Review of Domestic Rent Policy

Consultation Paper

Hong Kong Housing Authority

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Introduction

Review of Domestic Rent Policy

1.1 In January 2001, the Housing Authority (the Authority) decided to set up an ad hoc committee to review the domestic rent policy for public rental housing (PRH). The objective of the review is to map out a rent policy that is affordable, more flexible, provides greater choice to tenants, and contributes to the long-term sustainability of the public housing programme.

1.2 This is the third major review of the Authority's domestic rent policy. The last two reviews were conducted in 1986 and 1991 respectively.

The Committee

1.3 The terms of reference and membership of the Ad Hoc Committee on Review of Domestic Rent Policy (the Committee) are set out at **Appendix A**. The Committee held 18 meetings between April 2001 and February 2006. Its work was intervened by the judicial review cases concerning the Authority's decisions to defer reviewing the rents of its PRH estates, the legal proceedings of which straddled three years from end 2002 to end 2005.

Structure of this Consultation Paper

1.4 This consultation paper sets out the initial findings of the Committee for improving the way that domestic rents are set and reviewed. Chapter 2 provides a brief account of the existing domestic rent policy and the background leading to the review. Chapter 3 sets out some important guiding principles underpinning the Authority's domestic rent policy. Chapters 4 - 13 outline the main issues central to the domestic rent policy and suggest options for improvement. The key consultation questions are summed up in Chapter 14.

Sustainability Considerations

1.5 The Committee aims at putting forward options for improving the Authority's domestic rent policy that helps to promote the long-term sustainability of the public housing programme. This is consistent with the principle of sustainable development for our community. The Committee will be guided by public responses to the consultation before making its recommendations to the Authority.

Sending Us Your Views

1.6 This consultation paper seeks your views on the proposed options for improving the Authority's policy on domestic rents. We invite responses by 9 June 2006. All responses should be addressed to –

The Committees' Section
Housing Department
10/F, Block 2, Housing Authority Headquarters
33 Fat Kwong Street
Kowloon
(Fax no. : 2761 5770)

or e-mailed to: cdrp@housingauthority.gov.hk

1.7 Copies of this consultation paper are available at District Offices and the Authority's Estate Offices. It may also be accessed on the Authority website (http://www.housingauthority.gov.hk).

1.8 For enquiries, please contact the Housing Department at 2761 7763.

1.9 Views received may be made public together with the identity of the author. If you prefer to have your views reflected anonymously, please tell us when you send in your comments.

Existing Domestic Rent Policy

2.1 This Chapter provides an overview of the existing domestic rent policy, the background leading to the current review, and the implications of the recent ruling by the Court of Final Appeal on the judicial review cases concerning PRH rents. It goes on to identify broad areas where improvements are warranted.

General Framework of the Existing Domestic Rent Policy

Overview

2.2 The mission of the Authority is to provide affordable housing to those in genuine need. To this end, we have been embarking on a major public housing development programme providing a wide range of rental accommodation to low-income households at affordable rents. As of end September 2005, the Authority had a stock of 681 700 PRH units in 189 estates, offering a broad variety of flat types with different rent levels in meeting the needs of tenants. Some 29% of Hong Kong's population are living in PRH. PRH units are let on a month-to-month term until termination by either the Authority or the tenants with one month's notice. Rents charged by the Authority are inclusive of rates, management and maintenance costs.

Rent Levels

2.3 The Authority is committed to keeping rents for public housing at affordable levels. Rents for public housing range between \$250 and \$3,810 per month. They average at \$1,470 per month. Some 61% of public housing tenants are paying less than \$1,500 monthly for rent. These levels of rents should also be viewed from the broader perspective of the marked improvements in the living conditions of PRH in recent years. The average living space per person increased by 28% from 9.3 m^2 of internal floor area (IFA)[1] in the third quarter of 1996 to 11.9 m^2 IFA in the third quarter of 2005. For newly let units, it further reached 12.3 m^2 IFA, well above the upper tier of the allocation standard of 7 m^2 IFA per person. Within the same period, 109 200 old rental units were demolished and replaced by 218 300 new ones which are more spacious and with better design and amenities. The percentage of overcrowded families[2] also came down substantially from 6.5% to 0.9%.

Rent Setting for New Estates

2.4 Two rent fixing exercises are conducted annually to determine rents for newly completed PRH estates. For rent setting purposes, the Authority divides the territory into six broad districts. Rents of newly completed estates are fixed according to the so-called "best rent", expressed in terms of per m^2 of IFA, for each district. The "best rent" is determined having regard to the location and comparable estate values of the districts concerned. In general, rents per m^2 IFA are uniform across all the units in the same block irrespective of floor levels and orientation. Chapter 8 gives a more thorough analysis on the operation of the "best rent".

[1] *For Harmony blocks, 1 m^2 of IFA is broadly equivalent to 1.57 m^2 of gross floor area.*

[2] *Overcrowded families refer to those occupying units with less than 5.5 m^2 IFA per person.*

2.5 To ensure affordability, rents are set with reference to the median rent-to-income ratio (MRIR)[3] of the prospective tenants. Following a comprehensive review of domestic rent policy in 1986, the Authority agreed that rents should not exceed a MRIR of 15% at the then prevailing space allocation standard of 5 m^2 IFA per person. While the space allocation standard was increased by 10% to 5.5 m^2 IFA per person in 1987, the MRIR benchmark of 15% was kept unchanged.

2.6 In anticipation of the improvements in space allocation standards made possible by the new Harmony blocks coming on stream, the Authority conducted another review of the domestic rent policy and allocation standards in 1991. The review noted that any upward adjustment in the space allocation standards would bring about an increase in rents and hence the MRIR. It concluded that it would be neither desirable nor appropriate to increase rents with no regard to tenants' affordability.

2.7 The Authority therefore made another conscious decision to restrain the possible rent increase that may be brought about by a relaxation in allocation standards by another MRIR benchmark. Two MRIR benchmarks would be adopted for guiding the rent setting for newly completed estates according to the space allocation standards. Should the space allocation be based on the old standard of 5.5 m^2 IFA per person, the rents so set should not exceed a MRIR of 15% which has been in place since 1986. If it is based on a more generous standard of 7 m^2 IFA per person (which is the planning standard adopted for Harmony blocks), then the MRIR should not exceed 18.5%. The purpose of this two-tier structure is to provide more choice to tenants who may wish to be accommodated in smaller flats either out of personal preference or due to inability to pay higher rents. It also ensures that rents remain affordable while taking account of the substantial improvements in space allocation.

2.8 One important consideration we should stress here is that the two MRIR benchmarks have been set to ensure that the overall rental levels are affordable. However, it has not been the Authority's intention to solely determine rents for PRH on the basis of these two MRIR benchmarks. Other factors such as location, flat size, consumer price movement, wage movement, estate operating costs, rates charged by Government, the Authority's financial position, etc. are also taken into account.

[3] *Rent-to-income ratio is the expression of rent as a percentage of household income. The MRIR gives the median value of the rent-to-income ratios of all the PRH households. By definition, 50% of the relevant households' rent-to-income ratios will be below the MRIR and the other 50% above it. Chapter 4 provides a more detailed elaboration of the concept of MRIR.*

Rent Adjustments and Constraints under the Housing Ordinance (Cap. 283)

2.9 As noted in para. 2.8 above, the Authority takes account of a range of considerations, including tenants' affordability (which in general is reflected by the two MRIR benchmarks of 15% and 18.5%), consumer price movement, Government rates, wage movement, comparative estate values, running costs of the estates under review, the Authority's financial conditions, etc. in determining whether and, if so, the extent to which rents should be adjusted. It has also been the Authority's policy to review the rents of its estates in batches. Each review may comprise a mix of estates completed at different points in time.

2.10 Section 16(1A)[4] of the Housing Ordinance, which was introduced to the then Legislative Council by way of a Private Members' Bill in 1997 and came into effect in March 1998, imposes tight restrictions on the level and frequency that the Authority may adjust its domestic rents. It provides that any determination of variation of rent, which means rent increase according to the judgment of the Court of Final Appeal delivered in November 2005[5] by the Authority for any particular estate shall only take effect at least three years after the preceding determination for that estate, and that the overall MRIR of all rental estates shall not exceed 10% after a rent determination in any estate.

2.11 On the other hand, section 4(1)[6] of the Housing Ordinance calls upon the Authority to "secure the provision of housing" to those in need. Section 4(4)[7] goes further to direct the Authority to ensure that the revenue from its estates "shall be sufficient to meet the recurrent expenditure on its estates". The Authority's rental operating account accumulated a deficit of $11.4 billion over the period between 1993/94 and 2004/05. While a moderate surplus of about $0.4 billion is expected for 2005/06, we forecast a total deficit of $0.8 billion for the four-year period between 2006/07 and 2009/10.

2.12 The legislative constraints on rent adjustments have made it very difficult for the Authority to secure the provision of housing to the needy while balancing its estates' accounts. The law, as it currently stands, contains provisions which may not be easily reconciled.

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[4] *Section 16(1A) of the Housing Ordinance provides that –*

(a) Any determination of variation of rent after the commencement of the Housing (Amendment) Ordinance 1997 (108 of 1997) by the Authority under subsection (1)(a) in respect of any class (whether determined by the nature of the land or status of the lessee) of land in an estate for residential purposes shall only take effect at least three years from the date on which any immediately preceding determination in respect of the same such class of land came into effect.

(b) The rent determined under paragraph (a) in respect of any such class of land shall be of such amount that the MRIR in respect of all classes of land in all estates let for residential purposes, as determined by the Authority, shall not exceed 10%.

[5] *Details of the Court of Final Appeal's ruling are set out in paras. 2.21 to 2.23.*

[6] *Section 4(1) of the Housing Ordinance provides that -*

The Authority shall exercise its powers and discharge its duties under this Ordinance so as to secure the provision of housing and such amenities ancillary thereto as the Authority thinks fit for such kinds or classes of persons as the Authority may, subject to the approval of the Chief Executive, determine.

[7] *Section 4(4) of the Housing Ordinance provides that -*

The policy of the Authority shall be directed to ensuring that the revenue accruing to it from its estates shall be sufficient to meet its recurrent expenditure on its estates.

Rational Allocation of Housing Resources

2.13 The Authority has to ensure that public housing subsidies are available only to those in genuine need, and that the continuing needs of those living in PRH are regularly reviewed and properly assessed. This objective is achieved through two important policies - the Housing Subsidy Policy introduced by the Authority in 1987 and the Policy on Safeguarding Rational Allocation of Public Housing Resources in 1996.

2.14 Under the Housing Subsidy Policy, better-off tenants are required to pay higher rents. To do this, tenants who have resided in PRH for 10 years or more are required to declare household income at a biennial cycle. Households with income exceeding two times the Waiting List Income Limits have to pay 1.5 times net rents plus rates. Those with income exceeding three times the Waiting List Income Limits, or who choose not to declare income, have to pay double net rents plus rates.

2.15 The Policy on Safeguarding Rational Allocation of Public Housing Resources forms another strand of our strategy to ensure that public housing subsidies are only available to those in genuine need. Tenants paying double net rents plus rates under the Housing Subsidy Policy are required to declare their assets at the next cycle of declaration if they wish to continue to live in PRH. Households with income exceeding three times the Waiting List Income Limits and net asset value exceeding the prescribed asset limits (currently set at 84 times of the Waiting List Income Limits), or those households who choose not to declare their assets, are required to vacate their flats. These households may apply for a licence to remain in their PRH units for a period of not more than one year, during which a licence fee equivalent to market rent will be levied.

Additional Help for the Needy

2.16 The Housing Subsidy Policy and the Policy on Safeguarding Rational Allocation of Public Housing Resources seek to address the problem of potential misuse of housing resources by those who are no longer in need of any rental housing subsidies. However, at the other end of the spectrum is a group of people who cannot afford paying normal rents due to temporary financial difficulties. To address this problem, the Authority introduced the Rent Assistance Scheme in 1992. The Scheme provides for 25% to 50% rent reduction to households with rent-to-income ratios exceeding 20% or with income below 60% of the Waiting List Income Limits[8]. It offers one of the most effective safeguards to ensure rents are affordable to individual households. For those households facing long-term financial problems, they can apply for Comprehensive Social Security Assistance (CSSA) under which a rent allowance, adequate to cover the full amount of rent payable in most cases, is provided by Government. Further details on the operation of the Rent Assistance Scheme are considered in Chapter 13. Recipients of CSSA and rent assistance together account for some 23% of the total number of PRH households.

[8] *Details of the eligibility criteria for the Rent Assistance Scheme are set out in Chapter 13.*

Background to the Review

2.17 The Asian financial turmoil brought an unprecedented impact on the economy of Hong Kong. Downward adjustments in wages and rising unemployment caused hardship to some of the Authority's tenants. To help our tenants overcome this difficult period of time, the Authority waived the rent increases approved in 1998 and 1999. As a result, the rents of the majority of the public housing estates still remain at the 1995 and 1996 levels. The Authority has also deferred all rent reviews since 1999.

2.18 In December 2001, in view of the continuing difficult economic conditions, the Authority further decided to grant one-month rent holiday for all PRH tenants, except for those who were paying additional rents.

2.19 Despite the above rent relief measures, the MRIR has been increasing gradually and exceeded 10% in the second quarter of 2000. It peaked in the third quarter of 2004 at 14.7%. As at the third quarter of 2005, the MRIR dropped slightly to 14.6%. The continuing surge of the MRIR has aroused public concern and raised important questions about the long-term sustainability of the Authority's existing domestic rent policy and finances.

2.20 It was against this background that the Committee was commissioned to advise the Authority on how its domestic rent policy should be shaped within a framework which balances the need to ensure rents are within the affordability of our tenants and the sustainability of the public housing programme.

Implications of the Court of Final Appeal's Ruling

2.21 In October and November 2002, two PRH tenants applied for judicial review of the Authority's decisions to defer rent reviews. At the heart of the judicial review lies the important question as to whether under the Housing Ordinance the Authority has a statutory duty to review rents every three years and to ensure that the MRIR does not exceed 10%.

2.22 The Court of First Instance and Court of Appeal respectively ruled in favour of the appellants and the Authority. The case eventually went to the Court of Final Appeal. In November 2005, the Court of Final Appeal handed down its judgment in favour of the Authority. In brief, it ruled that –

(a) the Authority's decisions to defer rent reviews did not amount to determinations of variation of rent;

(b) the Authority is not under a statutory duty to review rents and revise them so as to ensure that the 10% MRIR is not exceeded;

(c) the Appellant did not have a legitimate expectation that rents would be revised at three-year intervals or at all so as to ensure that the 10% MRIR is not exceeded;

(d) the words "any determination of variation of rent" in section 16(1A) of the Housing Ordinance mean any decision to increase rent and do not extend to a decision to reduce rent;

(e) 10% MRIR is not a statutory definition of affordability; and

(f) the Authority is under a statutory duty to ensure that the revenue accruing from its estates shall be sufficient to meet its recurring expenditure.

2.23 In his judgment, Mr Justice Chan PJ also comments that the problems discussed in the appeal illustrate the desirability of having a long-term and comprehensive review of the whole public housing policy, including the MRIR methodology and its ceiling now fixed at 10% which has been criticized by some as arbitrary.

2.24 The relevant judgment of the Court of Final Appeal on this judicial review case (Ho Choi Wan v. Hong Kong Housing Authority) can be accessed on the Judiciary website (http://legalref.judiciary.gov.hk/lrs/common/ju/judgment.jsp).

