet, when we consider the long-term urbanization curve, it quite noticeable that such policies have been more easily adopted in countries with mature urban systems at the top end of the curve.

In Western Europe, which is the region where meaningful comparative housing policy work is the most advanced owing to the formation of the European Union and now the creation of the Euro zone, there have been much work regarding the merits of shifting from supply-side subsidies to demand-side support to the housing sector, a

¹⁰ See for instance, Yue-Chim Richard WONG, *On Privatizing Public Housing*, Hong Kong Economic Policies Series; City University of Hong Kong Press, 1998.

¹¹ Hong Kong's housing policies face some fundamental questions following 1997. What could make its housing sector more resilient to macroeconomic shocks? What new policies could be built upon Hong Kong's functional reconnection with its hinterland? What would it mean for Hong Kong to switch from its traditional supply-side approach to social housing needed for city building in the 20th century to a demand-side approach now that Hong Kong is a modern, high-income metropolis? What are appropriate privatization strategies for the public sector housing stock? And, more broadly, given its SAR status, what does it mean for Hong Kong to become once again one of China's great cities?

policy choice that is also called “aid to stones versus aid to people”. As Fig. 4.a for 1984 and Fig. 4-b for 1998, there has been a strong shift to demand side subsidies over the last two decades.¹²



However, the shift has been far from uniform. Is it because the choice of new housing policies is “path-dependent” from previous policies? Does the initial set of institutions existing at the take-off of urbanization prior to the urban inflexion point affect what can be done when adopting a change of policy strategy much later? For instance, comparing Figures 4-a and 4-b the difference in the adoption of demand-side policies between France and Germany is quantitatively more pronounced after 14 years, not less.

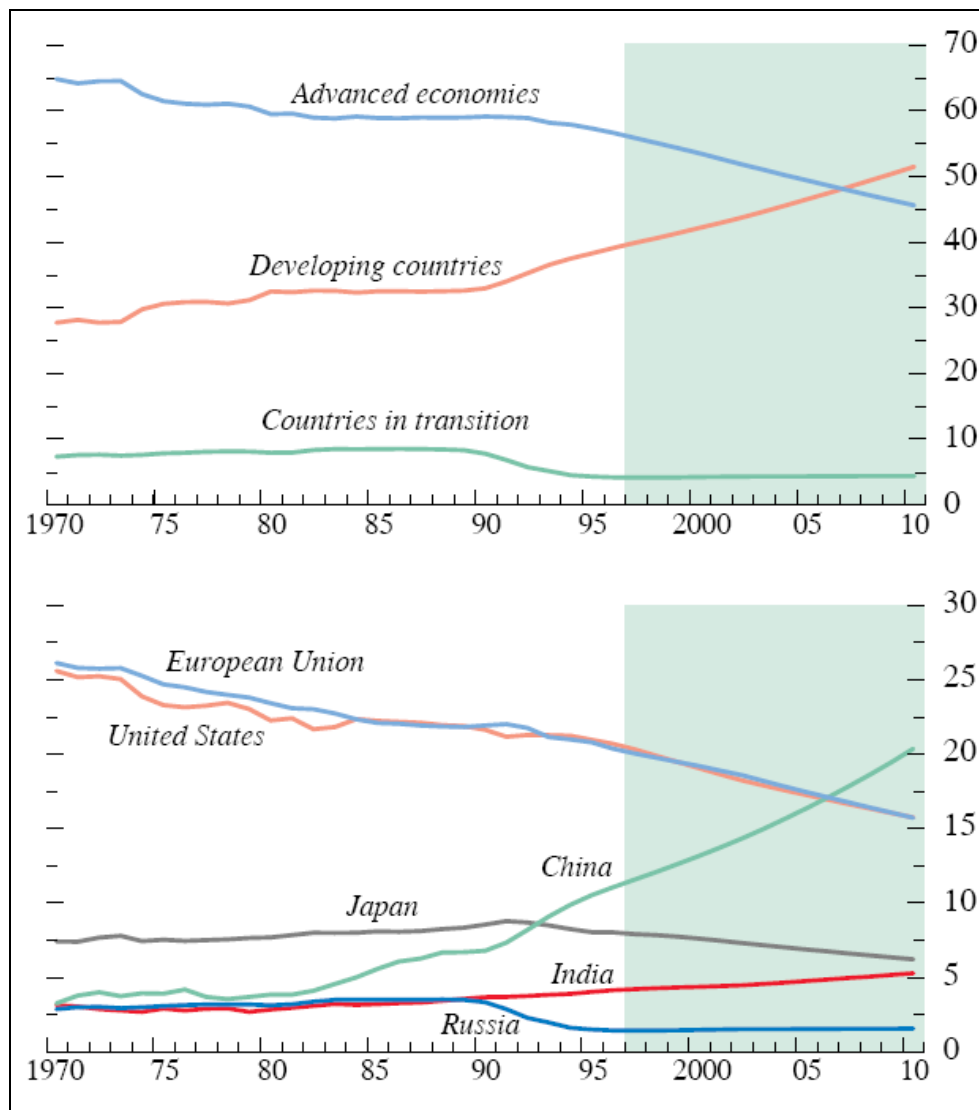
Could we expect housing policies in the countries of East Asia to be even more differentiated? When studying the development of financial markets among countries, the legal and institutional decisions of the past still affect choices that are made today. We commonly speak of an institutional “path-dependency”. In a comparable way, are the institution and policies adopted 50 years ago in East Asia still shaping housing policy choices today?

¹² Claude LOUVOT-RUNAVOT, [2001] “Le Logement dans l’Union Européenne », INSEE, *Économie & Statistique*, No. 343 -3

III. TRADING PLACES: ASIAN CITIES IN THE 21st CENTURY

Asian cities can be expected to become increasingly important sources of world-level urban innovations because they will have the necessary depth of scientific, institutional and financial resources to create solutions for their own specific problems. Recent economic projections developed separately from the demographic UN projections also show how Asian urbanization will be a dominant force in the first half of this century and the rebalancing across economies in favor of Asia that is likely to occur. The projections embedded in Figure 5 were based on 1997 data, and have come to be fully realized. If anything the growth path of India has shifted upward following India's new direction in macroeconomic policies after 1991.

FIGURE 5: Changing Relative Positions in the World Economy 1970-2010



Source: IMF, *World Economic Outlook*, October 1997 (Figure 3)

Important: The aggregates are computed using weights based on purchasing power parity in accordance with standard practice in the *World Economic Outlook*. Projections to 2010 are based on extrapolations of the IMF staff's medium-term baseline projections (Refer to *World Economic Outlook* of October 1997, Statistical Appendix).

IV. EAST ASIAN HOUSING STRATEGIES IN THE 20TH CENTURY

East Asia and the "Developmental State" in the 20th Century

The collapse of the Soviet system in 1990 appears to have given an additional boost to the revival of conservative ideologies regarding the role of the state that go back to the 1970's and P.M. Margaret Thatcher in the UK. Other powerful forces were at work to promote market-based development, among others the IT revolution and a remarkable burst of financial innovations in two decades.¹³ We are experiencing a renewed policy emphasis on markets, and even in some corners on government *laissez-faire* as the foundation of economic growth and socio-economic development. Yet, the East Asian growth experience which has been by far the strongest and fastest in the world in the post-World War II era hardly fits such views. Neither does China's remarkable economic renaissance since the early 1980s match the prescription.

Chalmers Johnson first wrote of the "developmental state" to describe the central role of the state in guiding East Asian economies on very high growth paths in a sustained way.¹⁴ By that he meant a strong state that determines the goals of national development and override specific interests even when business interests are the main beneficiaries of growth. However, a strong state does not by itself guarantee a successful development process: the seemingly awesome growth of the centrally planned economies in the 1950's and 1960's soon proved to be on a path of secular decline, as the vivid contrast between North and South Korea reminds us today.

Rather, the East Asian experience suggests that "the secret of development seems to lie in the combination between the rationality of the market in allocating resources, and the strategic guidance of the state in charting the development course in a comprehensive way, while keeping the state's relative autonomy over the interest of specific groups." (Manuel Castells).¹⁵ As Figure 1 reminded us, the economic take-off in Korea and China have been very fast by any historical standard.

