

# The Solution to Hong Kong's Subdivided Housing Crisis

Michael B. Wong (HKU)

February 2024

For almost a decade, Hong Kong has been plagued by a proliferation of subdivided homes. The large number of poor families living in cramped and inhumane conditions has attracted global concern.

In response, the Government has proposed solutions that require significant time and cost to implement. The Light Public Housing program will construct short-term homes for suffering households. In the longer term, new public housing estates will be built to increase the supply of subsidized units. Meanwhile, public housing wait times remain stubbornly high.

In this article, I suggest two policy changes that will quickly reduce public housing wait times and eliminate subdivided units. My proposal is based on a thorough economic analysis of housing policy and trends. According to this analysis, the root cause of the subdivided housing crisis is not a lack of supply, but rather *mispricing in the public housing system*.

To fix the problem, it is sufficient to increase the rents of well-off public housing tenants and reduce the premium repayment requirements of subsidized sale homeowners. These changes will eliminate disincentives that prevent higher-income public-sector households from upgrading to higher-quality private-sector homes. Low-income populations in subdivided units can then move into the public sector. No increase in the fiscal deficit is necessary.

## **1. Make PRH rent proportional to income.**

The Well-off Tenants Policy was established in 1987 to encourage well-off Public Rental Housing (PRH) tenants to vacate units. Due to this policy, PRH households with incomes exceeding certain thresholds pay 1.5X or double rent. Right now, PRH monthly rent is roughly \$2,000 for a non-elderly household of three with a monthly income of \$20,000, or about 10% of household income. If their income is \$100,000 instead, rent is around \$4,000, or about 4% of income. They would be asked to vacate if their incomes exceed \$122,000.

This policy is no longer adequate for targeting housing assistance to the needy. Today, the rent of a private-sector unit of similar quality as a PRH unit is easily \$10,000 or more. As private-sector rents soared during the past two decades, well-off tenants are increasingly disincentivized from vacating PRH units.

As shown in Table 1, the number of well-off public renter households, defined as those with real incomes more than 2X the 2021 PRH income limit, has risen from 18,900 in 2006 to 51,600 in 2021. The number of public renter households with real incomes between 1X and 2X the 2021 PRH Income Limit rose from 137,080 in 2006 to 244,860 in 2021. Average real household income among PRH residents grew by 25% between 2006 and 2021.

Table 1: Number of Public Renter Households by Real Income

	2006	2011	2016	2021
Below PRH Limit	536,180	574,340	495,180	521,840
1-2X PRH Limit	137,080	157,240	237,120	244,860
2-3X PRH Limit	13,640	14,620	29,260	41,920
> 3X PRH Limit	5,260	4,420	7,520	9,660
Total	692,160	750,620	769,080	818,280

Source: 5% Samples of the Hong Kong Population Census. Real incomes are computed using non-housing CPI. The 2021 PRH Income Limit is used throughout.

Because low rents disincentivize well-off public housing residents from upgrading, poor households cannot move in and are instead forced to live in tiny, expensive, and unsafe subdivided units. As shown in Table 2, the number of private renter households with real incomes below the 2021 PRH income limit increased from 104,860 in 2006 to 165,620 in 2021. Public housing wait times soared from 2 years in 2011 to 5.6 years as of the end of 2023.

My proposed reform package revises PRH rents to a fixed percentage — namely, 10% of the renter household's income. For low-income households, rents will not increase. However, rents will rise for well-off tenants. For example, a non-elderly household of three with a monthly income of \$100,000 will now have to pay a monthly rent of \$10,000, which is close to market rent, rather than a heavily subsidized amount of \$4000.

This nudges well-off tenants to vacate and upgrade, thereby freeing up units for households on the PRH wait list. Not only will PRH wait times fall, the demand for subdivided units will decrease, so the rents of low-income private renters will also fall. This is a low-cost and effective reform that will quickly alleviate the immense suffering of the most marginal members of our society.

To help sitting tenants adjust to the increased rents, some offsetting cash assistance can be provided. This assistance may last a few years and be gradually reduced. In this manner, the incentives facing tenants can be changed without significant welfare losses.

For well-off tenants, cash compensation is not necessary. These households will be close to indifferent between staying in a small but cheap PRH unit and living in a nicer but pricier private-sector unit. Rent increases induce them to move out but do not cause them to suffer, so they do not need to be compensated.

By encouraging well-off tenants to upgrade, this policy will increase rents and prices of medium-quality homes in the private sector. This upward pressure makes it harder for vacating tenants to move out. Thankfully, it can be counterbalanced by downward pricing pressures from the second part of my proposal, so that price stability is maintained.