Problems with the Current Rent Policy

2.25 Taking account of the Court of Final Appeal's ruling, the Committee has identified a number of key problem areas in the current rent policy framework. These include –

(a) the statutory 10% MRIR provision following any rent increase has imposed an unprecedented constraint upon the Authority's power to adjust its domestic rents to meet its policy and financial objectives;

(b) the recent increase in the MRIR has been brought about by a combination of many extraneous factors other than changes in rents and household income. It calls into question whether the MRIR as a measure of tenants' affordability still meet the modern day requirement. Even if so, there is a clear case to examine whether the current methodology for its assessment has scope for improvement;

(c) the MRIR has been contrived as a general measure of tenants' affordability rather than a mechanism for rent adjustments. The requirement under the existing Housing Ordinance that following any rent increase the MRIR should not exceed 10% has confused the role of MRIR. The current system imposes tight restriction on rent increases, but provides no objective basis for the Authority to consider when and, if so, to what extent a rent reduction is warranted. Another fundamental question to be addressed is whether a more well-defined alternative mechanism should be put in place to guide rent adjustments; and

(d) the rigidity of the existing rent structure has limited the Authority's flexibility to fix rents in a more rational and fairer manner. More important, it has severely reduced the choice available to tenants to select flats that suit their needs and affordability.

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Guiding Principles for Rent Setting and Adjustments

3.1 Before identifying options for improving the existing framework, the Committee considers it important that the principles underpinning its proposals are properly understood by the public. It has thoroughly examined and reaffirmed a number of guiding principles upon which the Authority's domestic rent policy is built. These broad principles are set out in this Chapter.

Tenants' Affordability

3.2 The Authority's PRH programme plays a central role in providing accommodation to those who find private housing beyond reach. Insofar as it is only provided to those in genuine need and with financial means below the prescribed income and asset limits, tenants' affordability should continue to sit at the very heart of the Authority's whole approach to domestic rent policy.

Long-term Sustainability of the PRH Programme

3.3 The provision of suitable and adequate subsidized rental accommodations to maintain the average waiting time at around three years is a long-term commitment of the Authority. Its delivery requires substantial and continuous investment by the Authority in the PRH programme. In addition, pursuant to sections 4(1) and 4(4) of the Housing Ordinance, the Authority has a statutory duty to secure the provision of housing to those in need and to ensure that the revenue accruing from its estates shall be sufficient to meet the recurrent expenditure of its estates. The long-term sustainability of the PRH programme must therefore be an important consideration in framing our domestic rent policy.

Rational Allocation of Resources

3.4 The Committee maintains the principle that housing resources should be allocated to those in genuine need. The level of housing subsidies should generally correspond with the households' financial means. PRH tenants who can afford private housing should cease to enjoy PRH subsidies. On the other hand, special assistance should be made available to those who cannot even afford the subsidized rents.

Respect for Tenants' Choice

3.5 The Committee recognizes that many of the PRH applicants would like to have a wider choice of flats with different rental levels that match their individual preferences and affordability. The Committee is convinced that we should give due respect for tenants' choice. The Authority's rent policy should therefore work towards, where possible, widening the choice available to tenants by setting rents more closely according to the type, size and location of the flats.

Comparable Estate Values

3.6 The rental values of individual estates and housing units vary according to factors such as location, size, age, design of the properties, estate facilities, surrounding environment, transportation and other amenities. The Committee believes that it is appropriate to continue to set rents to reflect the comparable values of the estates.

Market Rents

3.7 The Committee has considered the appropriateness for the Authority to make reference to the rent levels in the private sector in the determination and adjustment of its domestic rents. However, market rents are driven not so much by tenants' affordability as other external factors such as supply of stock and economic conditions. They could not provide a fair and consistent basis for setting the Authority's domestic rents. The Committee therefore believes that it is not appropriate to set or adjust the Authority's domestic rents according to the movements of the market rents. Nonetheless, reference to market rents is still relevant in measuring the extent of subsidies for providing PRH.

Objectives of the Current Review

3.8 The Committee is putting the above principles into practice by aiming to –

(a) keep rents at affordable levels;

(b) identify a viable rent adjustment mechanism that reflects closely tenants' affordability and promotes the long-term sustainability of the PRH programme;

(c) improve the current method for measuring affordability;

(d) provide greater choice of flats with different rental levels to tenants;

(e) enhance the flexibility of the rent structure to provide a closer link between rents and value of the flats; and

(f) explore scope and options for enhancing the provision of rent assistance to those in financial hardship.

Measuring Tenants' Affordability

4.1 Insofar as rents are set with reference to tenants' affordability, there is a need to put in place some form of affordability indicator. In this respect, the Authority has been using the MRIR as a general indicator of affordability for years. This Chapter covers the operation of the MRIR as a measure of tenants' affordability and analyses the factors accounting for the recent rising trend of the ratio.

Data Source

4.2 The MRIR is compiled based on the most up-to-date rent and household income data collected from the General Household Survey, which is a sample survey conducted by the Census and Statistics Department on a continuous basis. The survey covers a sample size of around 24 000 households in a three-month period. Of these, some 7 000 households reside in the Authority's PRH estates. The MRIR is derived primarily based on the data collected from these sampled households with suitable statistical procedures.

Methodology for Calculating the MRIR

4.3 For the purpose of calculating the MRIR, household income refers to the total cash income of a household, including earnings from all jobs and other cash incomes received by members of the household. The General Household Survey also covers households receiving CSSA, and the social security receipts are counted as "income" of these households. Likewise, rates are counted as part of the rental payment notwithstanding the fact the Authority does not pocket the money so collected.

4.4 On the basis of the findings of the General Household Survey, the rent-to-income ratio, which is the amount of rent (inclusive of rates and management cost) expressed as a percentage of household income, is worked out for each and every individual household. The rent-to-income ratios for all households are then placed in an ordered sequence (i.e. either in ascending order or descending order), and the middle rent-to-income ratio is the MRIR. By definition, therefore, half of the households have rent-to-income ratios above the MRIR and the other half below it. To elaborate the calculation of the MRIR, a simple illustrative example is given at **Appendix B**.

MRIR Benchmarks Adopted by the Authority

4.5 As noted in para. 2.7, since 1991, the Authority has adopted two MRIR benchmarks for measuring tenants' affordability according to the space allocation standards. For newly completed estates, a MRIR of 15% is adopted for an allocation standard of 5.5 m^2 IFA per person whereas a MRIR of 18.5% is adopted for an allocation standard of 7 m^2 IFA per person. The objective of introducing a higher MRIR benchmark of 18.5% is to ensure that the rents for the newly completed Harmony blocks, which were rolled out by 1992, remained affordable. This upper tier of MRIR is considered a reasonable benchmark for measuring tenants' affordability taking account of the considerable improvement in space allocation standard, building design, amenities and overall living conditions brought about by the Harmony blocks.

Legal Restriction on the Overall MRIR

4.6 In 1997, the then Legislative Council introduced amendments to the Housing Ordinance to impose restrictions on the Authority's power to vary domestic rents. One of the restrictions provided for under section 16(1A)(b) of the Ordinance is that the overall MRIR of all PRH estates shall not exceed 10% after any determination of variation of rent. The amendments came into effect in March 1998. It is important to note that the legal requirement for the overall MRIR not exceeding 10% does not apply to the rent fixing exercises for newly completed estates, which continue to follow the 15% and 18.5% affordability benchmarks. The Court of Final Appeal further ruled in November 2005 that the 10% MRIR cap applies only when a decision is made to increase rents. It also ruled that the 10% MRIR is not a statutory definition of affordability.

4.7 An important consequence of this legal restriction is that the Authority is prohibited from increasing rents once the MRIR exceeds 10%. The MRIR becomes the overriding consideration in determining whether rents could be increased. It confuses the role of the MRIR, which is essentially a broad brush indicator to measure affordability, and inadvertently translates it into a rent adjustment mechanism. Chapter 7 analyses in greater detail the drawbacks of using MRIR as a mechanism for rent adjustments.

Merits and Demerits of MRIR as an Affordability Measure

4.8 Adopting the MRIR as a measure of affordability has the following advantages –

(a) the calculation method is relatively straight forward;

(b) the figure is simple and easy to understand;

(c) it is not affected by extremely high or low rent-to-income ratios of certain households; and

(d) the data is readily available from the General Household Survey.

4.9 The MRIR, particularly taking account of the way that it is being calculated, does have its limitations as a measure of affordability. These include –

(a) the MRIR only relates rent to household income. The figure itself does not tell the interplay of a host of extraneous factors that have pushed it up. For instance, improvements to the living conditions (such as allocation of newer or larger flats) are not reflected in the figure;

(b) it only provides the "middle figure" in a set of rent-to-income data. It does not provide any indication on the overall distribution of the rent-to-income ratios of the households;

(c) the data on monthly household income are based on the results of the General Household Survey. As with other household surveys, it may be possible that some respondents in the General Household Survey are reluctant to disclose their genuine household income. The accuracy of the MRIR so calculated therefore hinges on the reliability of the reported household income in the survey; and

(d) the current calculation of MRIR includes tenants receiving CSSA, which may affect the objectivity of MRIR as a measure of affordability among tenants. This is because the issue of affordability is not directly relevant to the majority of the households receiving CSSA as their rents are fully paid by the Social Welfare Department.

Latest Trend of the MRIR

4.10 The Authority has not implemented any rent increase since 1998[9]. However, the overall MRIR has been generally moving along an upward path over the last few years. Since the second quarter of 2000, the MRIR has exceeded 10%. It stood at 14.6% as at the third quarter of 2005.

4.11 The soaring MRIR in the absence of any rent increase has a string of systematic causes. These are set out below.

Median Rent-to-Income Ratio for PRH Households from 1996 to 2005

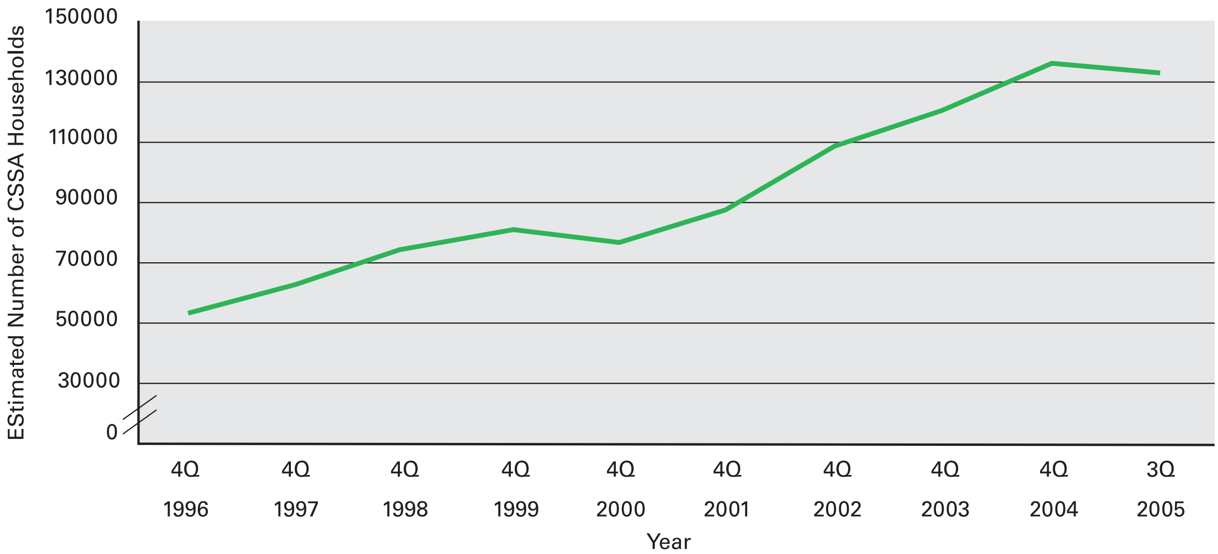
Notes: 1. "3Q" stands for the third quarter of the corresponding year.
2. Sudden slide of MRIR in 4Q 2001 was due to the one-month rent waiver for all PRH households in December 2001. Rates rebate by Government accounted for the drop in 4Q 1998 and 3Q 2003.

[9] *Except for additional rent payers in PRH.*

Increase in CSSA Cases

4.12 It is estimated that the number of recipients of CSSA among PRH tenants leap-frogged from 53 400 households in the fourth quarter of 1996 to 133 200[10] households in the third quarter of 2005 –

Estimated Number of CSSA Households in PRH from 1996 to 2005



Notes: 1. "3Q" and "4Q" stand for the third quarter and the fourth quarter of the corresponding year respectively.
2. The CSSA statistics for the third quarter prior to 2000 are not available.

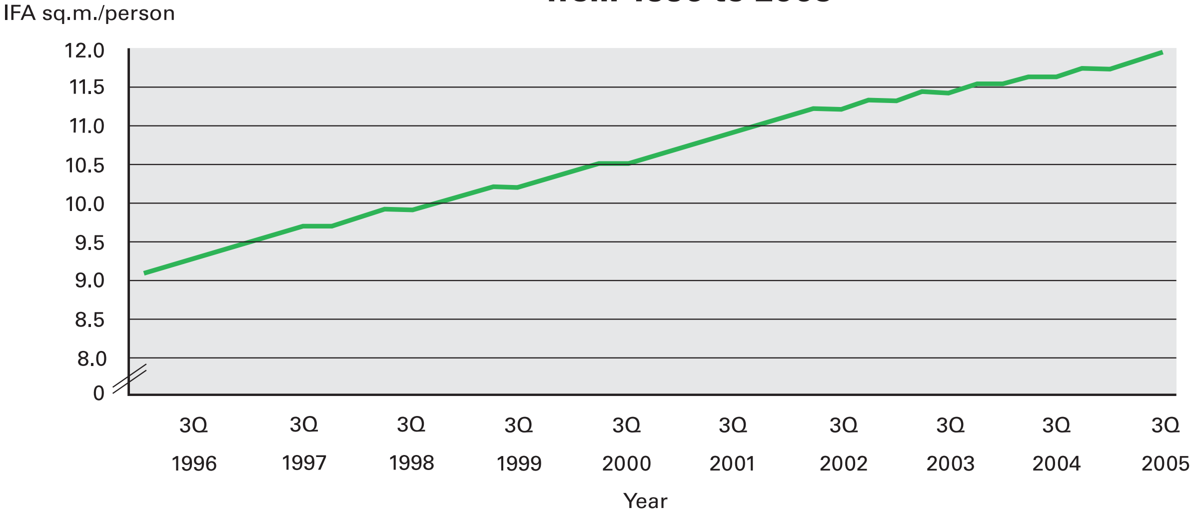
4.13 Although CSSA recipients do not have any "affordability" problems as their rents are fully covered by the Social Welfare Department in great majority of the cases, they tend to have higher rent-to-income ratios. Their inclusion in the calculation of the MRIR contributes to the upward trend of the MRIR.

[10] This estimate is based on the General Household Survey. According to the administrative records of the Social Welfare Department, there are some 160 100 CSSA cases in PRH as at the third quarter of 2005. This discrepancy may be due to under-reporting in the General Household Survey and the fact that a CSSA household may involve more than one CSSA case.

Improvement in Living Space

4.14 The average living space per person of PRH households increased substantially from 9.3 m^2 IFA per person in the third quarter of 1996 to 11.9 m^2 IFA in the third quarter of 2005, thereby lifting up the average amount of rents payable per household even without any increase in the unit rents –

Average Living Space per Person (IFA sq.m. / person) in PRH from 1996 to 2005



Note: "3Q" stands for the third quarter of the corresponding year.

Supply of New Flats

4.15 As a result of the substantial increase in the Authority's investment in building new rental units over the past few years, the supply of new PRH units in the period from 1996/97 to 2005/06 (up to September 2005) reached 218 300 units –

Number of New PRH Flats Constructed from 1996 / 97 to 2005 / 06

Year	Number of new PRH flats
1996 / 97	14 900
1997 / 98	17 900
1998 / 99	9 600
1999 / 00	27 700
2000 / 01	46 800
2001 / 02	29 800
2002 / 03	20 400
2003 / 04	15 100
2004 / 05	24 700
2005 / 06 (up to September 2005)	11 400

4.16 The rental values of these new units are usually higher than the old ones, reflecting major improvements in space allocation, facilities and living environment.