Japan, South Korea, Taiwan, and Singapore have combined a strong developmental state with the ability to take advantage of the opportunities provided by the growing internationalization of the market economy. Otherwise these economies differed significantly in their industrial structure, and they have been equally diverse in their connections to the global economy. But what about Hong Kong? As Castells and his co-authors wrote more than a decade ago, with a fair amount of sarcasm:

"As everybody knows, with the possible exception of Milton Friedman, the free-market paradise of Hong Kong operates the second-largest public housing system in the capitalist world in terms of the percentage of the population living in housing units developed, built, and managed by the government: about 45% in 1986"

(Castells, Goh and Kwok, *The Shek Kip Mei Syndrome*, 1990, p.9)

¹³ Peter L. BERNSTEIN, [1993], *Capital Ideas, the Improbable Origins of Modern Wall Street*, The Free Press.

¹⁴ Chalmers JOHNSON, [1982], *MITI and the Japanese Miracle*, Stanford University Press. Note that this paper refers to the countries sharing culturally what Edwin Reischauer called "the Great East Asian Tradition" in his famous Harvard textbook, not to geography.

¹⁵ Some of the features of the developmental state include long-term economic planning by an efficient bureaucracy able to make rapid incremental policy adjustments, sound macroeconomic management, opening to external trade, administrative guidance of economic behavior, strategic support and reliance on large conglomerates, mix of public and private corporations, high rates of public and private education, and limited scope for labor movements.

Clearly, when it comes to the housing strategy followed for the last 50 years, Hong Kong also belongs with the other East Asian “developmental states.”

The role of the “development state” is a great topic of discussion for political scientists and economists.¹⁶ Two questions are highlighted in Japan by the lost decade of economic growth after the burst of the 1990 bubble and in Korea with the 1997 financial crisis. First, why and how did the developmental state appear to have outlived its usefulness at high levels of development? And, second whether reliance on the ‘development state’ has become more constrained during the past two decades because globalization?¹⁷

From an urbanization point of view it can easily be argued that one major strategic achievement of the Asian developmental states has been their ability to focus on the efficient delivery of public goods as understood by economists and to manage urban externalities at various stages of urbanization and levels of incomes. Most critically perhaps, the East Asian developmental states have been able to maintain a satisfactory balance between urban shaping infrastructure and directly productive investments.¹⁸

Four very different choices of housing strategies across East Asia in the 1950s

If we compare the place of social housing in the overall economic growth strategies followed by East Asian states during the third quarter of the 20th Century we find four dramatically different families of housing strategies after the 1950s. Given the long-term nature of housing investment and urban infrastructure, the legacy of these strategies is still being felt today in the 21st century:

- *Demand redirection and under-investment in housing.* South Korea followed the Japanese strategy of redirecting demand away from consumption in order to speed up industrialization. Housing being a domestic non-traded, non-industrial good was also taken as part of “consumption”.¹⁹ The inadequate national accounting convention of the time helped reassure state planners that housing investment should be suppressed because of its high capital/output ratios, however calculated. In Japan, this strategy that was born of the war effort was maintained afterwards. Distorting land use policies did not help. As a result, both Japan and South Korea have under-invested in housing over long periods of times. But when Korea adopted Japan’s urban policies, Japan was already over 60% urban while the Korean urbanization level was less than 28%. It can easily

¹⁶ It was not possible to avoid the triumphalism of the developmental state during the Japan boom of the 1980s with the famous “flying geese” concept of pan-Asian development anymore than we were spared the vocal triumphalism of the laissez-faire model during the great US boom of the 1990s. Now that both bubbles have burst, what comes next? Every region of the world follows its preferred path?

¹⁷ For a thorough and thoughtful analysis of Korea’s experience, see Stephen HAGGARD, Wonhyuk LIM, and Euisung KIM [2003], *Economic Crisis and Corporate Restructuring in Korea*. Cambridge University Press.

¹⁸ See for instance Daniel KAUFMANN [1991] “The Forgotten Rationale for Policy Reform: the Productivity of Investment Projects.” Background paper for the World Development Report 1991. World Bank.

¹⁹ See William LOCKWOOD, [1954] “Structural Change: The Redirection of Demand”, chapter 8 in *The Economic Development of Japan, Growth and Structural Change 1868-1938*. Princeton U. Press. And also, Edwin Mills and Katsutoshi Ohta [1976] “Urbanization and Urban Problems,” in H. Patrick and H. Rosovsky *Asia’s New Giant, How the Japanese Economy Works*, Brookings Institution.

be argued that under-investment in housing has contributed directly and indirectly to episodes of labor unrest in Korea for the last two decades.²⁰

- *Large-scale public housing programs in support of a small open market economy.* When Hong Kong and Singapore adopted their public housing strategies they were both refugee economies whose internal stability and economic success was far from being the foregone conclusion that some might now be tempted to assume ex-post. Being both very small, open economies dependent on their international competitiveness on the international markets, one way to achieve social stability while keeping wages as competitive as possible was to improve the housing environment of the workers. The choice was to go for state public housing.²¹

Being city-states, the direct link between an efficient city infrastructure and macroeconomic competitiveness was not lost on Hong Kong and Singapore policy makers. In clear contrast, macroeconomic planners in Japan and Korea have long had a tendency to see urban growth mostly as a social problem to contain and not as a wealth-creating process. Public housing in Hong Kong and Singapore therefore became an integral part of overall urban infrastructure planning policies, given the control of the land market by the state.

It is noteworthy that the very influential housing policies that Chile put in place in the 1980s have also been based on a comparable macroeconomic strategy of direct support to low-income workers, in order to improve social stability while achieving competitive wages internationally. However, given its large territory and highly skewed income-distribution, Chile chose to rely on the competitive delivery of low-income housing by the private sector combined with demand-side subsidies. This is a housing delivery strategy that fits Chile's high urban ratio of 86% and its lesser and different city-building needs along its spread out national urban hierarchy, which is an urban policy context quite different from Hong Kong or Singapore fifty years ago.

- *Central planning's view of housing as a social good to be distributed by the state.* Both China and North Korea took the central planning path to housing delivery in the 1950s. The next section discusses the evolution of China's housing policies away from that misguided start. We should just note here that North Korea's housing policies have been much more Soviet than Asian in nature, because North Korea was initially more urban and industrial than either China or South Korea.²²

²⁰ Of course, this does not mean that either Japan or Korea failed to build modern cities! For evidence of Korean systemic under-investment in housing during the urban transition, see Hak K. PYO [1988], "estimates of Capital Stock and Capital Output Coefficients by Industries: Korea, 1953-1986" in *International Economic Journal*, Seoul, Vol.2, (Autumn). See also, B. RENAUD [1993] "Confronting a Distorted Housing Market: Can Korean Policies Break with the Past?" in L.B. KRAUSE and F.K. PARK, *Social Issues in Korea*; Seoul, Korea Development Institute.

²¹ For the strategy, see LEE Kuan Yew, [2000] "A Fair, Not Welfare Society", Chapter 7 in *From Third World to First. The Singapore Story: 1965-2000*. For a comparative study of policy implementation in Hong Kong and Singapore refer to CASTELLS, GOH and KWOK, [1990], *The Shek Kip Mei Syndrome*, already cited.

²² See: B. RENAUD [2003], "The Urban Dimension of the North Korean Economy; A Speculative Analysis" in E. K. Choi, E.H. Kim and Yesook Merrill (eds) *North Korea in the World Economy*; Routledge-Curzon.

- *Non-interventionist housing policies based on income equality and a balanced growth path.* Among East Asian countries, Taiwan followed the only non-interventionist housing policies and has relied on market response mechanisms. This housing strategy was greatly facilitated by Taiwan's very balanced growth path.²³ The economic take-off in the 1950s was initially built on land reforms and rich and competitive agricultural exports followed by a gradual industrialization that was initially rural-based. As a result, Taiwan was also the economy with the best income distribution among market economies of Asia and the mildest rural-urban income disparities. The urbanization process was diffused across the island's urban system, thereby greatly mitigating the social stress and needs caused by a rapid concentration of low-income workers in a few very large cities. Table 2 shows these strategic differences across East Asian housing system in 1980s and early 1990s.

TABLE 2: HOUSING BY TYPE OF PROVIDER in EAST ASIA		
	Public	Private
Taiwan, China (1988)	5.0%	95.0%
Rep of Korea (1992)	17.0%	83.0%
Hong Kong, China (1986)	44.1%	55.9%
Singapore (1985)	85.0%	15.0%

Source: William D.H. Li, [1998] Housing in Taiwan, Agency and Structure, Ashgate, Table 5, p. 30

As is well known, in market economies where housing demand is driven by household choices most of the important distortions in a housing system are found on the supply side. In centrally planned economies (CPE) distortions exist on both the demand and the supply side; moreover, these CPE distortions tend to grow over time.