Table 2: Number of Private Renter Households by Real Income

	2006	2011	2016	2021
Below PRH Limit	104,860	100,440	141,780	165,620
1-2X PRH Limit	84,420	88,980	112,980	113,300
2-3X PRH Limit	37,240	47,320	56,780	57,980
> 3X PRH Limit	55,060	82,580	85,020	102,740
Total	281,580	319,320	396,560	439,640

Source: 5% Samples of the Hong Kong Population Census. Real incomes are computed using non-housing CPI. The 2021 PRH Income Limit is used throughout.

Even if cash assistance is included, rent adjustments will not impose much fiscal burden on the Government. Revenue from units initially housing high-income households will fall, since these households will be replaced with entering households who will have lower incomes and therefore pay lower rents. Revenues from tenants who do not move out will instead increase. Due to these offsetting forces, net revenue will not fall by much and may even rise.

In any scenario, recovering PRH units in this manner will be *much* faster and *much* cheaper than constructing new PRH units. The cost of new construction is almost \$1 million per unit and takes many years. This proposed reform can happen overnight, or it can be phased in at any speed that the Government prefers. Whatever small fiscal costs it may require will be easily offset by the next part of my proposal.

## **2. Reduce the land premium requirement for HOS and TPS owners.**

The Homeownership Scheme (HOS) program subsidizes middle-income households to buy new subsidized ownership units. The Tenants Purchase Scheme (TPS) program allowed a subset of PRH tenants to purchase their units at a highly discounted price. Both programs are aimed at promoting upward housing mobility.

However, HOS owners are required to pay a 35-50% land premium before they can lease out or resell their units. This requirement is sufficiently high that only 22 percent of the 351,000 HOS units have premiums paid.

Similarly, TPS owners must pay an 82-86% premium to sell or lease. According to 28Hse.com, the market price of a TPS unit is roughly \$2 million. This means TPS owners make only about \$300,000 from selling the unit on the open market. These proceeds are very low, so less than 2% of the 152,000 sold TPS units have paid premiums.

High premium requirements exacerbate the subdivided unit crisis. If the incomes of TPS and HOS owners grow, high premium requirements prevent them from reselling or leasing their units. Consequently, they do not vacate and upgrade to better units. This reduces the availability

of small units for low-income households and adds to congestion in the low-end market.

The second part of my proposal is to reduce the premium payment requirement for subsidized sale owners by one-half.

This change will create many benefits. First, it will benefit the owners, who will now be able to resell and lease their units more easily. Even if they don't sell, their properties will be more easily used as collateral to fund investments and entrepreneurial activity.

Second, as higher-income households trade up, the supply of lower-end homes in the open market will increase and their prices will face downward pressure. For medium-sized homes like HOS units, this downward pressure offsets the upward pricing pressure from the PRH rent adjustment proposed above, so price stability will be maintained. For small homes comparable to PRH units, there is no offsetting upward pressure, so prices and rents will unambiguously fall. This helps the Government achieve its goal of housing affordability for low-income populations.

Third, since higher-income households will now upgrade, the reform will generate upward pricing pressure in the high-end property market. This will offset downward pricing pressure from interest rate hikes. The Government can thereby better achieve price stability in the high-end property market.

Fourth, the reform will increase Government revenues. Presently, the Government collects almost no revenue from the land premium payment requirement. By reducing the land premium requirement, the Government can increase the quantity of land premium payments and thereby increase government revenue.

The exact premium discount can be chosen to maximize Government revenues. For example, suppose the HOS premium repayment requirement is revised from 35-50% to 20%. Further suppose that this results in premium payments for an additional 20% of the total HOS stock. According to 28Hse.com, the market price of an average HOS flat is around 4 million dollars. This means that there will be an added \$56 billion in Government revenue. This can pay for 56,000 newly constructed PRH units. Even better, it will easily offset any fiscal costs from rent adjustments for PRH tenants and leave a large surplus to spare.

Finally, increased transaction activity will support real estate professionals in the current housing market slowdown. There are essentially no downsides to this reform.

### **Broader policy impacts**

My proposal adjusts public housing rents and subsidized sale premium requirements to encourage high-income public-sector households to upgrade to better private-sector homes. It thereby makes room for low-income populations to move out of subdivided units.

The reform increases affordability at the low end of the housing market. It offsets downward pricing pressures at the high end created by rising interest rates and an adverse macroeconomic environment. It requires no increase in the fiscal deficit.

With this reform, subdivided homes can be eliminated from Hong Kong long before 2049, the deadline set by the Director of the Hong Kong and Macao Affairs Office, Xia Baolong. A better-functioning housing ladder will stem the exodus of talent, boost economic growth, and reduce political discontent.

Given the large benefits and minimal risks involved, the Government should seriously consider this reform. Precise projections of its benefits and costs can be calculated if Government administrative data is made available to academic researchers.

*Prof. Michael B. Wong is an Assistant Professor of Management and Strategy at HKU Business School. He is an expert on housing economics in Hong Kong. Jimmy Ho and William Lui provided excellent research assistance.*