Comprehensive Redevelopment Programme

4.17 At the same time, tenants from old estates where rents are cheaper have been progressively relocated to new estates with relatively higher rents under the Comprehensive Redevelopment Programme. In the period from 1996/97 to 2005/06 (up to September 2005), a total of 109 200 old PRH units were demolished with most of the affected tenants relocated to new estates –

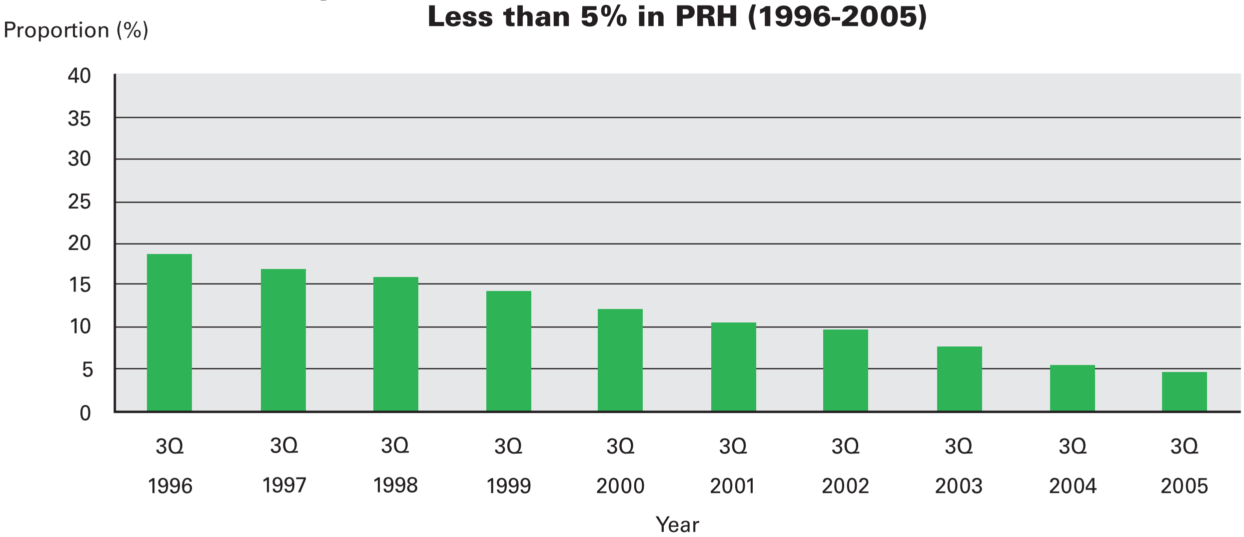
Number of Old Rental Flats Demolished from 1996 / 97 to 2005 / 06

Year	Number of demolished flats under CRP
1996 / 97	14 800
1997 / 98	14 800
1998 / 99	15 500
1999 / 00	5 900
2000 / 01	13 600
2001 / 02	32 400
2002 / 03	6 500
2003 / 04	5 200
2004 / 05	500
2005 / 06 (up to September 2005)	0

Exit of High Income Tenants

4.18 In the past 10 years, about 186 500 PRH tenants joined various subsidized home ownership programmes and left PRH. These tenants turned home owners usually have higher income and hence lower rent-to-income ratios. The exit of these high income tenants has contributed to the upward trend of the MRIR. For instance, the proportion of PRH tenants with rent-to-income ratio below 5% dropped from 18.8% in the third quarter of 1996 to 4.4% in the third quarter of 2005 –

Proportion of Households with Rent-to-Income Ratios Less than 5% in PRH (1996-2005)



Note: "3Q" stands for the third quarter of the corresponding year.

Elderly Households

4.19 The proportion of elderly households (i.e., those comprise all household members aged 60 or above) among the PRH tenants increased from 9.7% in the third quarter of 1996 to 14.3% in the third quarter of 2005. As the income of elderly households is in general lower than that of the average households, the cluster of elderly households in PRH tends to raise the MRIR –

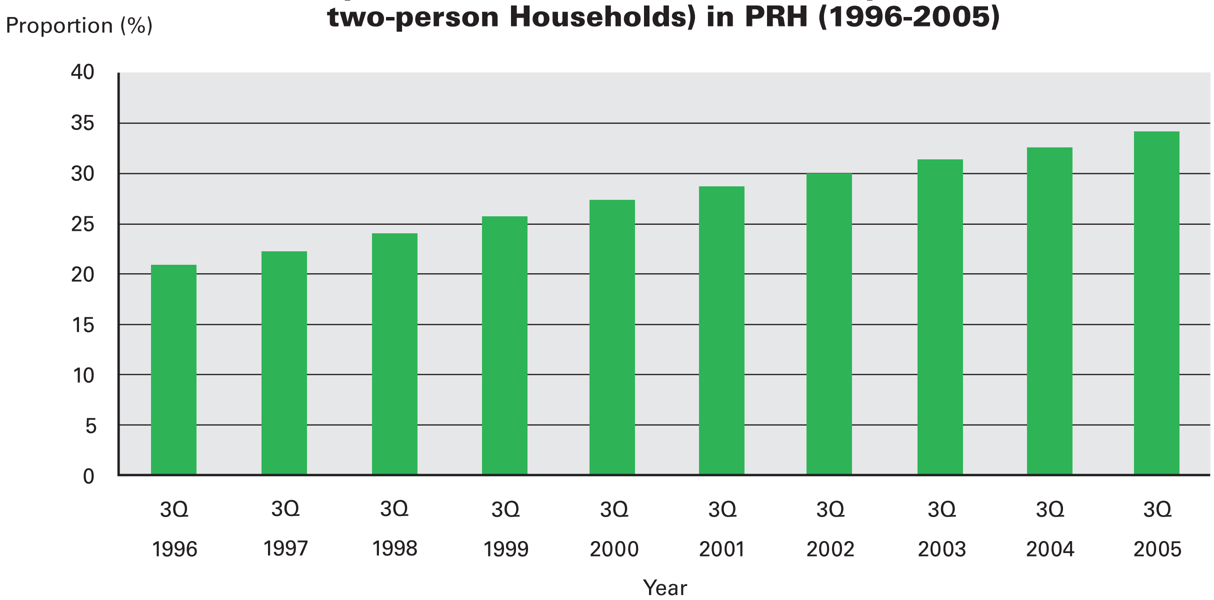
Proportion of elderly households living in PRH and their median household income

Year	Quarter	Proportion of elderly households in PRH (%)	Median household income of elderly households in PRH (HK$)
1996	3Q	9.7	2,800
1997	3Q	10.3	3,100
1998	3Q	11.3	4,000
1999	3Q	12.4	3,600
2000	3Q	13.2	3,700
2001	3Q	13.5	4,000
2002	3Q	14.0	3,700
2003	3Q	14.1	3,700
2004	3Q	14.2	3,900
2005	3Q	14.3	3,700

Small Households

4.20 The proportion of small households with one to two persons in PRH swelled from 20.9% of all households in the third quarter of 1996 to 34.0% in the third quarter of 2005. As the income of small households is usually lower than that of large households, their rent-to-income ratios tend to be higher –

Proportion of Small Households (one-person and two-person Households) in PRH (1996-2005)

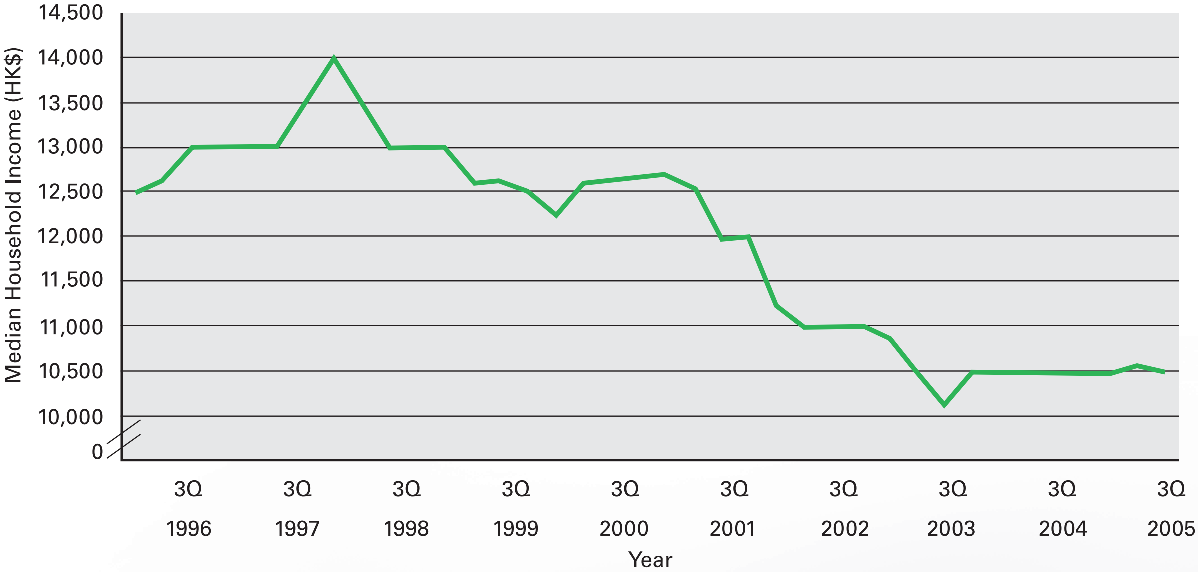


Note: "3Q" stands for the third quarter of the corresponding year.

Drop in Median Household Income

4.21 The median income of PRH households peaked in the first quarter of 1998 at $14,000. It dropped to $10,500 in the third quarter of 2005. Apart from the general downward adjustments in wages, this drop in median household income of PRH households has been the result of the sharp rise in the number of CSSA households, exit of higher income tenants from PRH, and increase in the proportion of elderly households and small households –

Median Monthly Household Income of PRH Households (1996 to 2005)



Note: "3Q" stands for the third quarter of the corresponding year.

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Alternative Options for Measuring Affordability

5.1 The Committee has examined a number of other possible methods for assessing tenants' affordability. A brief description of these alternative methods and their pros and cons are outlined in this Chapter.

(a) MRIR Variants

5.2 One alternative is to build on the framework of the existing MRIR model and develop different variants to cater for different requirements –

(i) *Different MRIRs for households with different incomes:* This variant is premised on the idea that different rents should be set for households with different incomes. Low income households can only spend a smaller proportion of their income on housing after paying non-housing expenses, whereas high income households can afford to use a greater proportion of their income on housing. Under this approach, a lower MRIR should be accorded to low income households and a higher MRIR to high income households.

(ii) *Different MRIRs for different types of rental blocks:* Compared with old estates, rents for the PRH units in new estates are higher, reflecting better facilities, improved living environment and a more generous allocation space standards. Many households prefer to live in new estates notwithstanding the fact that these estates have higher rents. Consideration can be given to adopting a higher MRIR for new estates and lower MRIR for old estates.

(iii) *Different MRIRs for households of different sizes:* Household income often relates to household size as a bigger household usually has more income earners, hence higher household income than a smaller one. Different MRIRs could be used for households of different sizes.

5.3 A major advantage of the above proposed MRIR modules is that they provide for a more sophisticated system to address some of the shortcomings of a uniform MRIR. However, many of the existing policies of the Authority have already incorporated the main features of the above proposals. For instance, the Rent Assistance Scheme seeks to reduce the rent-to-income ratios of those households with affordability problems; the Housing Subsidies Policy requires households with high income to pay additional rents; and different MRIR benchmarks are used for setting rents for new estates according to the allocation standards.

(b) Setting Rents Based on a Fixed Rent-to-Income Ratio

5.4 A major area of deficiency in using a uniform MRIR for assessing affordability is that it is unable to address the concern about having high rent-to-income ratios for low income tenants and low rent-to-income ratios for well-off ones. An egalitarian approach is to adopt a fixed rent-to-income ratio across-the-board so that all tenants should pay a fixed proportion of their income as rents.

5.5 The merit of this method is that the overall MRIR will be fixed at the prescribed rent-to-income ratio. No tenants will have their rent-to-income ratios above or below the prescribed level. The principal drawback of this approach is that household income will become the only factor determining rents. Flat size, space allocation standard, location, facilities and living environment will no longer feature in the rent setting mechanism. Adopting such a system would give rise to anomalies in which households with relatively high income but live in small flats in older estates in remote areas will have to pay significantly higher rents than other households living in large flats in new estates in the urban areas. The resulting rent structure would be extremely confusing to tenants. This would also create enormous difficulties for the Authority to let those flats which are less popular because of their location, age, etc. Assessing and verifying the income of all the tenants are also a formidable task involving intensive financial and manpower resources.

(c) Residual Income Approach

5.6 Another alternative option for measuring affordability is the so-called "residual income approach". The idea of this approach is to ascertain the income required for purchasing a basket of non-housing goods and services to maintain a certain standard of living. The residual portion of the household's income, after deducting the non-housing expenditure, should then be charged as rents according to the following formula –

Rent = Income – N($)
or = 0, if Income is less than N($)

N($) reflects the cost for purchasing a basket of non-housing goods sufficient to meet the socially acceptable minimum standards of consumption. In assessing N($), household size should be taken into account as it has a bearing on both housing and non-housing consumption. Since different households may have different incomes, the rents so determined under this approach will also be different for different households.

5.7 The main advantage of this option is that it ensures that households could maintain an acceptable living standard after deducting the rental expenditure. How to determine the socially acceptable minimum standards of non-housing consumption, however, is a controversial issue. For those households with relatively high income, it may not be fair to take all their residual income as rents. This approach also suffers from similar drawbacks found in option (b). Huge administrative resources would be incurred to conduct individual assessment of household incomes and their non-housing needs. In addition, the qualitative differences of the rental units are not reflected in the rents determined under this option.

The Committee's Views

5.8 Insofar as rents for the Authority's public housing estates are to be set with reference to the affordability of its tenants, the Committee considers it essential to put in place some form of affordability measure. The procedures for assessing tenants' affordability must be coherent, transparent and can be easily applied and administered.

5.9 The Committee recognizes the shortcomings of the MRIR as an indicator for tenants' affordability. The principal flaw of adopting a uniform MRIR lies in its inability to address the situation where the rent-to-income ratios of low-income or disadvantaged groups are usually higher than those of the more well-off tenants. The alternative methods described in this Chapter could remedy to some extent this deficiency. While appreciating the advantages of these alternative methods from the perspective of equity, the Committee is concerned that most of them require an individual assessment of the household incomes of all the PRH households. Given that there are about 638 000 households in the Authority's PRH estates, the administrative costs of implementing these options would be enormous, which would easily outweigh any intended benefits. The Committee considers that for the purpose of establishing a broad brush benchmark, tenants' affordability should best be assessed generally and collectively.

5.10 In addition, the criticism against using the MRIR as an affordability indicator overlooks the fact that the Authority's domestic rent policy spans a wide spectrum which includes far more elements than the MRIR. The Housing Subsidy Policy, the Policy on Safeguarding Rational Allocation of Public Housing Resources, the Rent Assistance Scheme and the CSSA Scheme operated by the Social Welfare Department are all designed to address the special needs of the different segments of our tenants with different income pattern. These measures have ensured that no eligible household is denied of access to PRH for want of financial means, and that no ineligible tenants should continue to enjoy PRH subsidies. The MRIR therefore does not stand alone as the only criterion for rent setting or adjustment. For individual households, a more effective way to address the problem of affordability would be through these interlocking measures that we have put in place.

5.11 More important, the MRIR should also be seen as a broad brush affordability measure. It should not be taken as a rigid mechanism dictating whether and when the Authority should adjust rents, which has to take into account other relevant considerations such as flat size, location, facilities of estates, etc. A sustainable and rational rent policy necessarily involves balancing these different considerations. The balance might be upset if some of these considerations are given statutory force. In this connection, the introduction of a statutory provision on the MRIR has unwittingly led some quarters in the community to misconceive the MRIR as the only criterion for rent setting as well as for rent adjustments.