The housing strategies chosen by East Asian governments in the 1950s are now facing important challenges in the 21st Century due to a convergence of factors:

- High income levels and a strong demand for better housing choices by the new urban middle-class;
- A very high level of urbanization and very deep real estate markets;
- The rapid development of housing finance systems since the 1980s and the development of pensions funds and capital markets;
- A universal demand for administrative devolution and local political decentralization;
- The demand for better governance and greater transparency;
- And in addition, the emergence of "metropolitan competition" at the global level, which has tendency to accentuate urban concentration in larger metropolitan areas and increases the level of complexity in managing large urban regions.

Among these six East Asian housing policy stories that could be evaluated, it seems appropriate to focus on China today because this is the country that has made the most drastic change in its housing strategy. Its government has done so because of the large-scale urban population growth that lies ahead. It is expected that one urban resident out of five in the world will be living in a Chinese city by the next generation.

²³ See: Tzong-shian YU [1989] 'Taiwan's Economic Development; A Case of Growth with Equity', Chapter 13 of Y.C. JAO, Victor MOK and Lok-sang HO, *Economic Development in Chinese Societies: Models and Experiences*. Hong Kong U. Press. For a comprehensive study of Taiwan's growth strategy, see John C.H. FEI, Gustav RANIS and Shirley W.Y. KUO [1989] *Growth With Equity: The Taiwan Case*; Oxford U. Press. For a specific view of the developmental state, see Thomas Gold [1986], *State and Society in the Taiwan Miracle*, M.E. Sharpe.

V. CHINA'S U-TURN IN HOUSING STRATEGY

Among the four types of housing strategies selected in East Asia, it is the housing strategy of China that has shifted the most dramatically over the last 50 years. In fact, China's experience spans the entire spectrum of housing policy experiences during the 20th Century, at lower levels of urbanization than other countries in the region.

What do demographic projections for China's urban population show?

China's level of urbanization was quite low at 12.5% in 1950, even if Chinese cities already formed a significant part of the urban world at 9.3% as Table 3 reminds us. By now China is rapidly reaching its own urban inflexion point. The size of the urban system which grew more than 6-fold over the last 50 years will double again become overwhelmingly large. China's share of the urban world is expected to rise further.

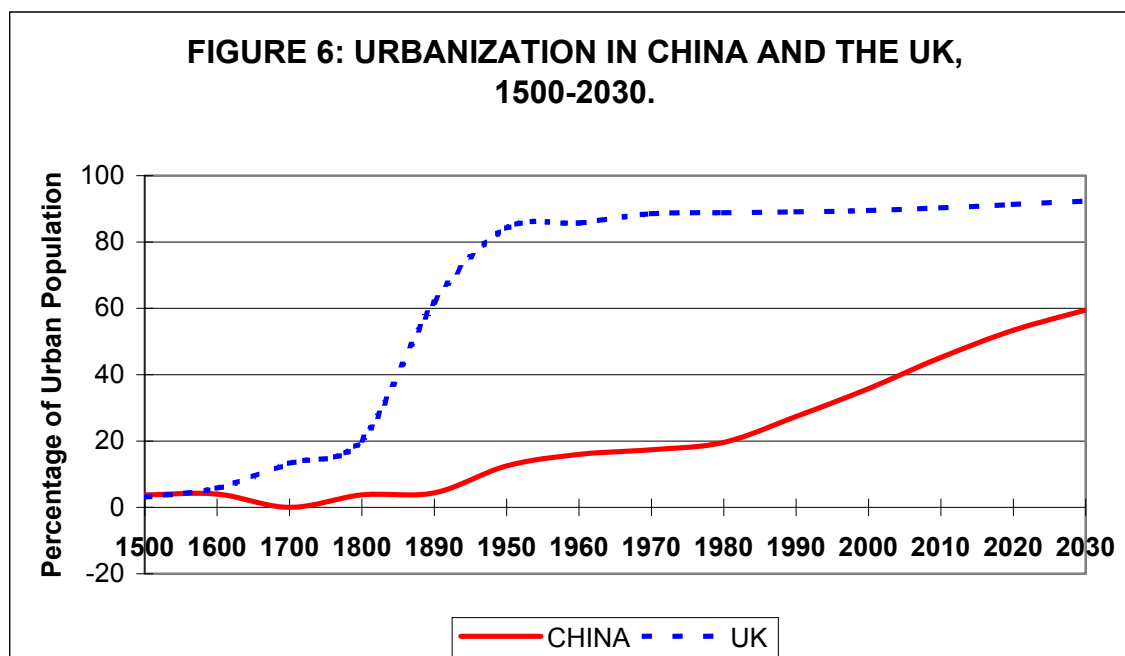
Focusing on China's transition from a centrally planned system to a market based system gives us an opportunity to revisit important policy lessons of that period. As Table 3 shows, China's population increased 6.5 times between 1950 and 2000 in spite of some major socio-economic crises along the road. And now Chinese cities expect to double their population again in about one generation and they will have to provide housing for almost 900 million citizens in three decades from now. In order to maintain growth and social stability, China needs to implement a housing strategy that is fully consistent with its overall economic strategy, and that will improve the efficiency – and equity – of urbanization processes.

TABLE 3: Ten Largest Urban Populations of the World in 1950, 2000, 2030 (In millions)												
	1950			2000			2030 projections			Increment 2000-2030		
	Country	Urban	Share	Country	Urban	Share	Country	Urban	Share	Country	Urban	Share
1	USA	101	13.5%	China	456	15.9%	China	883	17.7%	China	427	20.1%
2	China	70	9.3%	India	279	9.7%	India	576	11.6%	India	297	14.0%
3	India	62	8.2%	USA	219	7.6%	USA	303	6.1%	USA	84	4.0%
4	Germany	49	6.5%	Brazil	138	4.8%	Brazil	205	4.1%	Brazil	67	3.2%
5	Russia	46	6.1%	Russia	106	3.7%	Indonesia	180	3.6%	Indonesia	74	3.5%
6	UK	43	5.7%	Japan	100	3.5%	Nigeria	140	2.8%	Nigeria	40	1.9%
7	Japan	42	5.6%	Indonesia	87	3.0%	Pakistan	133	2.7%	Pakistan	46	2.2%
8	Italy	26	3.4%	Mexico	74	2.6%	Mexico	110	2.2%	Mexico	36	1.7%
9	France	24	3.2%	Germany	72	2.5%	Japan	103	2.1%	Japan	31	1.5%
10	Brazil	20	2.6%	UK	53	1.9%	Bangladesh	99	2.0%	Bangladesh	46	2.2%
...	Rep. Korea	4	0.0%	Rep. Korea	38	1.3%	Rep. Korea	48	1.0%	Rep. Korea	10	0.5%
	WORLD	751	100.0%	WORLD	2862	100.0%	WORLD	4981	100.0%	WORLD	2119	100.0%

Source: World Urbanization Prospects 2001, UN Population Division, Table 33

To make differently the same point that a large share of China's urban future still lies ahead, Figure 6 compares the time path of urbanization over the period 1500-2030 in China and in the United Kingdom. It is only in 1980 that China's level of urbanization reached that of the UK in 1800 when the industrial revolution had begun. Before 1500,

China was ahead of Europe. It is not pure coincidence that European philosophers of the Enlightenment discussed China as one model in their political and economic essays.



Sources: A. Maddison [2001], Table B-14, p.248. UN World Urbanization Prospects 2001, Table A-2

Milestones in the 20th century history of Chinese housing

The Chinese housing strategy has made a 180 degree policy turn between 1949 when all the tenets of central planning were adopted and 1998 when Directive 23 of the State Council formally shifted the national housing strategy from “distribution” housing back to “commodity” housing as the official housing policy of China. The well-known pragmatic reason has been that housing conditions in China, like in all the other socialist economies had become a major economic, social and political issue. The allocation of housing by state agencies or state enterprises had too many drawbacks. Without a return to market housing owned and finance for the most part by its citizens, China would not be able to grow and urbanize effectively, therefore jeopardizing social stability. From a macroeconomic perspective, housing reforms are a major component of the overall Chinese economic reforms.²⁴ A brief narrative may help gauge the scope and scale of the policy challenge.