Consultation point A :

The Committee would welcome views on whether the MRIR or other alternative methods, including those set out in paras. 5.2 to 5.7, should be used for measuring tenants' affordability. It also welcomes views on whether the affordability measure, be it the MRIR or other alternative methods, should be given statutory definition and control.

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Improvements to the Assessment of the Median Rent-to-Income Ratio

6.1 This Chapter discusses the appropriate MRIR benchmarks should MRIR continue to be used as the measure of tenants' affordability. It also sets out possible improvement measures to rationalize the current procedures and methodology for calculating the MRIR.

What should be the Appropriate MRIR Benchmarks?

6.2 Before considering what might be done to improve and rationalize the assessment procedures, it is important to consider what the appropriate MRIR benchmarks should be. As noted in Chapter 4, since 1991 the Authority has been making reference to two MRIR benchmarks for measuring the affordability of the prospective tenants moving to newly completed estates, i.e. a MRIR of 15% for a space allocation standard of 5.5 m^2 IFA per person and 18.5% for an allocation standard of 7 m^2 IFA per person. The Authority also makes reference to these MRIR benchmarks when reviewing rents of existing estates. The statutory control effective since March 1998 stipulates that the overall MRIR of all the PRH tenants should not exceed 10% following any determination of variation of rents by the Authority. The Court of Final Appeal ruled that the 10% MRIR cap applies only to any decision to increase rents and does not extend to a decision to reduce rents. It also ruled that the 10% MRIR is not a statutory definition of affordability. While the Court of Final Appeal's judgment clarifies the Authority's statutory obligations under the Housing Ordinance and defines the circumstances under which the 10% MRIR cap applies, there remains a dichotomy of the established policy of the Authority, which premises on the two MRIR benchmarks of 15% and 18.5%, and the legislative provision of 10% MRIR. This dichotomy is getting more and more difficult to reconcile as new estates adopting a more generous space allocation standard, and hence higher rents, continue to come on stream, and old estates with cheaper rents are demolished under the Comprehensive Redevelopment Programme.

6.3 The Committee has carefully considered this apparent inconsistency and reviewed the appropriateness of continuing to use the MRIR of 15% or 18.5% as affordability benchmarks for PRH tenants. It believes that the two MRIR benchmarks should be upheld on the grounds that –

(a) the affordability benchmarks were set in 1986 and 1991 following two comprehensive reviews by the Authority. Many of the principles and considerations set out in the 1986 and 1991 reviews remain valid. In particular, the average space allocation standard for newly rehoused households has been substantially improved over the past decade. In the first quarter of 1986, the average space allocation per person was 8.3 m^2 IFA. It increased to 12.3 m^2 IFA in the third quarter of 2005, far exceeded the upper tier allocation standard of 7 m^2 IFA per person by some 76%. In addition, the Harmony blocks coming on stream since 1992 are not only more spacious, but with better design and amenities than the Trident and Linear blocks. And all these improvements are only made possible by a substantial increase in housing investment by the Authority;

(b) the two MRIR benchmarks compare very favourably with similar benchmarks adopted internationally. The United Nations Centre for Human Settlement (Habitat) sets the housing affordability indicator at a rent-to-income ratio of 30% for households with income within the lowest 40th percentile of the overall population. The US Department of Housing and Urban Development also adopts a rent-to-income ratio of 30% as a benchmark for housing affordability;

(c) the MRIR benchmarks are much lower than the MRIR of households living in private permanent housing. The latter stood at 25.7%[11] as at the third quarter of 2005;

(d) since the adoption of the MRIR benchmarks of 15% and 18.5%, the number of prospective tenants refusing to accept the allocated flats on ground of high rents has been less than 1% of the total offers. This low percentage of refusal clearly underlines the fact that given a choice, the great majority of tenants prefer more spacious accommodation even at higher rents; and

(e) the CSSA and the Rent Assistance Scheme[12] operated by Government and the Authority respectively provide effective safety nets for those tenants who are unable to pay normal rents. The former provides its recipients with rent allowance that in most cases is sufficient to cover the PRH rents in full. The latter offers 25% to 50% rent reduction to eligible households with rent-to-income ratio exceeding 20%, which effectively ensures that PRH rents are affordable. At present, some 20.8% of the PRH tenants are receiving CSSA and another 2.5% rent assistance.

Consultation point B :

The Committee would welcome views on whether the current MRIR benchmarks of 15% and 18.5% for the respective allocation standard of 5.5m^2 IFA and 7m^2 IFA per person are appropriate. If not, what should be the appropriate MRIR benchmarks?

[11] Rents of public rental housing are inclusive of rates, government rent and management fees. For private permanent housing, whether the rents are inclusive of rates, government rent or management fee depends on the terms of the tenancy.

[12] Details of the operation of the Rent Assistance Scheme are discussed in Chapter 13.

Better Assessment Procedures and Methodology

6.4 Should we continue to rely on the MRIR to measure tenants' affordability, it is essential that the methodology for calculating the ratio is fair and reliable. We have identified several improvement areas to develop better procedures and methodology for calculating the MRIR.

Data Collection

6.5 The data on household income and rents for calculating the MRIR are based on the quarterly General Household Survey conducted by the Census and Statistics Department on a continuous basis. The main objective of the survey is to collect information for compiling labour force statistics. The sample size of the survey consists of some 24 000 households in a three-month period, of which some 7 000 households live in PRH. The sampled households in PRH are invited to provide their rent and income data on a voluntary basis.

6.6 We believe that the existing data collection method has two major shortcomings –

(a) the General Household Survey is a voluntary survey. The sampled households are free to decide whether to participate in it or not. Income information may be a sensitive issue to many people. As with other household surveys, some respondents to the General Household Survey may feel inhibited to disclose their true household income; and

(b) the General Household Survey is not specifically designed to suit the needs of the Authority in monitoring tenants' affordability. The statistical concepts adopted by the General Household Survey are not entirely in line with those used by the Authority. A case in point is the concept of household size. For the General Household Survey, household size refers to those household members who are usually living in the flat. As regards the Authority, it includes all the household members on the tenancy record.

6.7 In order to improve the reliability and accuracy of the data collected for calculating the MRIR, the Authority may consider operating its own system of data collection. One possibility is to adopt a system similar to the "income declaration" under the Housing Subsidy Policy to make the reporting of household income by sampled households mandatory.

6.8 It is estimated that for each round of exercise, a sample of around 8 000 to 10 000 households would be sufficient for obtaining reliable statistics for various analyses relating to the income movement and rent-to-income ratio of the households residing in PRH. The frequency of the exercise can be set at quarterly or half-yearly intervals as appropriate.

Comprehensive Social Security Assistance Cases and Households Paying Additional Rents

6.9 The main objective of putting in place an affordability measure is to assess whether the rents charged by the Authority are affordable to those tenants who are required to pay the rents in full. To include in the calculation households whose rental expenditure is taken care of by Government or those who are required to pay additional rents may distort the Authority's assessment of affordability.

6.10 According to the findings of the General Household Survey on which the calculation of the MRIR is based, there are some 133 200 CSSA households living in PRH as at the third quarter of 2005. About one out of five PRH households are receiving CSSA. With rents being fully covered by Government in great majority of the cases, the question of whether rents are affordable is largely irrelevant to those CSSA recipients living in PRH. Since the affordability of the CSSA households is not an issue, their inclusion in the calculation of the MRIR distorts the interpretation of the ratio as a benchmark for measuring tenants' overall affordability. The Committee is of the view that the CSSA households, who do not have an affordability problem per se, should be excluded from the calculation of the MRIR.

6.11 Likewise, for those households paying additional rents under the Housing Subsidy Policy or the Policy on Safeguarding Rational Allocation of Public Housing Resources, their rent-to-income ratios should not be counted when compiling the MRIR.

Rates and Management Fees

6.12 The gross rents received by the Authority, i.e. inclusive of rates and management costs, are used for compiling the MRIR. Chapter 9 assesses the case for charging net rents exclusive of rates and management fees. As far as the compilation of MRIR is concerned, lumping rates and management costs into the rents has inflated the true rental expenses of the PRH tenants.

6.13 The inclusion of rates in compiling MRIR is particularly unsatisfactory. On average, rates accounted for about 10% of the gross domestic rents receivable. Any fluctuations in the level of rates levied by Government, over which the Authority has no control, will impact on the MRIR. In addition, rates reflect market values of the flats. The extent of their adjustment may not fully correspond with that of the rents charged by the Authority. As regards the possible exclusion of management costs for compiling MRIR, it requires a proper assessment of what constitute management costs. Chapter 9 proposes a possible option in which management costs are limited to expenses on estate management, security and minor maintenance works.

6.14 **Appendix C** sets out the MRIR figures under different assessment methods.

The Committee's Views

6.15 The Committee considers that the MRIR should be used as a general indicator for measuring the affordability of those tenants paying normal rents. The reliability of its measurement could be enhanced by improving the data collection system and adopting a tighter definition of what constitute rents.

Consultation point C :

The Committee would welcome views on whether the calculation of the MRIR should be improved and rationalized by –

- *operating its own system to collect tenants' income data on a mandatory basis;*
- *excluding households receiving CSSA and those paying additional rents from the MRIR calculation; and*
- *excluding rates and management fees from the MRIR calculation.*

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Proposed Rent Adjustment Reference Index

7.1 This Chapter proposes a possible framework for introducing a rent adjustment reference index which aligns with movement in the consumer price index or tenants' household income.

Conceptual Distinction between Affordability Indicator and Rent Adjustment Mechanism

7.2 In Chapters 4 to 6, we examine in detail the merits and demerits of the MRIR, identify possible alternative options for measuring affordability and propose measures to improve the way the MRIR is being calculated. An important consideration that has been borne out from the analysis is the distinction between an affordability indicator and a rent adjustment mechanism. The MRIR has been intended as an affordability indicator, not a mechanism to determine whether or when rents should be adjusted. The statutory MRIR provision has blurred that distinction.

7.3 For both rent fixing of new estates and rent adjustments for existing estates, the Authority takes into account a host of different factors such as tenants' affordability (which is generally reflected by the MRIR indicators of 15% and 18.5%), the comparative values of the estates under review (in terms of location, transportation, age, environment and available facilities), inflation, Government rates, wage movement, management and maintenance costs, the Authority's financial conditions and the requirement under Section 4(4) of the Housing Ordinance to ensure that the revenue from the Authority's estates shall be sufficient to meet its recurrent expenditure on its estates, etc. These considerations all came into play in determining whether and, if so, the extent to which rent adjustments are warranted.

7.4 Overall, this system works well. It embraces all the factors which are relevant to rent adjustments and provided the Authority with a high degree of flexibility to increase rents to meet its policy and financial objectives. However, the lack of a clearly stated formula and well defined mechanism governing the exact degree of rent adjustments has prompted certain quarters in the community to call for restraining the Authority's power and latitude to increase rents. From this concern sprang the amendments to the Housing Ordinance in 1997, following which rent increase is subject to a statutory MRIR provision that the resultant MRIR should not exceed 10%.

Drawbacks of the Existing Rent Adjustment Arrangements

7.5 Using MRIR to limit the extent of rent increase, particularly when the benchmark of 10% was set not with reference to any clearly defined principles but merely as an expediency to curb the Authority's power to increase rents, has over the past few years brought to light the following intractable problems –

(a) the MRIR is subject to the influence of factors other than the income of households and the rents they pay. Chapter 4 gives a detailed account of the external factors that continuously contribute to the rise in the MRIR. These include, inter alia, the replacement of old estates by new ones; rising proportion of small and elderly households in PRH; major improvements in the space allocation standard; and sharp rise in the number of CSSA recipients;

(b) unless the rents for new Harmony estates are drastically lowered to bring them on a par with those for old estates, the simple fact that new estates with higher rents continue to replace old estates will inevitably bring the MRIR above 10%; and

(c) although the Court of Final Appeal has ruled that the 10% MRIR cap applies only to any decision to increase rents and does not extend to rent reduction, the current system only imposes restrictions on rent increases. It falls short of providing any objective basis for the Authority to consider when a rent reduction is warranted. Nor does it help define the extent of such a reduction.

7.6 As most of the factors contributing to the rise in the MRIR are likely to remain in the foreseeable future, the Committee is concerned that this is an area where the restrictions in the Housing Ordinance no longer fit with contemporary developments and are not sustainable in the long run.

Proposed Index-linked Rent Adjustment Reference Index

7.7 Rents should ideally be adjusted by the Authority based on the well established arrangements referred to in para. 7.3 above that are unfettered by law. The Committee is conscious of the fact that the statutory MRIR provision has been in place since 1998. Repealing the MRIR provision without replacing it by another objective rent adjustment mechanism is unlikely to go down well with the tenants. The Committee believes that it is worth considering the option of adopting a rent adjustment reference index which is fairer, more viable and sustainable than MRIR. Such an index should as far as possible –

(a) closely correlate with tenants' affordability;

(b) be easy to administer and readily understandable by our stakeholders;

(c) live up to the community's expectation that, if warranted, rents could be adjusted either upwards or downwards; and

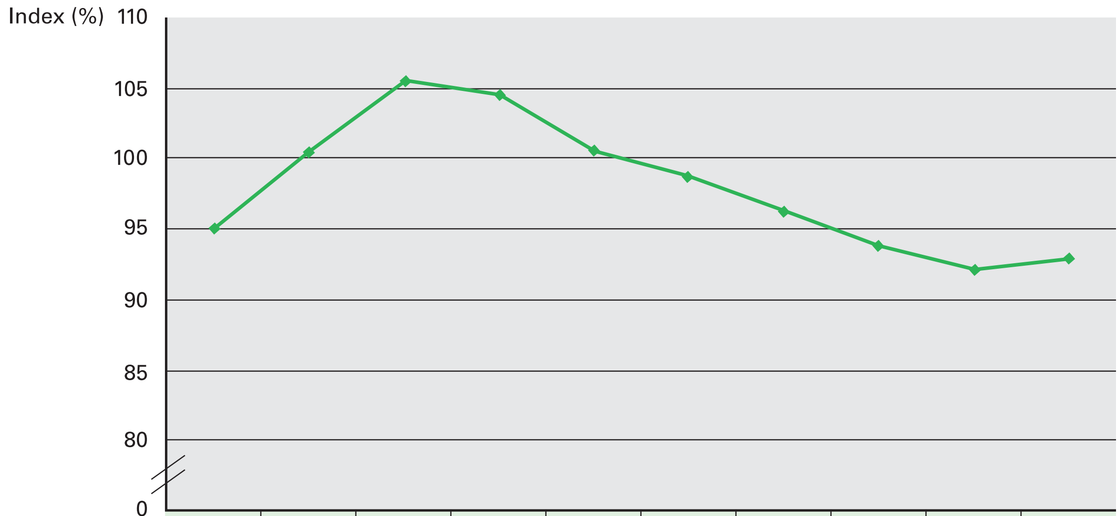
(d) support achievement of the Authority's policy and financial objectives.

7.8 In the following paragraphs, we discuss the operation of four reference indexes considered by the Committee, comprising two inflation/deflation-based indexes and two income-based indexes.

(a) Consumer Price Index (A)

7.9 The Consumer Price Index (CPI)[13], which measures movements of the price levels of consumer goods and services purchased by households over time, is the most commonly used indicator of inflation/deflation. The CPI (A) covers households with monthly expenditure ranging from $4,500 to $18,499[14], excluding recipients of CSSA. It is compiled by the Census and Statistics Department on a monthly basis. As the expenditure of most PRH tenants falls within the range of expenditure covered by CPI (A), this index is considered suitable for reflecting the price levels that have the most direct impact on PRH tenants. A simple and convenient option is to adjust PRH rents with reference to movements in CPI (A). The graph below shows the movements of the index over the past 10 years.