- **1949. State Provision of Housing Within a Central Planning Framework.**

In 1949 China’s economy, had reached its nadir.²⁵ With the establishment of the People’s Republic of China in 1949, housing allocation becomes based on a welfare system of housing as a “distribution good” allocated by the state. Rents are kept

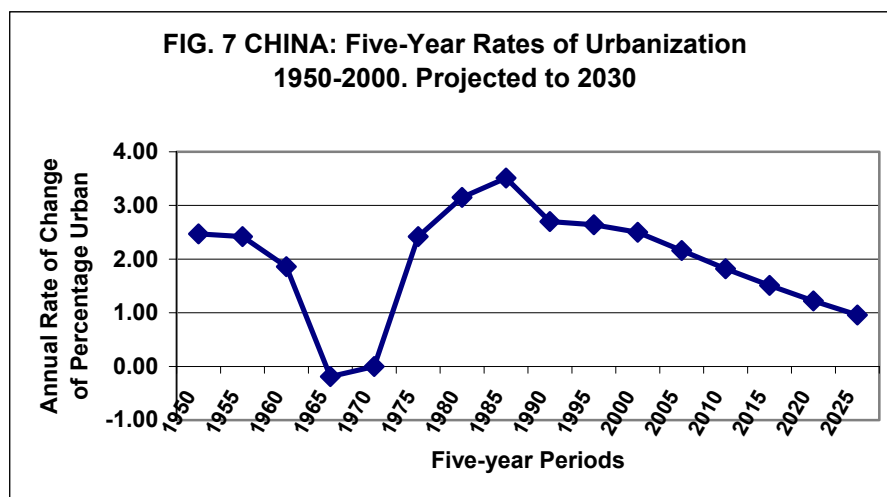
²⁴ See B. RENAUD [1990] *Housing Reform in Socialist Economies*, World Bank Discussion Paper, no.125, 60 pp

²⁵ Socio-economic conditions in 1949 were overwhelmingly difficult in China. “Between the 1840s and 1940s, China’s economy collapsed. *Per Capita GDP in 1950 was less than three quarters of the 1820 level.* Population growth was interrupted by major military conflicts. In 1950, “China’s GDP was less than a twelfth of that of Western Europe and the Western Offshoots” A. Maddison [2001], p.117. GDP per capita had fallen from \$600 in 1820 to \$439 in 1950, in 1990 international dollars according to A. Maddison [2001], Table A3-c, page 215.

very low, at levels even inadequate for good maintenance without speaking of capital recovery. Buying or selling urban houses as commercial goods becomes illegal. All forms of land become public property.

The welfare-based housing system exhibits a number of serious problems with the passage of time: patterns of unfair allocation of housing units as well as corruption emerged; artificially low rents led to a persistent demand for yet more low-rent housing; new construction is very slow due to an acute shortage of funds.²⁶

In addition to the systemic problems associated with the operations of any centrally planned housing system, the cities of China suffered from systematic under-investment as a matter of policy after 1949. The severe economic and political disorders of the period 1966-1976 even led to an negative rate of urbanization and a temporary fall in the urban population of China as seen in Figure 7.²⁷



Source: UN Population Division, *World Urbanization Prospects 2001*, Table A.9

The urban housing shortage becomes extreme. By 1978 the per capita living space per person in cities has deteriorated to 3.6m²/person. The overall quality of the housing stock has also severely deteriorated in the absence of maintenance for a decade or longer. DENG Xiaoping launches the national economic reforms in December 1978. He launches the housing reform experiments two years later.

- **1980. Launch of the Housing Reform Experiments**

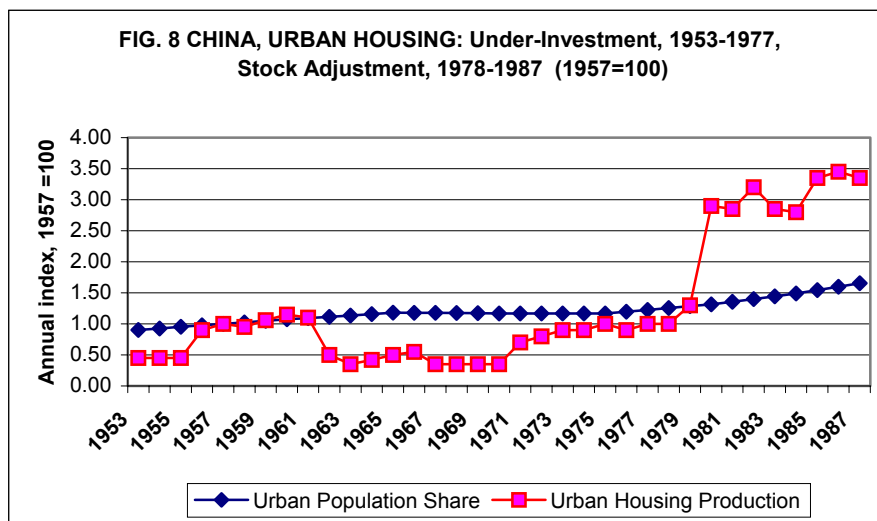
Chairman DENG Xiaoping states in April 1980: *"we should consider a series of policies concerning housing construction in cities and its distribution. Urban dwellers may purchases houses or build houses themselves. We may sell not only the newly built houses but also the old ones...Rents should be adjusted with the price of houses for sale in mind...Those people with low incomes should be given subsidies when rents are raised."*

²⁶ For an illustration of the systemic performance problems of a mature socialist housing system also present in China, see for instance B. RENAUD [1992], "The Housing System of the Former Soviet Union: Why do the Soviets Need Housing Markets?" Fannie Mae Foundation: *Housing Policy Debate*, Vol. 3, Issue 3.

²⁷ See Part IV "The National Economy in the 'Ten Years of Turmoil' (1966-1976)" in LIU Suinian and WU Qungan (eds) [1986] *China's Socialist Economy, An Outline History (1949-1984)*, Beijing Review Press.

The strategic issue is how to “cut the Gordian knot” – or more appropriately in China how to shatter “the iron rice bowl” that ties together housing, employment, wages, and the pension system under the *danwei* system of state enterprises. The inflexible system of public housing distribution created after 1949 simultaneously stands in the way of urban housing reforms, labor market reforms, state enterprise reforms, and pension reforms.

- Housing reforms are initiated that year through changes in the state budget: investment decisions are decentralized to local governments, state-owned enterprises and urban collective enterprises.
- The share of housing investment financed by the state budget falls from over 90% before the initial reforms of 1980 to 16% in 1988.
- By then, state-owned enterprises provide 52% and private sources 20% of the housing investment funds.
- A massive national housing stock-adjustment investment process takes place during the period 1980-1988 to fill the backlog of decades of under-investment and to meet new urban needs, as shown in Figure 8.
- A program of local housing reform experiments emerges in various parts of the country with State Council support in order to identify out successful approaches that will be economically effective and not socially destabilizing.



Source: YE, Yaoxian (1988, unpublished) reported in B. RENAUD (1988)²⁸

- **1988:** *Amendment to the Chinese Constitution to permit private ownership of land use rights*
 - Following successful experiments with land leasing in the new city of Shenzhen and elsewhere, the Chinese Constitution is amended to permit private ownership in urban land rights.
 - Long-term land leases can be granted for private real estate development. This is the turning point for the creation of the legal framework for a modern real estate industry in China.
 - In March 1988, a State Council directive announces “A plan for reforming the housing system in urban areas throughout the country”. “The objective of reform of the urban housing system is to commercialize housing according to

²⁸ B.RENAUD “China’s 1988 Urban Housing Reforms: Origins, Scope, and Obstacles” in G.C. LIM and Wook CHANG Ed. [1990], *Dynamic Transformation: Korea, NICs and Beyond*. CDS, Urbana, Illinois.

the demands of a socialist planned commodity economy” and goes on to promote eight actions regarding the management and pricing of existing housing, new housing units and their financing mechanisms that should be part of the housing reform plan of every city.²⁹

- The liberalized real estate industry continues to sell its housing products to enterprises and work units rather than directly to individuals. However, over time a small but increasing share of output goes to serve families without access to publicly sponsored housing.
 - Two experimental housing banks are created in Yantai and Bengbu
- **1994: Acceleration of the Housing Reforms. Housing Privatization and Creation of the Housing Pension Funds**
- A new State Council Directive on “The State Council Decisions on Deepening Housing Reforms” gives priority to resource mobilization over wage reforms and promotes four main measures:
 - (1) The establishment of *housing provident funds* to be managed by municipal governments;
 - (2) The further *increases in public housing rents*;
 - (3) *The sale of existing public housing* to urban workers on a cost recovery basis;
 - (4) The speeding up of the development of “*Anju*” (“comfort”) housing i.e. a heavily subsidized mass commodity housing program that provides financial and other support to housing construction *for sale* to low and middle-income families facing housing difficulties. However, these *Anju* units either remained unsold or were sold to other families than those intended by policy.³⁰
 - Chinese policy makers are divided over the diagnosis for the slow progress of privatization:
 - Some officials emphasize the low purchasing power of the workers, and worry about meeting important *numerical production targets*. They want to *focus on supply-side measures and on more subsidies*.
 - Others, including also the World Bank find that the core of the problem lies in the structure of the two-part socialist wage with its low cash wage plus compensation in kind by the employers. This compensation system leads to a structure of demand where housing decision and expenditures are made not by consumers but by their employers. In other words, the lack of progress does not lie in an aggregate resource shortage for housing, but in *the structure of incentives* that leads to the very low efficiency of the housing system and to resource misallocation.
 - Based on international experience with housing reforms in other transition economies, the World Bank advises that the demand for home ownership and mortgage loans would remain initially weak in Chinese cities because households would see limited value in home ownership under the low-wage,

²⁹ For an evaluation of the State Council Directive of February 1988 see Melinda BARLOW and Bertrand RENAUD [1989], “Housing Reforms and Commercialization of Urban Housing in China”, Tokyo, *Review of Urban and Regional Development Studies*, Vol.1, No. 1. January.

³⁰ This glut was less attributable to the business cycle itself than to the linkage between housing and enterprises, which accentuates business cycle effects under a significant element of State-owned enterprise (SOE) soft-budget constraint. Supply-oriented funding programs such as the provident funds and the *Anju* housing program compounded these effects.

low-rent system, which was reinforced by strong administrative rental property rights.

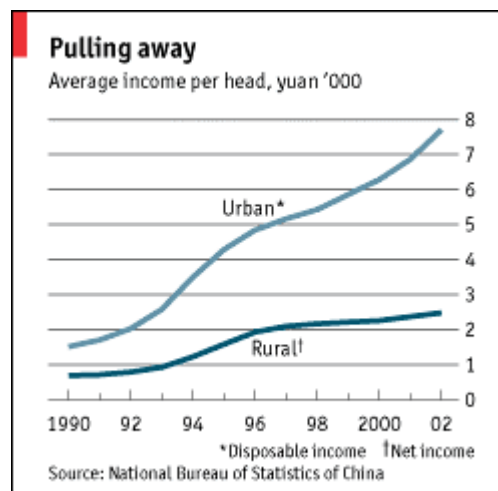
- Following previous practice, it is agreed to test the role of structure of incentives in four very different pilot cities (Beijing, Chengdu, Ningbo, and Yantai).³¹ These experiments receive increasing notice in professional real estate meetings and are increasingly widely supported.
- Most importantly, the balance between SOE employment and non-state employment is shifting very rapidly in favor of market-based wages in major economic areas of the country.

▪ **1998: Official Transition to a Market-Based Housing System**

- State Council Directive 23/1998 followed the announcement made in March 1998 by Premier ZHU Rongji that the provision of housing in-kind by employers should stop and that households should purchase their own units individually. This transition should be accomplished very rapidly. Directive 23/1998 contains 30 separate recommendations grouped under seven main headings that articulate the new housing strategy for the country.
- Directive 23 is a landmark in the history of Chinese housing policy because it finalizes the strategic policy shift toward the “commodification” of housing that had began 18 years earlier and it puts a quiet end of the rigid and unsuccessful “welfare” or “distribution housing” strategy adopted in 1949.
- Directive 23 promotes a more flexible and adaptable three-part housing policy. These three major housing policy segments are defined according to the income characteristics and purchasing power of various households:
 - high income households buy or rent “commodity housing” (*shang pin fang*) at the market price.
 - the low and middle income households will buy or rent “economic and appropriate” housing (*jingji shiyong zhufang*);
 - The poorest will have access to “low-cost rental housing” (*lian zu zhufang*) provided by the government or the work units;
- The government’s immediate focus will be on the development of “economic and appropriate” housing because the lowest tier of the system will continue to operate significantly like the old welfare housing system for some time, but the share of that lower tier of the housing system is expected to be sharply reduced over time. This Chinese policy framework parallels the broad distinction between “market housing”, “assisted housing” and “social housing” encountered in the housing policies of most market economies.

³¹ In the pilot cities, participating work units turned over their housing to new joint-stock housing management companies (HMC) in return for shares in these companies. The rents were increased to full cost levels at once. The workers of the participating units receive cash allowance from their employer in lieu of in-kind housing benefits. The housing companies rent and sell that existing housing stock and new housing on fully commercial terms. Long-term mortgage loans were provided to housing companies and to individuals. Participating employers by becoming shareholders of the housing companies have a voice in their rental and sale management decisions to workers. Enterprises can focus on their primary business and are freed from real activities for which they have no comparative advantage. Full-time real estate professionals, who must now be responsive to the preferences and incomes of families, handle housing supply decisions.

- **2003:** *Comprehensive blue-print for banking and financial reforms*³²
 - China's new government under President HU Jintao and Prime Minister WEN Jiabao are sworn in at the annual National Peoples' Congress in March. A high policy priority of the new government is the implementation of a comprehensive blueprint for banking and financial reforms. These banking reforms include the development of a safe and sound housing finance system. They will play a critical role in maintaining a stable growth of the economy.³³
 - Another challenge for the new government is to restore a better economic balance between coastal and hinterland provinces, across income groups, and between rural and urban areas (see graph below). Yet, China's entry in the WTO as of September 2001 could complicate the pursuit of this goal, as the new forms of global competition tend to favor large metropolitan regions.³⁴



Source: *Economist*, 27th September 2003

Earlier, Figure 1 has shown the very high speed of diffusion of innovation and industrialization in Korea and in China. The rapidly widening gap in income and quality of life between rural and urban areas in China today is very comparable to that observed in Korea in the 1970s and 1980s. There is a real possibility that current projections of future urbanization levels for China like those shown in Figure 4 underestimate forthcoming urbanization rates. Actual levels of urbanization in China could follow more closely the rapid South Korean urbanization path shown in Figure 2.

- **2004:** It is widely anticipated that the next National People's Congress will approve a constitutional amendment granting equal protection of private and public property rights.

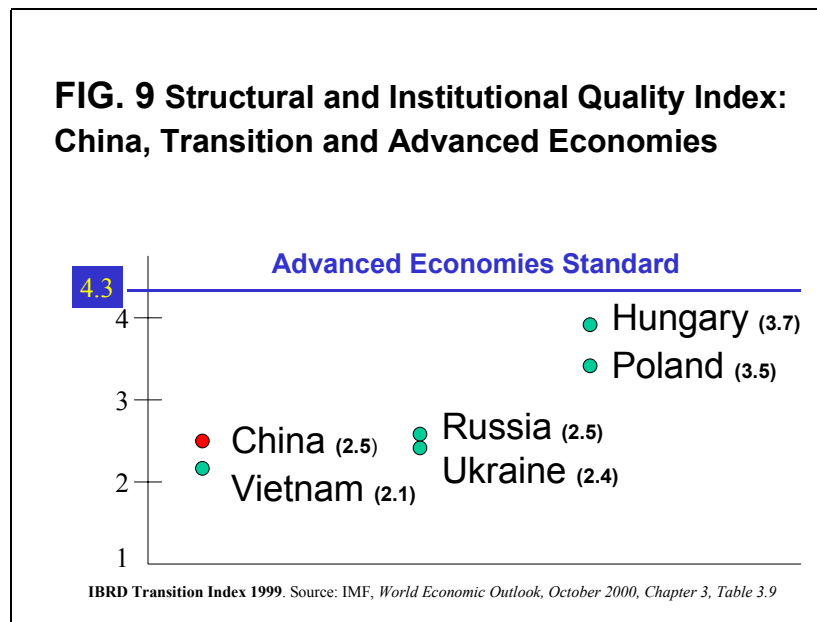
³² For an overview of the scope of the financial reforms needed in China, see Nicholas R. LARDY, [1998] *China's Unfinished Economic Revolution*, Washington DC, The Brookings Institution Press.

³³ The development of the financial sector contributes directly to better and faster economic growth and development. See WORLD BANK, [2001] *Finance for Growth. Policy Choices in a Volatile World*.

³⁴ See: Paul KRUGMAN [1991], *Geography and Trade*, MIT Press; Michael PORTER [1998] "Clusters and the New Economics of Competition" *Harvard Business review* (November-December); Jean-François THYSSE and Tanguy VAN YPERSELE [1999], "Métropoles et concurrence territoriale" *Économie et Statistique*, No 326-327.