Consumer Price Index (A) from July 1995 to June 2005
(Base Year: Oct 99 - Sept 00 = 100)



Period	95 Jul - 96 Jun	96 Jul - 97 Jun	97 Jul - 98 Jun	98 Jul - 99 Jun	99 Jul - 00 Jun	00 Jul - 01 Jun	01 Jul - 02 Jun	02 Jul - 03 Jun	03 Jul - 04 Jun	04 Jul - 05 Jun
CPI (A)	95.0	100.5	105.5	104.6	100.6	98.7	96.3	93.8	92.2	93.0
Year-on-year change	7.1%	5.8%	5.0%	-0.9%	-3.8%	-1.9%	-2.4%	-2.6%	-1.7%	0.9%

7.10 For illustration purpose, we assume that rents are reviewed every two years[15]. If a rent review was conducted in end 2005, we would track the movement of CPI (A) over the past two years from July 2002 – June 2003 to July 2004 – June 2005, which dropped 0.9%. PRH rents may be reduced by 0.9% if this index is adopted.

[13] As the expenditure pattern of individual households varies, the impact of an increase in consumer prices on them also varies. The Census and Statistics Department therefore compiles three sets of consumer price indexes, namely CPI (A), CPI (B) and CPI (C) based on the expenditure patterns of households of the low, medium and high expenditure groups respectively. Compilation of the Composite CPI is based on the overall expenditure pattern of all the above households.

[14] The expenditure range relates to prices in the base period from October 1999 to September 2000.

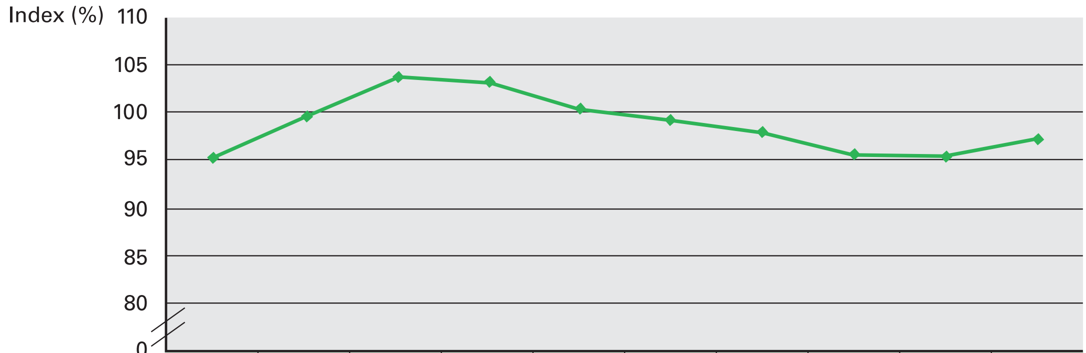
[15] Chapter 11 discusses in greater detail how frequent the rents of PRH estates should be reviewed.

(b) CPI (A) excluding housing expenditure

7.11 However, PRH rents are an important component in compiling CPI (A)[16]. Changes in PRH rents are likely to cause the price index to change in the same direction. Using CPI (A) as an indicator for rent adjustments may result in a vicious cycle in which rents and price index may spiral upwards or downwards one after the other.

7.12 To avoid the spiral effect associated with the use of CPI (A) as a rent adjustment index, an alternative option is to exclude housing expenditure from CPI (A). The data required for compiling this index can be readily obtained from the Census and Statistics Department. The graph below shows the movement of the index over the past 10 years. CPI (A) excluding housing expenditure increased 1.6% over the past two years. If a rent review were conducted in end 2005 using this index as an indicator, the PRH rents would be increased by 1.6%. However, it should be noted that compared to the movement of CPI (A) shown in the graph in para. 7.9, the extent of movement of CPI (A) excluding housing expenditure over this 10-year period was less volatile, indicating that any upward or downward rent adjustment based on this index is likely to be more moderate over the long-term.

CPI (A) Excluding Housing Expenditure from July 1995 to June 2005 (Base Year: Oct 99 - Sept 00 = 100)



Period	95 Jul - 96 Jun	96 Jul - 97 Jun	97 Jul - 98 Jun	98 Jul - 99 Jun	99 Jul - 00 Jun	00 Jul - 01 Jun	01 Jul - 02 Jun	02 Jul - 03 Jun	03 Jul - 04 Jun	04 Jul - 05 Jun
CPI (A) excluding housing expenditure	95.3	99.7	103.9	103.2	100.4	99.2	98.0	95.7	95.4	97.2
Year-on-year change	5.9%	4.6%	4.2%	-0.7%	-2.7%	-1.2%	-1.2%	-2.3%	-0.3%	1.9%

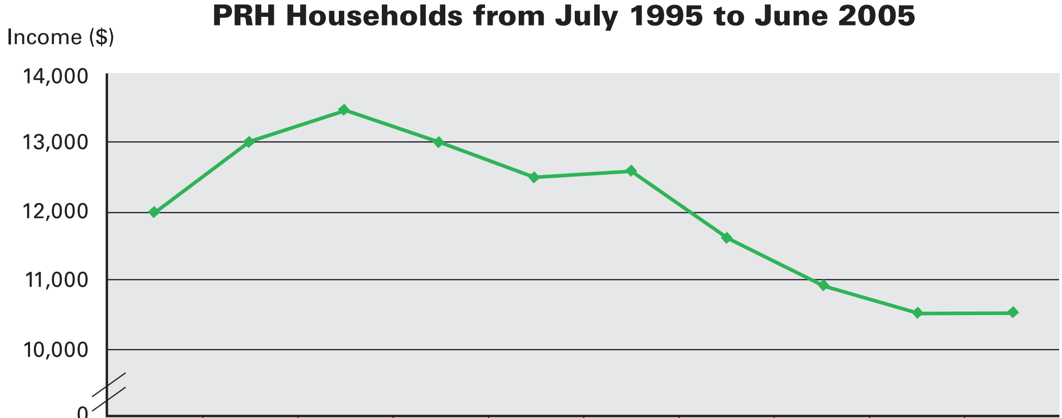
[16] *As the Authority has not effected any rent adjustment since 1998, the rental levels of the majority of its estates have largely been kept at 1995 and 1996 levels. The movements in CPI (A) over the past 10 years as indicated in the graph in para. 7.9 did not therefore capture the potential impact of any changes in PRH rents.*

7.13 An inflation/deflation-based system is easy to operate and widely understandable. However, inflation/deflation may not correlate directly with changes in tenants' affordability. An alternative system would be to adjust rents with reference to tenants' income which is a key factor affecting tenants' affordability. Two income-based indexes are proposed below.

(c) Median Monthly Household Income

7.14 A simple income-based system is to adjust rents based on the changes in the median monthly household income of the tenants. To avoid seasonal fluctuations, annualized income data should be used to assess the extent of adjustments warranted. The graph below sets out the movement in the annualized median monthly household income of PRH households since July 1995 – June 1996.

Median Monthly Household Income for PRH Households from July 1995 to June 2005



Period	95 Jul - 96 Jun	96 Jul - 97 Jun	97 Jul - 98 Jun	98 Jul - 99 Jun	99 Jul - 00 Jun	00 Jul - 01 Jun	01 Jul - 02 Jun	02 Jul - 03 Jun	03 Jul - 04 Jun	04 Jul - 05 Jun
Median Monthly Income ($)	12,000	13,000	13,500	13,000	12,500	12,600	11,600	10,900	10,500	10,500
Year-on-year change	7.9%	8.3%	3.8%	-3.7%	-3.8%	0.8%	-7.9%	-6.0%	-3.7%	0.0%

7.15 The median household income of PRH tenants dropped 3.7% between July 2002 – June 2003 and July 2004 – June 2005. PRH rents would be reduced by the same percentage should a rent review be conducted in end 2005 in accordance with this simple income-based approach.

7.16 The main advantage of this option is that income data can be readily compiled from the General Household Survey. The operation of the mechanism is simple and easily understandable. However, as with using MRIR as a measure of affordability, the main drawback of this system is that the movement in median household income may not reflect accurately changes in the average income for all households as the median figure can be affected by changes in the distribution of household size over time. As income of small households is usually lower than that of large households, there is a tendency for the median household income to drop simply because of an increase in the number of small households.

(d) Average Monthly Income Index (Discounting Impact of Changes in Household Size Distribution)

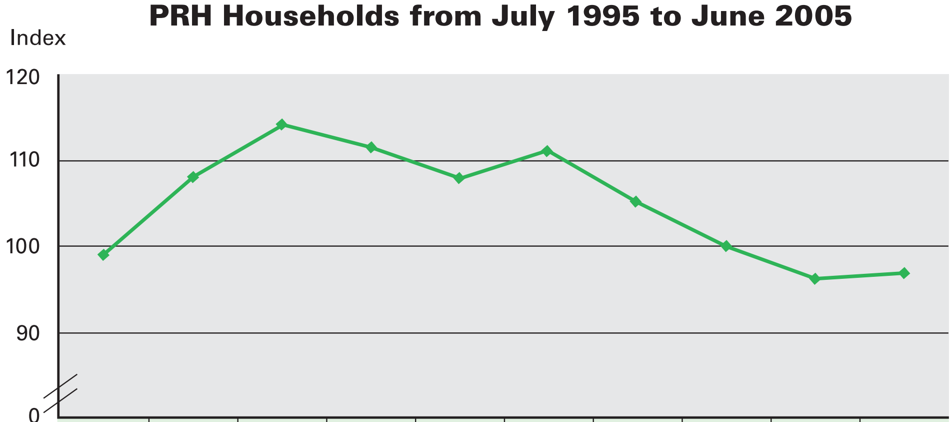
7.17 To address the shortcomings of a broad brush system of pegging rents with movement in median household income, a more sophisticated option is to develop an index tracking the movement in household income which only takes account of the "pure income changes" and discounts the impact of changes in the distribution of household size.

7.18 Before delving into this option, it would be useful to illustrate how an increase in the proportion of small households may distort the calculation of the average household income. Three self-explanatory cases based on the real household income and household size distribution data during July 2002 – June 2003 and July 2004 – June 2005 are shown in the tables at **Appendix D**. Table 1 at **Appendix D** shows that during the period under reference, there was a considerable increase in the number of small households comprising three persons or less while the average household income dropped across all households of different size. The combined effect of this shrinkage in both the household size and income was a reduction in the overall average household income by around 5.6% in the two-year period from July 2002 – June 2003 to July 2004 – June 2005. Tables 2 and 3 at **Appendix D** give an approximate breakdown of the changes in the average household income attributable to the changes in household size distribution and the "pure changes in household income". In brief, it is reckoned that changes in household size distribution caused the overall average household income to drop by around 2.5% (Table 2 refers). Should we only count the "pure income effects" as set out in Table 3, the average household income dropped by some 3.2% during the period.

7.19 As the illustration at **Appendix D** makes clear, a fairer income indicator would be one that is free from the influence of changes in household size distribution. The changes in the average income calculated under Table 3 at **Appendix D**, which holds the distribution of household size constant and only counts the "pure income effects", should better reflect the actual changes in household earnings.

7.20 Based on the principle that only "pure income effects" are taken into account with the effects of the changes in the distribution of household size discounted, we have worked out the average monthly household income index for PRH households from July 1995 – June 1996 to July 2004 – June 2005 as follows –

Income Index (counting only "pure income effects") for PRH Households from July 1995 to June 2005



Period	95 Jul - 96 Jun	96 Jul - 97 Jun	97 Jul - 98 Jun	98 Jul - 99 Jun	99 Jul - 00 Jun	00 Jul - 01 Jun	01 Jul - 02 Jun	02 Jul - 03 Jun	03 Jul - 04 Jun	04 Jul - 05 Jun
Income Index	99.0	108.1	114.2	111.5	108.0	111.1	105.2	100.0	96.2	96.8
Year-on-year change	6.3%	9.2%	5.6%	-2.4%	-3.1%	2.9%	-5.3%	-4.9%	-3.8%	0.6%

Note: For comparison purpose, the income indexes shown above have been compiled using the household size distribution in Jul 02 - Jun 03. (i.e. base year)
(i.e. Index for Jul 2002 - Jun 2003 = 100)

Detailed formula for calculating the index is shown in the technical note at **Appendix E**.

7.21 To adjust rents in a biennial rent review based on the above income index, a simple approach would be to assess the cumulative percentage change in the income index for the two-year period preceding the rent review and adjust the rents by the same percentage. For instance, should a rent review be conducted in end 2005, the income index dropped by 3.2% in the two-year period from July 2002 – June 2003 to July 2004 – June 2005. Accordingly, the rents for the PRH estates under review should be reduced by 3.2%.

7.22 In putting this income-based rent adjustment mechanism into practice, it is for consideration whether the distribution of household size should be perpetually fixed at one particular year (in the illustration above, we hold the distribution of household size constant at July 2002 – June 2003). One possible alternative is to "re-base" the distribution of household size regularly. For instance, should a rent review be conducted in end 2005, the income index should be assessed based on the distribution of household size in the period from July 2002 to June 2003. As regards the rent review to be conducted in end 2007 (assuming a biennial rent review cycle), the household size distribution should be "re-based" at the position for the period from July 2004 to June 2005. Such regular "re-basing" could strike a balance between the need to exclude the undue impact of changes in household size distribution in assessing the income index within the two-year rent review cycle and the need to make reference to more updated pattern of household size distribution in PRH for deriving the income index.

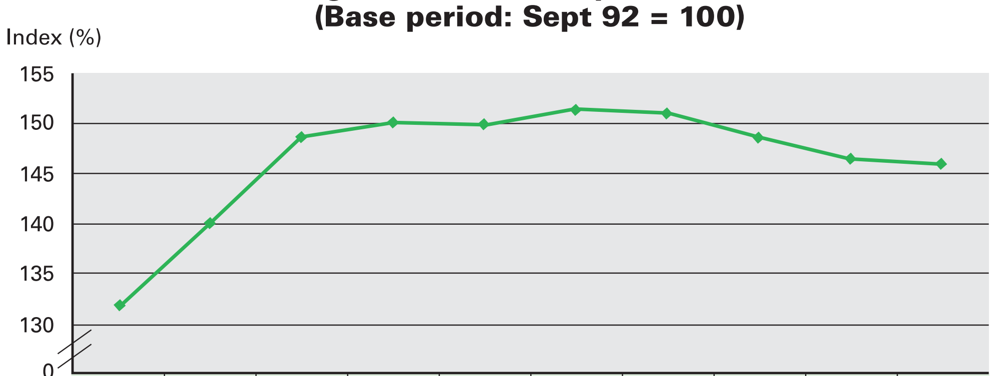
7.23 Furthermore, to ensure the reliability of the index, the Authority may consider collecting its own data on tenants' income instead of relying on the results of General Household Survey. The possibility for the Authority to operate a declaratory system to collect income data of its tenants is discussed in Chapter 6. Should the system be implemented, the data collected could also be used to compile the income index.

7.24 Average monthly income index provides a solid basis for assessing the income movements of households. Insofar as tenants' affordability depends in large measure upon how much they earn, the proposed mechanism provides a strong connecting thread between affordability and rent adjustments. It offers an effective safeguard against any rent adjustment that is not in tandem with tenants' earnings. This option, however, is not beyond reproach. Like the MRIR, the concept of average monthly income index is fairly complicated and may not be readily understandable by the general public. The income index discounting effects of changes in household size distribution is currently not readily available and the Authority will have to compile the index using its own resources. If it is considered necessary to give statutory effect to the proposed reference index, how to accurately capture the operation of the income index in legal terms would be a considerable challenge.

Other Possible Options

7.25 The Committee has considered the option of using wage indexes compiled by the Census and Statistics Department for guiding rent adjustment. However, wage indexes reflect only changes in the wages of those who are in employment. They do not capture the impact on household income brought about by changes in the number of working members in a household. In addition, many of the trades by which PRH tenants find their living, such as construction workers, hawkers, self-employed lorry, taxi and public mini-bus drivers, are not covered in the compilation of the wage indexes. Because of these limitations, wage indexes show a very moderate downward adjustment even during recession. As movement in wage indexes may have little bearing on the actual household income of PRH tenants, it may not be appropriate and fair to rely on them to form the basis of rent adjustment.