V. THE DEVELOPMENT OF CHINA'S HOUSING MARKETS

China remains a reforming transition economy. Much of the approach that central government policy makers have taken so far has been incremental and experimental with considerable responsibility assumed by the local governments. In fact, in a manner reminiscent of the other developmental states of East Asia, the local Chinese authorities have been rule makers and have often substituted successfully for the lack of clear and transparent legal and regulatory frameworks. The limits to this pragmatic approach are being reached very rapidly in increasingly large and complex cities.



Since 1980, China has been gradually developing the infrastructure and institutions for the market-based for macroeconomic management, for private enterprise development and for urban investment. In fact, China's very high and sustained rates of economic growth partly hide the gap that remains between its institutions and those of advanced economies. China even lags behind the institutions of the transition economies of Central Europe as suggested by Figure 9 that shows the institutional development index originally developed by the European Bank for Reconstruction and Development to track institutional progress in transition economies since 1989.

In Chinese cities proper, much remains to be done to develop the complete set of institutions necessary for a modern real estate economy where risks can be managed properly and resources are efficiently allocated. Volatility, instability and investment misallocation in urban markets remain important risks that need to be lowered as the scale and complexity of investment increases.³⁵ What is the emerging housing market structure? And what some of the next steps in the development of the institutional structure for the sector?

³⁵ For a discussion of the greater risks encountered in many Asian markets and in China in particular due to incomplete institutional development, see B.RENAUD [2003] "Speculative Behavior in Immature Real Estate Markets, Lessons of the 1997 Asia Financial Crisis" *Urban Policy and Research*, Vol.21, No. 2, June.

A. The Emerging Housing Market Structure ³⁶

There is a race at present between the very high rate of physical investment in Chinese cities and the institutions needed to make the right decisions. An overview of the emerging housing market structure can give a better sense of this institutional work in progress toward creating a full housing market system.

1. Commodity Housing Market (*Shang Pin Fang*)

Since the late 1980s, it has been possible to purchase housing at full price in what has become known as the commodity housing (*shang pin fang*) market. This form of housing now comprises about 15% of all housing stock in coastal cities. Commodity housing is unencumbered and the owner has full rights to sell the property and to retain all of the proceeds of the sale.

Commodity housing is produced, managed and exchanged on commercial terms. In today's urban housing market, commodity housing accounts for the lion's share of the new supply. Cities across the country are experiencing a boom in the real estate development industry. Almost all development companies are keen to take part in development of commodity housing.

Between 1993 and 1998, prices were distorted because the majority of housing purchasers used to be the work units (*danwei*) with strong financial conditions that vied with each other for housing in good location and of high standards, leaving housing price out as the main consideration. When the composition of the housing supply price is broken down, construction costs alone comprised 30 – 50% of the selling price. Generally, when housing is built at the outskirts of the city, the construction cost accounts for 50% of the housing price, and the land cost for another 20 – 30%. The remainder of costs includes taxes and other charges.

2. Economic Housing (*Jingji Shiyong Zhufang*)

State Council Directive 23 envisages that "*jingji*" (*economic and appropriate*) housing will be the mainstay of the new housing market. Directive 23 stipulates that newly constructed economic housing should be sold at a price set by the government to ensure cost recovery and minimum profit for the developer. The price of the *jingji* housing should cover the following cost elements: land purchase, compensation for persons displaced by the development, survey and design, engineering, construction, infrastructure development (including non-profit supporting public facilities), management costs, loan interests and tax. The rate of profit is to be limited to 3%.

The "economic and appropriate" (*jingji*) housing program can be traced back to 1994. Originally, it targeted certain groups of households and people affected by urban redevelopment and natural calamity. The program was more policy-related than

³⁶ This section draws on the work of various World Bank missions and studies of China's housing reforms, to which the author has contributed at various times from 1988 until the present; it benefits in particular from a 2002 internal report on the status of the housing reforms. The author has benefited from exchanges with officials, academic researchers and industry specialists; and from informal discussions over two decades at the World Bank with Dr. Songsu CHOI, the late Dr. Andrew HAMER and many other colleagues and consultants.

market-oriented. The government provided the program with preferential treatment, such as appropriation of land, exemption or reduction of some taxes and charges and priority access to bank loans. The program was further strengthened and structured in 1998 by State Council Directive 23. However, in many cities, economic housing has yet to play the dominant role expected by the Government. The proportion of economic housing in the total stock of commodity and economic housing (i.e. excluding former welfare housing which makes up 80% of all housing stock) is typically less than 25%.

3. Low Cost Rental Housing (*lianzu zhufang*)

This market segment remains the bulk of the urban housing system. Directive 23 envisages that the poorest segment of the population will be provided with "low cost rental" (*lianzu*) housing, either by the government or by their work units. There are two basic criteria for selecting the tenants: (1) households living in poverty, normally referring to those households whose per capita income is below the poverty line, or in the Chinese terms, those who have to rely on the social security fund (SSF). In addition, veterans and the disabled also qualify; (2) households whose per capita living space is less than the specified standard in the city. For example, it may be between 5 and 7m² of usable space per capita.

Although the Government initiated the low-cost rental-housing program in 1998, the cities have been relatively slow to get into implementation. No matter what model is used to carry out a low-cost rental-housing program, all cities governments realize that the poor should not be concentrated in the same place; otherwise, social unrest may develop.

4. Commercial Rental Housing

The commercial rental market is made up of two elements: one is made up of the large-scale rental operations carried out by national and local development companies. The other is the private rental market where individuals rent out property that they own. Hypothetically, owners need full property rights and should pay tax on the income to be able to legally rent out their property. However, it seems that there is a very large "grey market" for private rentals.

In large cities like Beijing, the private commercial rental housing market can be divided into four rather distinct segments:

- The first segment is luxurious rental housing, which accounts for about 5% of the rental housing market. The rent can be very high – as much as ten times the average market rent.
- The second segment is targeted to local white-collar staffs who work for large companies either foreign or domestic. Most of these people are new graduates from colleges or universities or migrants with some professional skills coming from other parts of the country. These people mainly rent housing in the second-hand housing market, which is basically composed of the former welfare housing sold at the subsidized prices. In addition to white-collar staff, some small businessmen may also demand for such housing.
- The third group of people who rent housing are those working in the services sector, like restaurant waiters or waitresses. They may live in the dormitories provided by their employers, or co-rent flats together. The rent may consume between one third and one half of their monthly salaries.

- The fourth group of people includes simple labor workers, such as hawkers, housekeepers or baby sitters. In the largest cities, they normally live in the basements of the high-rise buildings, shanty bungalows or farmers' houses on the fringe of the city and pay relatively low rent. These places are usually not provided with sufficient facilities. Also, a large proportion of migrant workers in large and medium-sized cities are construction workers, most of whom just live in temporary shelters on sites.

B. Building-up the Housing Market Infrastructure

The development of a market-based housing system that is the goal of China after State Council's Directive 23 of 1988 is a work in progress. Shifting from the state-controlled, administrative system of housing to a market-based system requires considerable legal and institutional developmental work, which will take time. The role of the state is shifting from direct intervention into construction and finance to an indirect regulatory role, but as we have just seen the largest proportion of the urban housing stock is still managed through mostly administrative processes.

What is important is that State Council Directive 23 has shifted the structure of incentives for the key participants in the market in the right direction to support a demand-driven, flexible housing system. The emerging new middle class' incentives to buy are no longer undercut by heavily subsidized housing from their work units; the new enterprises where almost all the new jobs are created are now free to concentrate on their business responsibilities; the real estate development companies are becoming more and more professional.

Two factors work in favor of China's housing reforms compared to the transition economies of Central Europe or Russia. One is that China is reforming in a context of rapid growth and the household savings rate is among the highest in the world. The other is that urbanization remains low and much of the city-building process still lies ahead. Traditionally, geographers have done excellent work studying the diffusion of innovations in time and space across expanding system of cities. It will be interesting to see what they might tell us about the diffusion of housing markets across China. One variable with a very large effect is certain to be the behavior of local governments who implement the rules of the road in their respective cities.

There are six areas where much work remains needed. Most of this work is of a legal and regulatory nature, and not of an engineering, technical or managerial kind. Under central planning, law was first and foremost an instrument of state control and administrative convenience. Law in a market economy is fundamentally different, it defines the rules of games and provides individual rights, but those are not self-enforcing: appropriate institutions, processes and professionals are needed. Inevitably the housing reform transition is a gradual process, but one where momentum keeps building-up. What gives cause for optimism is that the distance already traveled since 1988 is quite impressive.