Nominal Wage Index from July 1995 to June 2005
(Base period: Sept 92 = 100)



Period	95 Jul - 96 Jun	96 Jul - 97 Jun	97 Jul - 98 Jun	98 Jul - 99 Jun	99 Jul - 00 Jun	00 Jul - 01 Jun	01 Jul - 02 Jun	02 Jul - 03 Jun	03 Jul - 04 Jun	04 Jul - 05 Jun
Annualized Wage Index	131.8	140.0	148.6	150.0	149.7	151.3	151.0	148.5	146.4	145.9
Year-on-year change	6.5%	6.2%	6.1%	0.9%	-0.2%	1.1%	-0.2%	-1.7%	-1.4%	-0.3%

7.26 The Committee has also examined a cost-based rent adjustment mechanism, i.e. rents will be adjusted according to changes in the costs for developing, managing and maintaining the PRH estates. The main advantage of the option is that it can help ensure that the revenue accrued from the estates is adequate to meet their expenses. However, a cost-based rent adjustment system fails to take account of tenants' affordability. There is also concern that such a system may undermine the Authority's incentives to cut its operating costs. Overall, the Committee is of the view that the costs for developing, managing and maintaining the PRH estates should be one of the considerations, rather than a sole determinant, for rent adjustments.

Rent Setting for New Estates

7.27 To develop a coherent and consistent approach in both rent adjustments for existing estates and rent setting for newly completed estates, it is possible to subject the "best rents" for new estates to the same adjustment mechanism guided by the proposed reference index. The current policy that the MRIR of the prospective tenants to be re-housed to the new estates should not exceed 18.5% for an allocation standard of 7 m^2 IFA per person could continue to apply as an additional safeguard to ensure that the rents so determined according to the proposed reference index are affordable.

The Committee's Views

7.28 The Committee believes that the proposed reference index system, be it inflation/deflation-based or income-based, would provide the Authority and the tenants with a clearer and more certain basis for rent adjustments. Compared with the MRIR, the proposed reference index system would go some way in promoting a more sustainable and resilient rental structure in the long run. Adopting the same system to guide the movements in the "best rents" would also help create a coherent and common framework for both rent adjustments and rent setting for new estates.

7.29 A rational rent adjustment mechanism should take into account various relevant factors including tenants' affordability, economic environment (e.g. inflation and income movement), relative value of estates and operating expenses in managing the estates, etc. Ideally, the index should be treated as an important reference benchmark, but not the sole determinant for rent adjustments, so as to maintain the necessary flexibility. If the proposed rent adjustment reference index were given statutory backing and prescribed in the Housing Ordinance, the Authority would have to follow the reference index rigidly in determining rent adjustments and would not be able to cater for other factors that are relevant to rent adjustments. This may undermine our overall objective of keeping PRH rent affordable to tenants while ensuring long-term sustainability of the PRH programme.

7.30 It should also be emphasized that the proposed rent adjustment reference index should be considered in the context of the Authority's overall domestic rent policy which covers, inter alia, a comprehensive Rent Assistance Scheme. The Scheme has formed a subject of the present Review and the Committee has put forth proposals to improve the operation of the Scheme in Chapter 13. By offering 25% to 50% rent reduction to tenants with rent-to-income ratio exceeding 20%, the Scheme will continue to be in the vanguard of ensuring that rents are affordable.

Consultation Point D :

The Committee would welcome views on the following points –

- *Whether a system of index-linked rent adjustment mechanism should be introduced?*
- *If so, which of the four options identified in paras. 7.9 – 7.24 above should be adopted? Views on other possible options are also welcome.*
- *Whether the Authority should adjust rents in strict accordance with the proposed index or take it as a reference in rent adjustment? And whether the proposed rent adjustment index should be given statutory effect?*
- *Whether similar system should also be applied to guide the adjustments of the "best rents" for setting the rents of newly completed estates?*

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Differential Rents

8.1 This Chapter looks into the concept of differential rents and examines whether it should be introduced to enhance the existing rent fixing mechanism. The objective is to put in place a rent structure which is fairer and allows more choice for tenants.

Areas for Improvements

8.2 The Authority currently adopts a broad brush approach in dividing the territory into six geographic districts for rent setting purpose. A "best rent" for each district, expressed in terms of dollars per m^2 of IFA, is set taking into account the location and comparable estate values of the district concerned. It could be interpreted as the highest unit rent that the Authority would normally charge for newly completed estates in that district. The existing "best rents" in the respective districts are set out below –

District	Current "Best Rent" $/m² IFA
Urban	63.4
Shatin / Tsuen Wan / Tsing Yi / Kwai Chung	61.2
Tai Po / Tseung Kwan O / Ma On Shan	55.4
Fanling / Sheung Shui / Tung Chung	44.8
Tin Shui Wai / Yuen Long / Tuen Mun	42.2
Islands	36.4

8.3 The differences in the "best rents" among districts underline the fact that the Authority has already embraced to some extent the concept of differential rents in its domestic rent policy. However, when rents are set uniformly in the same district and differ only according to the size of the flats, there is too little flexibility in the current rent setting mechanism and too little choice to the tenants. To give the tenants the choice they expect, the current rent structure has room for improvements in at least two aspects.

8.4 First, the current rent structure fails to reflect the differences in the comparable estate values within the same district. The districts as currently zoned are too broad brush. Conditions in terms of location, transportation, environment and facilities within the same district could vary quite significantly. Yet these variations are not reflected in the "best rents" under the existing framework.

8.5 Second, the current system does not take into account the differences in the property values of the flats in the same building. Under the existing policy, rents for flats of identical size within the same estate are normally the same, irrespective of floor levels or external views. Flats on higher floors or with better orientation are naturally more popular. Flats on lower floors and those located close to unwelcome facilities, such as refuse rooms, are often more difficult to let.

8.6 A more refined system of differential rents would enhance the fairness, affordability and efficiency of the Authority's domestic rent policy. Flats that are in less attractive locations and with poorer supporting facilities should have lower rents than those without these disadvantages, and vice versa.

Possible Models for Introducing Differential Rents

A Moderate Model

8.7 A possible model for introducing differential rents, which is less comprehensive but easier to administer, is set out below –

(a) PRH estates in each of the current six broad districts (except the Islands district due to its small size) will be further divided into three sub-groups. The "best rent", which should more appropriately be called "reference rent", for each sub-group will be adjusted upwards or downwards by a specified percentage to reflect its varying conditions in terms of location, transportation, environment and other amenities. Those with higher estate value would be categorized in group I, whereas those with average estate value and lower estate value in group II and III respectively;

(b) the rents of individual units within the same housing block should be adjusted in accordance with a number of objective factors that are internal to the block. Relevant considerations include floor levels, proximity to certain unwelcome facilities such as refuse chambers or transformer rooms, etc. External factors such as views and orientation of the flats are not taken into account; and

(c) the rents of similar-sized units within the same block so determined would vary within a moderate range of, say, 15% of the "reference rent" and the overall effects on rental income within the same block should largely be neutral.

Appendix F gives an illustration of the operation of this proposal.

8.8 This option provides a practical framework towards meeting our objective of developing a fairer rent structure to reflect differences in location, floor level, and other internal feature of properties while having full regard to the tenants' affordability. In so doing, the prospective tenants would also be given more choices to select flats that match their preferences and affordability. It is, however, not entirely satisfactory insofar as it fails to reflect the values of the properties in full. The relatively limited range of rent differential between units of similar size may not offer adequate incentive for prospective tenants to take up flats in less favourable locations.

A More Comprehensive Model

8.9 The Committee has also examined a more comprehensive approach in taking forward the idea of differential rents. Under this more comprehensive approach, all the key factors of the "moderate" model set out in para. 8.7 above would be adopted with the following modifications –

(a) in addition to internal factors, rents would be set taking account of such external factors as the orientation and views of the flats; and

(b) the rent differential between units of similar size within the same block would be widened to around 30% of the "reference rent". The impact on the rental income within the same block should largely remain neutral.

Appendix G illustrates the operation of this model.

8.10 This more comprehensive model can better reflect the values of individual PRH units. The wider margin of rent differential would also provide greater incentive for prospective tenants to choose flats that are considered less popular. However, the assessment of rent differential attributed to external views and flat orientation is likely to be controversial. A higher administrative cost is also expected for operating this more comprehensive model.

Implementation Framework

8.11 The initial implementation framework under the two models set out at **Appendixes F and G** respectively is for illustration only. Subject to a decision being taken to proceed with a system of differential rents, we will commission further work to develop the precise model for implementation. In mapping out the implementation framework, the following important points should be taken into consideration –

(a) complementary improvements should be made to the flat allocation process so as to provide prospective tenants with greater flexibility in choosing flats that suit their quality and price preferences; and

(b) the measures should be introduced to newly completed estates in the first instance to avoid disruption to the existing tenants. Consideration should be given to introducing differential rents in the existing estates based on the same principles in the longer term. However, whether and when this convergence will take place should be decided taking account of the impact on the existing tenants; and

(c) the rents charged by the Authority are generally below the maximum rate of rent allowance provided under the CSSA. In other words, even if the CSSA recipients are allocated with PRH units of higher rents, they will receive sufficient allowance to cover the rents payable in great majority of the cases. CSSA recipients therefore do not have to consider their affordability when choosing PRH units. Should a system of differential rents be adopted, there is a likelihood that CSSA recipients may choose units with better location and hence higher rents given that rental affordability is not a main concern. As CSSA households normally have higher rent-to-income ratios, allocating flats with higher rents to them will not only increase the amount of public subsidies to CSSA households, but also lift their rent-to-income ratios further, which will in turn add to the pressure on MRIR.

The Committee's Views

8.12 The Committee believes that widening the rental differential of PRH units could help enhance the flexibility of the rent structure and provide greater choice to tenants. On the other hand, it is mindful of the potential pitfall of a system of differential rent that is based entirely on market principles, which would lead to fairly drastic changes to the existing rent structure. A market-oriented system may result in substantial rent increases for flats located in urban areas or those commanding good views. We certainly do not want the rents of the public housing to follow the more extreme trends in the private rental market. The two options identified in this consultation paper seek to strike a balance between the objectives of reflecting property values in rents, offering more choice to tenants, and the need to ensure that rents remain affordable to people on low incomes.

8.13 The Committee also considers that should a system of differential rents be introduced, we should adhere to the upper tier space allocation standard (i.e. 7 m^2 IFA per person) for CSSA recipients. However, if flats of similar size but different rents are available in the same district or estate, it is for consideration whether flats with relatively higher rents should be allocated to CSSA recipients, taking account of the possible impact on the overall MRIR and amount of public subsidies to be incurred.

Consultation Point E :

The Committee would welcome views on the following points –

- *Whether a system of differential rents should be introduced?*
- *If so, whether a moderate and relatively broad brush model (para. 8.7 refers) or a comprehensive model (para. 8.9 refers) of differential rents should be adopted? Suggestions on other possible systems of differential rents are also welcome.*
- *Should the proposed system of differential rents be applied to new estates only? Should it be gradually extended to the existing estates and, if so, when the extension should take place?*
- *Should a system of differential rents be introduced, whether flats with relatively higher rents should be allocated to CSSA recipients, taking account of the possible impact on the overall MRIR and amount of public subsidies to be incurred?*

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Exclusive Rents

9.1 The rents of PRH flats are inclusive of rates, management fees and maintenance expenses. This Chapter examines the case for changing the current practice of charging all-inclusive rents.

Existing Arrangements

9.2 Prior to 1980, rents for public housing estates were exclusive of rates[17]. In 1980, the Authority decided to collect rents inclusive of rates for all of its estates to address the concern that it was imposing too frequent rent adjustments due to increases in rates. The net rent payable to the Authority and the amount of rates payable to Government are shown separately on the tenants' rent cards. Between 2000/01 and 2004/05, about 8.5% – 13.2% of the Authority's gross domestic rental income went to the payment of rates.

9.3 Rates for PRH units are based on block assessments[18] by the Rating and Valuation Department and are apportioned by the Housing Department according to the size of each flat. It has been the Authority's practice to pass on any rate concession offered by Government to the tenants. However, any change in rates between rent reviews due either to general revaluation or changes in the percentage charged on rateable values is not passed onto the tenants immediately, but absorbed by the Authority until the next rent review.

9.4 In addition to rates, PRH rents also cover management costs and maintenance expenses. Unlike the practice in private sector where management fees normally cover only routine estate management, security, cleansing and minor maintenance expenses, the Authority also incurs considerable expenses in major repairs and maintenance as well as tenancy management services (e.g. administering letting and transfers).

9.5 The major drawback of all-inclusive rents is that the public and PRH tenants are not made fully aware of what constitute the "rents" so charged. Nor do they understand that the "net rents" collected by the Authority, after deducting rates, management costs and maintenance expenses, are far lower than the "nominal rents" they pay.

[17] Except for Group B Estates and Former Government Low Cost Housing Estates.

[18] A block assessment of the rateable rent is the aggregate of the estimated open market rents of all the flats in a PRH block as at a designated valuation reference date.

Exclusive Rents

9.6 The Committee has examined the case for charging net rents exclusive of rates and management expenses. Such arrangements have the following advantages –

(a) setting rents on an exclusive basis will more accurately reflect the Authority's rental charges. It also follows that the magnitude of any rent variations will no longer be distorted by adjustments in the amount of rates payable to Government which is beyond the Authority's control;

(b) at present, rates for PRH units are based on block assessments, which are apportioned to individual units solely on the basis of the size of the concerned units. This arrangement, while administratively convenient, does not take into account the unique attributes of individual flats. If rates are to be paid separately, the Rating and Valuation Department would have to assess the rateable values of the PRH flats individually as with any private residential flats. Tenants living in flats with lower rateable values will pay lower rates and vice versa. The rates payable will therefore reflect more accurately the comparable values of the individual units; and

(c) tenants would better understand the operating and management costs of PRH units and the amount of housing subsidies they are receiving.

Practical Considerations

9.7 There are, however, a number of practical and administrative considerations which need to be addressed if we are to charge rents separately from rates and management fees. These include –

(a) the existing tenancy agreement provides for the charging of rents inclusive of rates and management fees. The Authority will need to change the tenancy agreement before it could revert to the practice of charging exclusive rents;

(b) assessing the rateable values of all the existing PRH units is a complex exercise. The Rating and Valuation Department would need time and additional resources to complete the assessment of all existing PRH estates;

(c) direct collection of rates by Government from individual PRH tenants would increase the overall administrative costs of rates collection and cause inconvenience to tenants;

(d) any arrears of rates would ultimately have to be borne by the Authority as the landlord; and

(e) management fees vary according to estates. The evaluation of management fees would be a controversial issue if these are to be charged on a full cost recovery principle.

An Alternative Option to Enhance Transparency

9.8 The Committee agrees in general that the Authority should move towards separating the collection of rates from rents and having a separate assessment of management fees in the long term. However, noting the practical difficulties and potential inconvenience to tenants, the Committee is of the view that the case for an immediate switch to exclusive rents is less than clear cut. A more viable alternative would be to continue to charge inclusive rent but to let PRH tenants know clearly the rental components, including the amount of rates, management fees and net rents, by way of an annual statement to be issued to individual tenants to enhance transparency. The advantage of this approach is that PRH tenants would better understand the costs incurred in operating PRH and the amount of net rents charged by the Authority.

9.9 As regards the evaluation of management fees, the Committee accepts that in common with the private sector practice, management fees should cover expenses on estate management, security, cleansing and minor maintenance works. Expenses on major repairs and maintenance works, and tenancy management matters such as arranging for transfers, evictions, etc, should be excluded. This proposed option is solely for enhancing transparency and would not impact on the actual rent level.

Consultation Point F :

The Committee would welcome views on the following points –

- *Whether the Authority should separate the collection of rates and management fees from rents, i.e. tenants will be required to pay the rates to Government, and management fees and rents to the Authority separately? In particular, should the proposed system of exclusive rents be applied to new estates only? Should it also be introduced to the existing estates and, if so, when should it be introduced?*
- *Alternatively, should the Authority continue with the existing practice of collecting inclusive rents but separately list out the rates and management fees by way of an annual statement to individual tenants to enhance transparency?*

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Fixed-Term Tenancy

10.1 The Authority has been adopting a system of monthly tenancy for many years. This system of tenancy arrangement is very different from the fixed-term tenancy that is being widely practised in the private rental market. In this Chapter we consider the desirability of introducing fixed-term tenancy in place of the existing monthly tenancy for PRH.

Monthly Tenancy

10.2 Monthly tenancy has been in place since the development of public housing in 1954. All PRH tenancies are let on a month-to-month term until termination by notice in accordance with the provisions of the tenancy agreement or the Housing Ordinance. Monthly tenancy has the following advantages –

(a) it provides the Authority with a high degree of flexibility in enforcing management actions such as arranging for transfer arising from major repairing works;

(b) it enables the Authority to enforce tenancy conditions effectively. For instance, in the event of breaches of tenancy conditions, the tenancy can be terminated by giving one month's notice; and

(c) it allows the Authority to review and adjust rents flexibly.

10.3 Although legally it is clear that monthly tenancy does not confer any right on the tenants to perpetuate their stay in PRH, monthly tenancy has been criticized for giving tenants an impression that their tenure would continue perpetually. The apparent lack of a proper mechanism to review and renew the tenancy agreements has also been cited as one of the reasons why tenants have very little incentive to surrender their flats even when they are no longer in need of housing subsidies.

Merits and Demerits of Fixed-Term Tenancy

10.4 To ensure that public housing resources are allocated in accordance with need, there have been suggestions that the Authority should replace the current monthly tenancy by fixed-term tenancy. Fixed-term tenancy provides for a tenancy agreement which is valid only for a fixed period of time. On the expiry of the tenancy, the tenant has to apply for renewal on the basis of verified need. The principal merit of introducing fixed-term tenancy to PRH is that it will help get across a clear message to the tenants that the enjoyment of public housing subsidies is by no means a perpetual right and PRH should only be provided to those in genuine need subject to periodic review of their eligibility.

10.5 Despite its potential benefits, fixed-term tenancy is inherently less flexible than monthly tenancy in the following aspects –

(a) the level of rents must be clearly prescribed (either by fixing the rent level or by stipulating the mechanism for rent adjustment) within the period of the tenancy, lest the tenancy agreement would be void for uncertainty. Each flat would also have a different date of tenancy expiry depending on when the tenancy was signed initially. As rents need to be prescribed within the tenancy period, any rent adjustments could only be implemented upon expiry of the tenancy for each flat. This would not only have major impact on the Authority's latitude of adjusting rents, but is also likely to cause confusion among tenants;

(b) fixed-term tenancy is less flexible in terms of enforcing tenancy conditions. Early termination of a tenancy even with a good cause may result in claims; and

(c) considerable staffing resources and time would be needed for the initial conversion of all the existing monthly tenancies to fixed-term tenancies, and for processing subsequent tenancy expiries and renewals. Potential resistance from tenants is another area for concern.

The Committee's Views

10.6 On the whole, the Committee is of the view that the current system of monthly tenancy is working well. It provides a flexible framework for the Authority to take effective tenancy enforcement actions and implement rent adjustments. Adopting fixed-term tenancy may compromise the Authority's flexibility in these important areas. More important, conversion to fixed-term tenancy alone may not offer an effective barrier to prohibit perpetual extension of tenants' stay in PRH. What really matters is the establishment of a set of criteria to determine whether tenancies are to be renewed. Tenants' incomes or assets would logically form the basis of tenancy renewal. In this respect, there are already existing policies such as the Housing Subsidy Policy, Policy on Safeguarding Rational Allocation of Public Housing Resources and the Policy on Grant of New Tenancy upon the Death of the PRH Tenant, which specifically deal with the eligibility of sitting tenants to continue to stay in PRH. The Committee is of the view that should these eligibility criteria need any changes, these should best be achieved through proper review of the relevant policies.

Consultation Point G :

The Committee would welcome views on whether a system of fixed-term tenancy should be introduced to replace the current monthly tenancy.

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Rent Fixing and Review Cycles

11.1 There has been concern over the frequency of the existing rent fixing and rent review cycles. In this Chapter, we look at the present arrangements and consider if changes are warranted, taking account of the measures proposed in previous Chapters to improve other aspects of the rent policy.

Present Arrangements

11.2 The Authority conducts two rent fixing exercises for newly completed PRH estates annually. On rent review, the Authority reviews the rents of PRH estates in batches. Each batch comprises different number of estates in different locations. In general, the rents of individual estates were reviewed every two years prior to 1998. Following the amendments to the Housing Ordinance that came into effect in March 1998, section 16(1A)(a) provides that any determination of variation of rent in a PRH estate shall only take effect at least three years from the date on which any immediately preceding determination came into effect. Having considered the prevailing circumstances and all relevant factors, the Authority has decided to defer all the rent review exercises since 1999.

Rent Fixing

11.3 The Authority has put in place a rolling PRH construction programme under which newly built PRH units with staggered completion dates are rolled out in different locations each year. Since a proper rent schedule has to be fixed prior to intake of tenants, the Committee considers that it is necessary to maintain the current arrangement of conducting two exercises every year to fix the rents of newly completed estates.

Rent Review Cycle

11.4 The Committee has reviewed the frequency which, under normal circumstances, the Authority may review the rents of individual estates. A longer rent review cycle of, say, three years, may provide tenants with a greater degree of certainty in terms of managing their rental expenditure. However, the magnitude of any rent adjustment under a triennial cycle is likely to be greater as it would reflect the cumulative effects of the economic, social and other relevant financial considerations over a three-year period. Overall, the Committee has expressed a preference for a shorter rent review cycle of two years in normal circumstances. This would allow timely implementation of any rent adjustments so warranted and possibly within a moderate range.

Batching of Estates for Rent Review

11.5 Should the Authority adopt the proposed reference index to guide rent adjustments (details are set out in Chapter 7), reviewing the rents of PRH in batches may result in inequitable treatment to different tenants. Under the current proposal, the rent adjustment reference index is to be based on CPI (A) or tenants' household income, which in general move in tandem with the general performance of the economy. Accordingly, the index so derived, and hence the rate of rent adjustment that follows, would vary at different points in time. Reviewing the rents of PRH estates in different batches may give rise to a less than equitable situation in which the rents of a batch of estates could be adjusted downwards in one year due to deflation or a drop in household income, whereas the rents of the next batch of estates to be reviewed in the next year could be increased when inflation returns or household income records an increase.

11.6 The potential inequitable treatment to different tenants could be avoided if the rents of the whole PRH stock are reviewed and adjusted in one go. All tenants would then receive the same treatment and have the same level of rent adjustment. Overall, the Committee is of the view that it would be more sensible and equitable to cover all PRH estates in any rent review exercise, particularly if future rent adjustments are to be guided by the proposed index-based system.

Consultation Point H :

The Committee would welcome views on the following points –

- *Whether the existing arrangements of having two rent fixing exercises per year should be maintained?*
- *What would be the appropriate frequency of rent review? In particular, whether a triennial or biennial cycle should be adopted under normal circumstances?*
- *Whether rent of all PRH estates should be reviewed in one go instead of staggering the review of different estates in batches?*

Relationship Between Flat Size, Rents and Tenants' Affordability

12.1 This Chapter examines the relationship between flat size, rents and tenants' affordability.

Flat Size and MRIR

12.2 Rental levels and tenants' affordability are closely related to flat allocation policies. As noted in Chapter 4, the marked improvement in tenants' living space is one of the key factors leading to the rise in MRIR. The average living space per person increased by 28% from 9.3 m^2 IFA in the third quarter of 1996 to 11.9 m^2 IFA in the third quarter of 2005. For newly let units, it further reached 12.3 m^2 IFA, exceeding the upper tier of the existing allocation standards of 7 m^2 IFA per person by 76%. In the case of one-person households, some 34% of them are occupying flats with living space of more than 20 m^2 IFA[19]. As for two-person households, over 41% of them enjoy a living space of more than 30 m^2 IFA. As PRH rents vary with the size of the flats, we reckon that the increase in the average living space per person has raised the average rent of PRH by 28% over the past 10 years.

12.3 The sharp increase in average living space per person is the result of many factors. These include –

(a) the Authority's drive over the past few years to reduce the number of overcrowded households through internal transfer exercises;

(b) increase in the number of one-person households which normally occupy more space per person;

(c) demolition of smaller flats in old estates under the Comprehensive Development Programme;

(d) reduction in household size following moving out of family members; and

(e) conversion of a significant number of surplus Home Ownership Scheme flats into PRH following changes in Government's policy on Home Ownership Scheme. Since the majority of Home Ownership Scheme flats are two-bedroom or three-bedroom flats, transferring these units to rental use has distorted the planned flat mix of PRH and resulted in a sharp increase in the supply of large PRH flats.

[19] *These cases are mainly brought about by deletion of household members from the tenancies.*

12.4 When tenants are allocated flats that far exceed the allocation standards, it worsens their rental burden and raises the MRIR. To address the problem, the Authority has ceased construction of three-bedroom flats in new PRH projects. It is also expected that following the consumption of all the Home Ownership Scheme-converted units, the flat size of new PRH production would match more closely the household size of the prospective tenants.

The Committee's Views

12.5 The Committee agrees in principle that the Authority should follow the established allocation standards as far as possible. When planning new PRH projects, the overall flat mix should as far as possible match the household size distribution of Waiting List applicants and other prospective tenants. It should also be reviewed regularly and adjusted as necessary.

Rent Assistance Scheme

13.1 Whatever the basis on which rents are set, there is bound to be a group of needy tenants who find the normal rents beyond their affordability. This Chapter sets out the operation of the Rent Assistance Scheme and a series of measures that the Authority has captured to enhance the scheme lately.

Rent Assistance Scheme

13.2 The Rent Assistance Scheme was introduced in 1992 offering 50% rent reduction[20] to tenants facing temporary financial hardship. Tenants with long-term financial difficulties may apply for the CSSA operated by the Social Welfare Department.

13.3 Prior to recent improvements, applicants for rent assistance had to meet, inter alia, the following eligibility criteria –

(a) the household income falls below 50% of the prescribed Waiting List Income Limit; or

(b) the rent-to-income ratio of the household exceeds 25%; or

(c) the household income is between 50% to 60% of the respective Waiting List Income Limits and the household's rent-to-income ratio exceeds 15%.

Improvements Recommended by the Committee

13.4 To provide suitable and timely relief to needy tenants, the Committee decided to put forward its recommendations on improving the Rent Assistance Scheme to the Authority in advance of other proposals covered by the current rent policy review. These include –

(a) relaxing the income limit for elderly households from below 50% of the respective Waiting List Income Limits to below 60%, and lowering the rent-to-income ratio threshold from 25% to 20%;

(b) allowing tenants affected by redevelopment to apply for rent assistance immediately upon rehousing to new or refurbished flats; and

(c) extending the grace period for moving to cheaper flats from two to three years. Elderly households and households with disabled members would continue to be exempt from this relocation requirement.

13.5 These improvements were endorsed by the Authority and took effect on 31 October 2002[21].

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[20] *Only 25% rent reduction was offered when the Scheme was first introduced in 1992. The extent of reduction was increased to 50% in 1995.*

[21] *Cumulatively the Rent Assistance Scheme has benefited 29 900 households since 1992. As at the third quarter of 2005, some 16 300 households were receiving rent assistance under the Scheme.*

Further Enhancements

13.6 On 29 December 2005, the Subsidized Housing Committee further endorsed the following enhancements to the Rent Assistance Scheme –

(a) offering 25% rent reduction to those non-elderly households with rent-to-income ratios exceeding 20% or those with income below 60% of the Waiting List Income Limits; and

(b) lifting the requirement that applicants have to live in their flats for at least three years for tenants of older block types[22].

13.7 These further enhancements have taken effect since 1 March 2006[23].

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[22] *Older block types cover those completed before 1992 and exclude all Harmony blocks and those converted from Home Ownership Scheme/Private Sector Participation Scheme/Buy-or-Rent Scheme.*

[23] *It is estimated that the proposed enhancement to the Rent Assistance Scheme would increase the number of eligible households by 33 800 to a total of around 148 000.*

Summary of Consultation Points

14.1 A summary of the consultation points set out in this paper is listed below –

Chapter 5 – Alternative Options for Measuring Affordability

Consultation Point A :

The Committee would welcome views on whether the MRIR or other alternative methods, including those set out in paras. 5.2 to 5.7, should be used for measuring tenants' affordability. It also welcomes views on whether the affordability measure, be it the MRIR or other alternative methods, should be given statutory definition and control.

Chapter 6 – Improvements to the Assessment of the Median Rent-to-Income Ratio

Consultation Point B :

The Committee would welcome views on whether the current MRIR benchmarks of 15% and 18.5% for the respective allocation standard of 5.5m^2 IFA and 7m^2 IFA per person are appropriate. If not, what should be the appropriate MRIR benchmarks?

Consultation Point C :

The Committee would welcome views on whether the calculation of the MRIR should be improved and rationalized by –

- operating its own system to collect tenants' income data on a mandatory basis;
- excluding households receiving CSSA and those paying additional rents from the MRIR calculation; and
- excluding rates and management fees from the MRIR calculation.

Chapter 7 – Proposed Rent Adjustment Reference Index

Consultation Point D :

The Committee would welcome views on the following points –

- Whether a system of index-linked rent adjustment mechanism should be introduced?
- If so, which of the four options identified in paras. 7.9 – 7.24 above should be adopted? Views on other possible options are also welcome.
- Whether the Authority should adjust rents in strict accordance with the proposed index or take it as a reference in rent adjustment? And whether the proposed rent adjustment index should be given statutory effect?
- Whether similar system should also be applied to guide the adjustments of the "best rents" for setting the rents of newly completed estates?

Chapter 8 – Differential Rents

Consultation Point E :

The Committee would welcome views on the following points –

- Whether a system of differential rents should be introduced?
- If so, whether a moderate and relatively broad brush model (para. 8.7 refers) or a comprehensive model (para. 8.9 refers) of differential rents should be adopted? Suggestions on other possible systems of differential rents are also welcome.
- Should the proposed system of differential rents be applied to new estates only? Should it be gradually extended to the existing estates and, if so, when the extension should take place?
- Should a system of differential rents be introduced, whether flats with relatively higher rents should be allocated to CSSA recipients, taking account of the possible impact on the overall MRIR and amount of public subsidies to be incurred?

Chapter 9 – Exclusive Rents

Consultation Point F :

The Committee would welcome views on the following points –

- Whether the Authority should separate the collection of rates and management fees from rents, i.e. tenants will be required to pay the rates to Government, and management fees and rents to the Authority separately? In particular, should the proposed system of exclusive rents be applied to new estates only? Should it also be introduced to the existing estates and, if so, when should it be introduced?
- Alternatively, should the Authority continue with the existing practice of collecting inclusive rents but separately list out the rates and management fees by way of an annual statement to individual tenants to enhance transparency?

Chapter 10 – Fixed-Term Tenancy

Consultation Point G :

The Committee would welcome views on whether a system of fixed-term tenancy should be introduced to replace the current monthly tenancy.

Chapter 11 – Rent Fixing and Review Cycles

Consultation Point H :

The Committee would welcome views on the following points –

- Whether the existing arrangements of having two rent fixing exercises per year should be maintained?
- What would be the appropriate frequency of rent review? In particular, whether a triennial or biennial cycle should be adopted under normal circumstances?
- Whether rent of all PRH estates should be reviewed in one go instead of staggering the review of different estates in batches?