1. Clearing-up the Administrative Legacy of Fragmented Housing Property Rights

Housing is the largest asset for most households, with the potential for significant capital gains. During the transition from housing welfare to commodity housing, the demand for home ownership by residents is complicated by the fact that the old implicit and explicit property right system differs from the set of property rights needed for

market-based housing. Some households do not want to give up the benefits of public housing sold at discount price; but they are not satisfied with their housing space, facilities and location. Multiple types of demand for housing can only be realized through market exchange. The ability to trade of a bundle of rights is a prerequisite for a well-functioning housing market. The legal framework for clarified property rights must be put in place and should include: (1) the clarification of property rights to ensure their legal protection; and, (2) property rights that are practical and tradable in order to realize their value in the exchange.

Urban housing is rapidly becoming a major component of household wealth in China like in all other market economies, especially in East Asia where pension systems have been historically limited, Unequal opportunity for different income groups to obtain housing and trade real estate properties could have a significant negative impact on the income distribution and on social stability.

A high priority is therefore to clear up the economically inconsistent legacy of implicit and explicit rights that result from earlier administrative rules regarding the use of housing and to move deliberately to market property rights. Until now, ambiguous property rights have restrained the interests in home ownership and trade in housing.³⁷ For instance, some people bought public housing many years ago. They failed to get the formal document or title of property rights. Without legal document, they lose the opportunities to sell the housing units. Some home purchasers got "limited ownership rights", which include the rights in virtual perpetuity to live in housing units and pass them to their heirs. They are barred from selling the housing units, because the original owners, which are the work-units, have the right to buy back first. Some buyers have only ownership rights of housing without land-use rights. When this kind of housing is traded in the market, buyers have to pay for the transfer of the land-use right. These and other ambiguous institutional arrangement for property rights are disincentives to the demand for home ownership. More importantly, housing property rights arrangements neglect the potential value associated with land use rights.³⁸

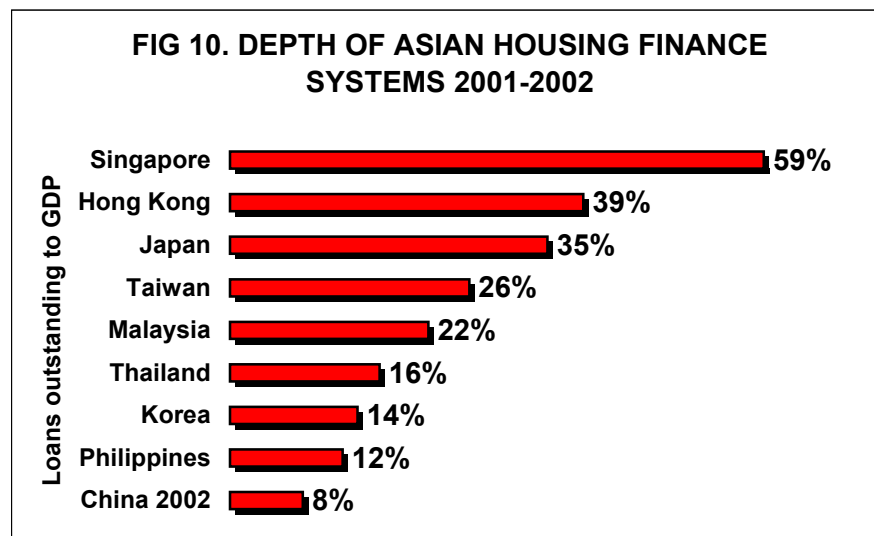
³⁷ For an important law paper on the costs of fragmented property rights that originates from World Bank experience with Russian property reforms, see Michael Heller, [1998] "The Tragedy of the Anticommons: Property in the Transition from Marx to Markets" *Harvard Law Review* Vol. 111, p. 621. For an economic analysis see, James Buchanan and Yong J. Yoon [2000] "Symmetric Tragedies: Commons and Anticommons", *Journal of Law and Economics*, Vol. 43, April. Heller's definition is that "a resource is prone to underuse in a tragedy of the Anticommons when multiple owners have a right to exclude others from a scarce resource and no one has an effective privilege of use." For the illustration in the case of Russian real estate, see April Harding, [1995], *Commercial Real Estate Development in Russia*, CFS Discussion Paper No. 102, World Bank; especially Figure 2 describing the actual fragmentation of the ownership right bundles across central government, local government, and market participants.

³⁸ "The owner of a commodity house may spend 10,000 RMB/m² of housing, and obtain a land use right of 70 years which is the longest possible term for housing development. In contrast, the owner of a former welfare housing unit who spends just 400 RMB/m² -- maybe even less after discounts on account of working age and depreciation -- could enjoy full land use rights in perpetuity with the payment of a relatively small additional fee." (World Bank internal report 2002)

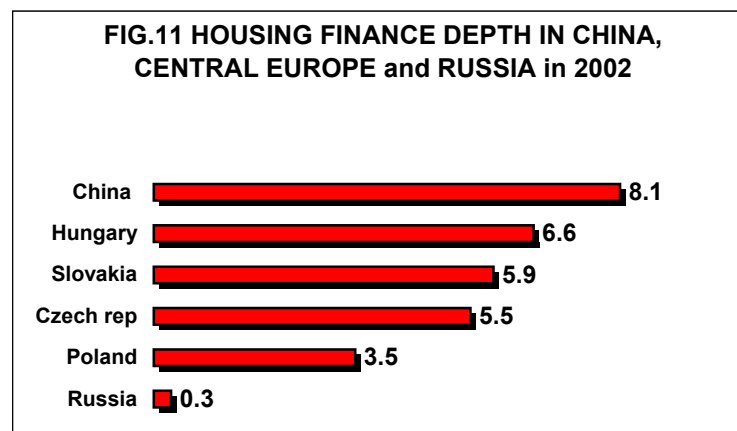
2. Development of an Efficient and Stable Mortgage Finance System

The development of banking services for housing is dependent on the overall pace of reforms in the financial system in particular accounting systems, banking laws and regulations, and supervisory systems for various specialized form of lending such as construction finance, commercial real estate and long-term housing finance for home purchases.

The development of the new housing finance in China has been extremely rapid since the Construction Bank of China offered the first individual home loans in 1992. Figure 7 shows the size of China's housing finance system measure as the ratio of total mortgage loans outstanding in the balance sheets of the banking system to national GDP. . In an Asian perspective, the result of a first decade of work may not appear very impressive: China's system is the smallest, however the annual rate of growth of mortgage loan portfolio is extremely high and challenges the operational capacity of the banks.



Compared to its peer group of transition economies, however, China is at the head of the class.



In spite of its extremely rapid growth over the last three years, China's housing finance system is still in an experimental phase and there are hidden systemic risks, of which the People's Bank of China is aware.

At present, China's housing finance system operates more like a *de facto* system of unsecured consumer credit than a genuine mortgage finance system. Yet, there is often a great deal of enthusiasm for introducing very sophisticated secondary mortgage market instruments like securitization, when the foundations of a solid primary market still need to be fully secured. Substantial work is needed on each of the three basic functions of a mortgage finance system: (1) mortgage loan origination (2) mortgage holding and financial risk management, and (3) mortgage loan servicing.³⁹

Symptoms of these mortgage industry start-up problems from a consumer perspective are:

- Consumer protection is not in place
- Titling and registration is a difficult process and is not yet secure
- The costs of loan applications are high. A common estimate is that borrowers have to give up about 10 working days to get all the necessary documentation to apply for a loan. Then loan approval is slow.
- The types of mortgages available are very limited
- Loan product standardization is lacking
- Interest rate policies remain directly regulated
- The availability of mortgage loans is spatially concentrated

Restructuring the housing provident funds is a high priority area. From both a financial sector and a general public policy viewpoint, it is urgent to develop a sound and complete legal framework in order to improve their governance and turn them into genuine financial institutions. These funds also need to be effectively supervised. Otherwise, social problems can develop in some cities, as has happened with comparable structures in other countries.

The risk of overheating housing and commercial real estate markets is a concern of the financial authorities. The July 2003 PBC guidelines on real estate lending reflect this concern. However, a modern, risk-based regulatory framework for mortgage finance will necessitate considerably more work.

3. Use of Competitive Mechanisms For the Allocation of Land Leases

After 1949, the state or "collective" communities owned all land in China. It could not be exchanged as a commodity. Land for the purpose of development or construction in urban areas was therefore administratively allocated without any restriction to the terms of tenure. Shenzhen first introduced a "land lease" system into its local market in 1987.