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Hong Kong Housing Authority
Ad Hoc Committee on Review of Domestic Rent Policy

Membership

Chairman

Mr NG Shui-lai, BBS, JP

Members

Mr Walter CHAN Kar-lok, SBS, JP

Mr CHAN Bing-woon, SBS, JP

Dr LAU Kwok-yu, JP
(from March 2001 to March 2002)

Mr WONG Kwun, BBS

Mr KWOK Kwok-chuen, BBS
(from March 2001 to December 2003)

Ms LUI Lai-bing

Deputy Director of Housing (Estate Management)

Principal Assistant Secretary, Housing Bureau or his representative
(from March 2001 to July 2002)

Secretary

Senior Administrative Officer (Strategic Planning) 2

Terms of Reference

Having regard to the evolving profile of both tenants and rental housing stock under the Housing Authority, the Committee should –

(a) review the current domestic rent policy, taking into account –

(i) the need to reflect tenants' affordability while ensuring public housing subsidy is given in relation to need;

(ii) the existing legislative provisions of having a 10% cap of the MRIR after rent adjustment as stipulated in the Housing Ordinance; and

(iii) the financial performance of the rental business.

(b) consider whether there should be changes to the domestic rent policy in respect of, but not limited to, the following issues –

(i) methodology for assessing tenants' affordability;

(ii) financial assistance for tenants in need;

(iii) composition of PRH rents; and

(iv) rent fixing and review mechanism.

(c) consult the public on any proposed changes and to make recommendations on necessary changes to the Authority with reference to the views of the public.

Calculation of the MRIR

The following shows how the MRIR is compiled :

Step 1 For illustration purpose, we assume that there are only 11 households living in all PRH estates and whose rents and incomes are shown below. The rent-to-income ratios are derived by dividing the rent with the income of the households concerned.

Household	Rent ($) (a)	Household Income ($) (b)	Rent-to-Income Ratio (%) (c) = [(a)/(b)] x 100%
1	1,700	23,000	7.4
2	1,599	10,700	14.9
3	433	4,200	10.3
4	1,388	59,800	2.3
5	1,100	23,600	4.7
6	780	13,700	5.7
7	1,593	7,500	21.2
8	1,890	20,100	9.4
9	459	5,000	9.2
10	620	9,300	6.7
11	1,900	17,300	11.0

Step 2 As there are 11 households, the median is the value of the 6th household (the middle value) if the rent-to-income ratios are re-arranged in ascending order. That is, the median in this example is the rent-to-income ratio of household 9 which is 9.2%.

Household	Rent-to-Income Ratio (%)
4	2.3
5	4.7
6	5.7
10	6.7
1	7.4
9	9.2 (Median)
8	9.4
3	10.3
11	11.0
2	14.9
7	21.2

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MRIR of Public Rental Housing Tenants Under Different Assessment Methods

	MRIR (%)
1. MRIR in the 3rd Quarter of 2005 using existing calculation procedures	14.6
2. Excluding CSSA households and households paying additional rent	12.7
3. Excluding rates	13.0
4. Excluding management fees	10.4
5. Combined effect of (2) and (3)	11.4
6. Combined effect of (3) and (4)	8.8
7. Combined effect of (2), (3), and (4)	7.7

Notes:

1. *Data on household income and rents for calculating the MRIR figures are based on the General Household Survey conducted by the Census & Statistics Department.*
2. *It is not possible at this stage to estimate the impact on MRIR if the Authority operates its own data collection system since there is no information on whether, and if so, the amount of over/under-reporting of income by PRH households in the General Household Survey.*
3. *For the purpose of this illustration, it is assumed that management fees cover such expenditure items as security, cleansing, minor maintenance and improvement works, and other recurrent expenses on personal emoluments and overheads which constitute about 29% of the total amount of rent receivable.*

An Illustration of Pure Income and Household Size Effects on Changes in Household Income

Table 1: Average Household Income by Household Size in July 2002 – June 2003 and July 2004 – June 2005

Household size	Household Distribution in base period (July 2002 – June 2003)	Average Household Income in base period (July 2002 – June 2003)
1-person	13.3%	$4,533
2-person	18.1%	$8,831
3-person	22.7%	$13,276
4-person	27.5%	$16,136
5-person or above	18.4%	$19,315
Overall	100.0%	***$13,206***

Household size	Household Distribution in July 2004 – June 2005^	Average Household Income in July 2004 – June 2005
1-person	14.7%	$4,587
2-person	19.5%	$8,564
3-person	23.4%	$13,048
4-person	26.0%	$15,584
5-person or above	16.5%	$18,321
Overall	100.0%	***$12,472***

^ Figures may not add up to 100% due to rounding.

The overall average household income changed from $13,206 in July 2002 – June 2003 to $12,472 in July 2004 – June 2005.

Overall change in average household income :

$$\frac{12{,}472 - 13{,}206}{13{,}206} \times 100\% = -5.6\%$$

It can be broken down *approximately* into two components as follows (see Technical Note at Appendix E):

Overall change in average household income ≅ **Household size effect (see Table 1 and related notes) + Pure income effect (see Table 2 and related notes)**

≅ **(-2.5%) + (-3.2%)**

Table 2: Calculation of Effect of Household Size Distribution on Average Household Income from July 2002 – June 2003 to July 2004 – June 2005

Household size	Household Distribution in base period (July 2002 – June 2003)	Average Household Income in base period (July 2002 – June 2003)
1-person	13.3%	$4,533
2-person	18.1%	$8,831
3-person	22.7%	$13,276
4-person	27.5%	$16,136
5-person or above	18.4%	$19,315
Overall	100.0%	***$13,206***

Household size	Household Distribution in July 2004 – June 2005^	Average Household Income in base period (July 2002 – June 2003)
1-person	14.7%	$4,533
2-person	19.5%	$8,831
3-person	23.4%	$13,276
4-person	26.0%	$16,136
5-person or above	16.5%	$19,315
Overall	100.0%	***$12,877***

^ Figures may not add up to 100% due to rounding.

Average income for households of different household sizes is assumed to remain unchanged between two reference periods, namely, July 2002 – June 2003 and July 2004 – June 2005. The overall average household income changed from $13,206 to $12,877 as a result of the change of household size distribution.

Effect of household size distribution on overall income level (estimated by keeping the average household income of different household size as at the position of the base period):

$$\frac{12{,}877 - 13{,}206}{13{,}206} \times 100\% = -2.5\%$$

Table 3: Calculation of Effect of Pure Change in Income Level on Average Household Income from July 2002 – June 2003 to July 2004 – June 2005

Household size	Household Distribution in base period (July 2002 – June 2003)	Average Household Income in base period (July 2002 – June 2003)
1-person	13.3%	$4,533
2-person	18.1%	$8,831
3-person	22.7%	$13,276
4-person	27.5%	$16,136
5-person or above	18.4%	$19,315
Overall	100.0%	***$13,206***

Household size	Household Distribution in base period (July 2002 – June 2003)	Average Household Income in July 2004 – June 2005
1-person	13.3%	$4,587
2-person	18.1%	$8,564
3-person	22.7%	$13,048
4-person	27.5%	$15,584
5-person or above	18.4%	$18,321
Overall	100.0%	***$12,779***

Household size distribution for individual average household income is assumed to remain unchanged between two reference periods, namely, July 2002 – June 2003 and July 2004 – June 2005. The overall average household income changed from $13,206 to $12,779 as a result of the change of average household income for individual household size.

Effect of individual income level on overall income level (estimated by keeping the household size distribution as at the position of the base period):

$$\frac{12{,}779 - 13{,}206}{13{,}206} \times 100\% = -3.2\%$$

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Technical Note on the Proposed Income Index (Discounting Impact of Changes in Household Size Distribution)

Average household income

The average household income for the households in PRH at time t can be estimated by the following formula[24]:

$$Y_t = \sum H_{it} I_{it}$$

where Y_t = average household income at time t,
H_{it} = proportion of household size i at time t,
I_{it} = average household income of household size i at time t.

The rate of change in household income between two time points t and 0 is

$$\Delta Y = \frac{Y_t - Y_0}{Y_0}$$

The rate of change in overall average household income (ΔY) can be approximately expressed by the following equation[25]:

$$\Delta Y \cong \Delta Y_i + \Delta Y_h$$

i.e. $\Delta Y =$ Income change due to pure income effect + income change due to household size effect

where ΔY = change in overall average household income between two time points,
ΔY_i = change in overall average household income due to pure change in income level,
ΔY_h = change in overall average household income due to the change in household size distribution.

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[24] $\sum H_{it} I_{it} = H_{1t} I_{1t} + H_{2t} I_{2t} + H_{3t} I_{3t} + \ldots + H_{nt} I_{nt}$

[25] *Strictly speaking, the rate of change in overall average household income is expressed by the following equation.*

$$\Delta Y = \frac{Y_t - Y_0}{Y_0}$$

$$\Delta Y = \frac{\sum H_{it} I_{it} - \sum H_{i0} I_{i0}}{\sum H_{i0} I_{i0}}$$

$$\Delta Y = \frac{\sum H_{i0}(I_{it} - I_{i0})}{\sum H_{i0} I_{i0}} + \frac{\sum (H_{it} - H_{i0}) I_{i0}}{\sum H_{i0} I_{i0}} + \frac{\sum (H_{it} - H_{i0})(I_{it} - I_{i0})}{\sum H_{i0} I_{i0}}$$

For PRH, it is found that the value of $\frac{\sum (H_{it} - H_{i0})(I_{it} - I_{i0})}{\sum H_{i0} I_{i0}}$ *is small.*

Hence, the equation can be approximately expressed as follows:

$$\Delta Y \cong \Delta Y_i + \Delta Y_h$$

Income index discounting the effect of household size distribution

To calculate the changes in the average household income of PRH due to pure income effect over time, the following index can be constructed.

$$\text{Income index (ID)} = \frac{\sum H_{i0} I_{it}}{\sum H_{i0} I_{i0}} \times 100\%$$

where H_{i0} = proportion of household size i at time 0,
I_{i0} = average household income of household size i at time 0,
I_{it} = average household income of household size i at time t.

In most cases, the index will be used to calculate the changes in average income level for PRH between two periods which are two years apart. For instance, the pure income change between years 2003 and 2005 can be worked out by the following steps:

$$\text{Income index for year 2005 } (ID_{2005}) = \frac{\sum H_{i2003} I_{i2005}}{\sum H_{i2003} I_{i2003}} \times 100\%$$

$$\text{Income index for year 2003 } (ID_{2003}) = \frac{\sum H_{i2003} I_{i2003}}{\sum H_{i2003} I_{i2003}} \times 100\%$$

$$\begin{array}{l}\text{Rate of change in income index}\\ \text{between the years 2003 and 2005}\end{array} = \frac{ID_{2005} - ID_{2003}}{ID_{2003}} \times 100\%$$

It is expected that there is a gradual, but not drastic, change in the relative weights of household size for PRH in two years' time.

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An Illustration of the Operation of Differential Rents Under the Moderate Model

Relevant Adjustment Factors

Internal Adjustment Factors

1. Floor Level		**Adjustment (%)**
Floor level above reference floor (Reference Floor 11/F – 15/F depending on the number of storeys)		+0.2% to +0.3% per floor / band of floors
Floor level below reference floor		-0.2% to -0.3% per floor / band of floors
Highest Floor	Top Floor	-2% to -4%
Lower Floors	1/F – 3/F	-2% to -6%
2. Function Room Effect		
Refuse room	For flats adjacent and above	-4% to -5%
Function room for building services e.g. pump room, switch room & transformer room etc.	Affected units	-1% to -2%

Note:
The percentage of adjustments displayed above is a broad brush assessment solely for illustration. The precise model for implementing differential rents is to be further developed.

Example Showing the Maximum Rent Differential Between Two Flats in a Harmony Block

	(A) 2-Bedroom flat on 39/F (below top floor)		**(B) 2-Bedroom flat on 1/F (adjacent to refuse room)**	
Fixed Rent ($)		2,200		2,200
Area (IFA) (m^2)		39.74		39.74
Unit Fixed Rent ($\$/m^2$)		55.36		55.36
Internal Factor Adjustment				
(i) Floor Level note 1	+4.5%	+$99	-6.3%	-$139
(ii) Function Room Effect note 2		—	-4.5%	-$99
Adjusted Rent ($)		2,299		1,962
Proportionment Factor note 3		0.998		0.998
Differential Rent ($) note 4		**2,290**		**1,960**
Rent Increase / Decrease		4.09%		-10.91%
Rental Difference of Highest and Lowest Rent			15.0%	

note 1 Floor Level – rent adjusted upwards if above the reference floor and downwards if below the reference floor. Further adjustment in Flat (B) due to first floor.

note 2 Function Room Effect – downward adjustment for flats adjacent to or above refuse room.

note 3 To apportion the share of total adjustments on area basis in the whole block and to limit the range within 15%.

note 4 Sum of differential rents is equal to the sum of fixed rents for the whole block/estate.

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An Illustration of the Operation of Differential Rents Under the Comprehensive Model

Relevant Adjustment Factors

Internal Adjustment Factors

1. Floor Level		**Adjustment (%)**
Floor level above reference floor (Reference Floor 11/F – 15/F depending on the number of storeys)		+0.2% to +0.3% per floor / band of floors
Floor level below reference floor		-0.2% to -0.3% per floor / band of floors
Highest Floor	Top Floor	-2% to -4%
Lower Floors	1/F – 3/F	-2% to -6%
2. Function Room Effect		
Refuse room	For flats adjacent and above	-4% to -5%
Function room for building services e.g. pump room, switch room & transformer room etc.	Affected units	-1% to -2%

External Adjustment Factors

3. Orientation	**Adjustment (%)**
From North facing aspect to South facing aspect (reflecting the direction facing the living room in respect of the largest window)	+0% to +5%
4. View	
– popular e.g. open view , sea view, greenery / garden view	+1% to +5%
– unpopular e.g. cemetery, crematorium, pylon and transmission lines, etc. – blocked view e.g. visual obstruction from nearby buildings	-1% to -5%
5. Accessibility	
Away from public transport / commercial facilities & services, etc. (applicable to large estates only)	-1% to -3%

Note:
The percentage of adjustments displayed above is a broad brush assessment solely for illustration. The precise model for implementing differential rents is to be further developed.

Example Showing the Maximum Rent Differential Between Two Flats in a Harmony Block

	(A) 2-Bedroom flat on 39/F (below top floor)			(B) 2-Bedroom flat on 1/F (adjacent to refuse room)		
Fixed Rent ($)			2,200			2,200
Area (IFA) (m^2)			39.74			39.74
Unit Fixed Rent ($/$m^2$)			55.36			55.36
Internal Factor Adjustment						
(i) Floor Level note 1		+6.0%	+$132		-9.0%	-$198
(ii) Function Room Effect note 2			—		-5.0%	-$110
External Factor Adjustment						
(iii) Orientation	South	+5.0%	+$110	North-west		—
(iv) View	Open	+3.0%	+$66	Blocked by carpark	-3.0%	-$66
(v) Accessibility to Facilities note 3			—			—
Adjusted Rent ($)			2,508			1,826
Proportionment Factor note 4			0.965			0.965
Differential Rent ($) note 5			**2,420**			**1,760**
Rent Increase / Decrease			10.00%			- 20.00%
Rental Difference of Highest and Lowest Rent				30.0%		

note 1 Floor Level – adjusted upwards if above the reference floor and downwards if below the reference floor. Further adjustment in Flat (B) due to first floor.

note 2 Function Room Effect – downward adjustment for flats adjacent to or above refuse room.

note 3 Accessibility to facilities – applicable only to blocks located at far end of a large estate, not applicable in this example.

note 4 To apportion the share of total adjustments on area basis in the whole block and to limit the rent differential within 30%.

note 5 Sum of differential rents is equal to the sum of fixed rents for the whole block/estate.

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