Following the Constitutional Amendment of 1998, land leasing has been extended to the entire country by the State Council's Decree No. 55: "Provisional Regulation on Lease and Transfer of the State-Owned Urban Land Use Right." Since then, most of the urban land has not been administratively granted, but has been leased through a

³⁹ A discussion of China's mortgage finance agenda is beyond the scope of this presentation. For an introduction to the set of issues facing a country like China see B. Renaud [2003] *Housing Finance in Emerging Markets; An Overview of Current Issues*. This presentation is posted on the websites of the World Bank Institute (finance section) and of the European Mortgage Federation <http://www.hypo.org/>

process of negotiation. Although the land lease system was a great breakthrough, its early implementation caused problems as land was leased through negotiation rather than in a transparent way like public auctions or tendering. Due to repeated private trading and other factors, the process is blamed for speeding up prices for new housing over years. Selected cities have put an end to the negotiation of land leases and introduced a public bidding system, which has been welcomed by all parties concerned, the professional developers in particular.

4. Streamlining Provincial and Local Taxes, Fees and Charges on Housing

One important element of the transition policies away from central planning adopted in the early 1980s has been the very significant reduction of the fiscal role of the central government and the decline of central fiscal revenues as a share of GDP. In the case of housing, the first structural change was the shift in the funding of housing from the central budget to work units (*danwei*) and local governments.

There have been two consequences of this structural shift. The first is that the central government now has very little scope to stimulate the housing sector and/or assist low-income families by fiscal means. The only instrument available would be quasi-fiscal subsidies via state-owned banks, but such an approach goes against the goals of the much needed banking reforms. The second consequence flows from the decentralization of housing responsibilities to provincial and local governments. Given the weak fiscal base at the provincial and the local levels, a proliferation of taxes and fees on housing has taken place.⁴⁰

At present, there are officially approved and clearly defined taxes and fee charges during the trading of housing.⁴¹ In addition to these specified taxes and fees, there are also numerous unregulated charges. There are two significant issues here. One is the lack of clear functional connection between the charges imposed and the services provided by provincial and local governments. In addition, the longer this proliferation of taxes last, the more dependent on housing taxes local governments, which will become a major obstacle to modernizing local government revenue and/or improving housing performance as the two become increasingly intertwined.

5. Developing Real Estate Services Across Urban Areas

As mentioned at the beginning of this presentation, the housing markets represent the largest single class of assets in almost all economies. This is a sector that is information intensive, which explains why real estate services employment employ 5 to 7% of the total labor force in highly urbanized and industrialized economies. The provision of real estate services across all classes of real estate assets, including housing, plays an essential role in the operation of modern cities. Information and brokerage services set up a bridge between the sellers and buyers. Appraisal and legal service guarantee the fairness and justice of a transaction and improve its pricing. In the

⁴⁰ See Chapter 5 "Local Governments' Ownership and Incentive Compatibility" in Leroy JIN [1994], *Monetary Policy and the Design of Financial Institutions in China, 1978-90*, London: St Martin's Press.

⁴¹ These charges include: 4% deed tax, 1% service charge, 0.5% stamp tax, and 0.1%-5% of real property appraisal fee, based on the housing value. In registration of property title, the taxes and fees include: (1) registration fee, (2) stamp tax and (3) title booklet fee. In a city like Beijing, adding up all these costs, which exclude guarantee and insurance fees on loan borrowing, the total housing transaction taxes amount to approximately 7% of the total value of the housing unit sold or traded.

absence of a suitable real estate code and its proper enforcement in every city, there are too many problems in China's services to housing market. Moreover most of the real estate companies do not yet comply with regulations. These problems are rather typical of the urban take-off. China is already drawing on the experience of its neighbors that are ahead on the urbanization curve, and should continue to do so.

6. Property Management and Diffusion of a Condominium System

China housing shares this problem area with other transition economies. Property management is essential to the supply of housing services in China where multifamily housing is the norm. Like other durable investments, housing will deteriorate over the years. In order to avoid a permanent reduction in the flow of services from the existing stock and the possible abandonment of structures well before the end of their theoretical useful life cycle, housing estates must be brought under proper management.

For decades in urban China, managerial energy and resources have been concentrated on the physical construction of housing. When housing units are in great demand, the promotion of the housing development is definitely necessary. However, the incentive structure is usually more important because it will determine the design and engineering choices. When the central Government and the work units were the only investors in housing and the rent paid by the tenants was nominal, property management had always been severely under-financed. As a result, many housing units, including the massive additions to stock after 1980s, began to deteriorate rapidly.⁴²

Benefiting from the experience of neighboring Hong Kong, Shenzhen first introduced property management in the early 1980s and became one of the first cities to prepare regulations on property management in 1994. Other cities have now done so. Yet what seems to be still lacking in China is a good condominium law that can provide the foundations for: sound property management; a life-cycle approach to the management and maintenance of properties; and the resolution of potential conflicts between the various stakeholders in the process: developers, tenants, owner-occupants, and property management companies.

7. An Institutional Summing-up

The Chinese housing system is growing very fast, yet its market infrastructure is very much in need of improvement in order to move from quantitative to qualitative growth. The agenda is clear. The legacy of ambiguous property rights needs to be worked out, market segment by market segment. Improving the banking and financial system is a priority of the new government, which should include a more explicit strategy for developing the mortgage finance system. The proliferation of local taxes and fees needs to be brought under control for the mutual benefit of local governments, consumers and the real estate industry. The transfer of land must become open and transparent, which is also predominantly a matter of local priorities. Property registration must be modernized from both a legal and an operational point of view. An appropriate set of incentives needs to be put in place to develop genuine real estate services. In this regard, there is now enough international experience for Chinese markets to draw from and identify the right incentive system. Once the proper legal

⁴² At the time, there was a popular saying about the urban housing stock: "new for the first year, old by the second, and dilapidated by the third."

framework is in place with a suitable condominium law, real estate maintenance and after sale management of housing, practical training for local managers will need a deeper and permanent educational network.

As a result of all these legal and regulatory improvements, the secondary market for rental housing and the resale of old housing stock, which are still small in most cities should also expand. New housing units are always a small fraction of the existing stock. An active market in the trading of existing units will generate a variety of large economic benefits across the income distribution. The goal should be to lengthen the "chain of moves" throughout the existing stock triggered by the sale of one new unit, which has a large welfare pay-off for all, especially for younger and lower-income families. Given their strong preference for new construction and its desirable multiplier effects, central and local government administrations will need to be reminded of the benefits of creating a liquid and transparent market within the existing housing stock.

This agenda could appear overwhelming. However, what is needed at the national level is primarily a sound legal and regulatory framework. Once this is done, implementation is mostly a local matter. The pilot project approach that has been used so effectively can continue to be put to good effect. In terms of aligning incentives for the modernization of Chinese cities, one important ingredient that is increasingly available is a growing urban middle-class that expects such improvements and appreciates their broader benefits.⁴³

CONCLUSION: What Kind of East Asian Cities in the 21st Century?

Five decades ago, the countries of East Asia were following four very different kinds of housing strategies. Because of the path-dependent nature of institutional development these choices still carry weight in the individual housing policy that each country of the region follows today. However, we can expect some degree of convergence in housing policy views across the region because the demand for good housing policy and for modern housing finance systems is strong in Asia. Almost all of the future aggregate urban growth in East Asia will now take place in China. I have offered an analysis of the very impressive changes in housing policy that have taken place over the past two decades. Yet building the legal, institutional and professional infrastructure of housing markets remains a work in progress. The pressures on Chinese cities are most likely to increase. Given the pragmatism shown by policy makers and the emergence of a genuinely professional real estate industry there is cause for optimism that an appropriate market infrastructure will diffuse successfully throughout the Chinese systems of cities, even if differences across provinces and cities will remain very significant for some time.

The East Asian and Chinese metropolitan economies now interact globally while remaining the engine of growth for the domestic urban network in their hinterland. How will future growth be created and shared among urban residents? Are East Asian megalopolises in the process of evolving if not inventing new modes of urbanization as they urbanized at much higher levels of density and lower resources than other regions of the world? In addition to the necessity to insure stable macroeconomic conditions, Asian cities – especially those of China -- are faced with three core challenges: how to

⁴³ See for instance the story about China entitled "Property Rights", *The Economist*, 21st March 2003, Beijing By-line. Posted on the Economist's website.

develop suitable financial mechanisms for the development of urban infrastructure? How to develop effective system of governance and effective management? How to insure equality of access to services and employment to all urban residents in very large cities socio-economic inequalities are rising and poverty becomes more and more urban?