

## China's new housing policy risks unintended consequences

By Mark A. DeWeaver

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On May 17, Chinese Premier Wen Jiabao announced a six point plan intended to make it easier for the average urban family to find housing. It called for: (1) more smaller-sized units, (2) macro-control using tax, credit, and land policies, (3) fewer forced relocations, (4) a more orderly market, (5) more rental and low-income housing, and (6) better information disclosure.

At the time, this initiative seemed unlikely to amount to much, particularly as there had been relatively little follow-through after a similar State Council announcement last year. But over the summer, as detailed policies began to emerge from a variety of central government ministries and commissions, it became clear that the real-estate industry was now facing a major change in its regulatory environment.

So far five measures have had the biggest impact. Two tax policies have been changed to punish speculators while housing starts have been disrupted by a requirement that seventy percent of all new units have a floor area of ninety square meters or less. State-owned land auction methods are being modified to encourage developers to build more affordable housing. And foreign investors are now facing rules requiring them to form Chinese-registered entities with high minimum capital requirements.

While these are major changes, the effect on prices nationwide has been unspectacular. Five months after the announcement of the six point plan, the National Bureau of Statistics' housing price index for the top seventy cities is still rising, though at a declining rate. Year-on-year, average prices were up 5.3% in September, after rising 5.5% in August and 5.7% in July.

This is not surprising as there is no guarantee that the new measures will work as planned. In the short-term, increased policy risk for developers is likely to depress supply—exactly the opposite of the intended effect. In the long term, the new regime will make it more difficult for market forces to bring supply and demand into balance. The average person might eventually find that long waiting lists had become as great an obstacle to home ownership as high prices are now.

### New taxes

The two new tax policies, which apply to sales of existing homes held for less than five years, were introduced with the goal of discouraging speculators from “hoarding” inventories of residential property.

The first is a change in the tax basis for the 5.5% sales tax. Formerly (in the case of property sales) this was collected on capital gains; since June 1, it has been based on total sale proceeds. On August 1, sellers also began paying a further 20% capital gains tax.

This had originally been required by the personal income tax law of 1994 but was rarely collected. Now payment has become a mandatory part of the title transfer process.

As the original purchase amount, remodeling expenses, mortgage interest payments, and sales tax can all be included in the tax basis for capital gains, the sales tax bill will generally be the higher of the two.

These taxes have both bullish and bearish effects. While speculators will be discouraged from adding to their existing stocks, they will also be encouraged to withhold inventory from the market, for example by renting instead of selling. In the short term, there may be both reduced speculative demand for new units, which would tend to lower prices, and less supply, which could raise them.

Naturally, there's no way to lower prices by squeezing the speculator once he has left the market. In the long term, this isn't really a policy that can reverse the upward trend in the cost of housing. If anything, a reduction in speculative inventories implies future price rises. The reason is simply that hoarding units in the current period actually has a beneficial effect: transferring supply to a future period in which relative scarcity is expected.

#### Smaller units

The requirement that 70% of new residential property projects consist of units with a floor area of ninety square meters or less came out on May 27. On July 7, the Ministry of Construction added an important clarification: the policy refers to 70% of all the projects in a given locality rather than 70% of each project. But even now there is still some uncertainty on this point as going project-by-project is the only obvious way to be sure of meeting the target. Perhaps this is why Shenzhen and Beijing, so far the only local governments with any detailed regulations, have both opted for this approach.

Unfortunately, most of the units now planned are in the 120 – 150 square meter range. If these all go ahead, only about a third of the new supply is expected to be 90 square meters or less. But if existing projects have to be redesigned, some developers may face lower margins or even losses, particularly those who paid high prices for land in the expectation of building luxury housing.

The most likely solution would be to allow existing projects to go ahead while requiring new ones to follow the “90-70” rule. Beijing and Shenzhen appear to be doing this by “grandfathering in” those built on land acquired directly from their city governments, a category which analysts say covers most of what the big developers have planned.

As with the new tax policies, the “90-70” rule may lead to some unintended consequences. It already appears to have stimulated speculative demand for larger units, which are expected to be scarce in the coming years. At the same time, it is unlikely that much new supply of smaller flats can quickly be brought to market. Project launches are likely to be delayed until the local governments come up with clear policies and, in cases

where new designs are called for, redrawing the blueprints and getting them approved will cause months of delay.

The end result could well be a shortage of residential units of all sizes next year, leading to even higher prices. Longer term, it is hard to believe that 70% will always be exactly the right fraction for every locality. Insisting on a single, arbitrarily chosen percentage for the whole country will almost certainly lead to the same problems with excess supply and demand that occur whenever production decisions are subject to a state plan.

Excess demand?

To ensure a future supply of affordable smaller-sized units, on July 29 the Ministry of Land and Resources announced a new policy on state-owned residential land sales. In choosing buyers, local governments are now required to consider not only their bids but also other factors including the percentage of units ninety square meters or less and limits on the selling prices for completed projects.

In Guangzhou, the city government is planning to implement these new criteria by having developers submit both bids for residential land and pre-set selling prices for their finished units. The winner will be determined through a scoring system that rewards high values for the former and low values for the latter. If successful, this may become the model for localities throughout the country.

In theory, the system should lead to lower prices. Formerly, land would go to whoever put in the highest bid for it, which would tend to be whoever expected to get the most for his finished units. The new setup will force the winner to commit to relatively low finished unit prices, which, to be a profitable strategy, will imply a relatively low bid for the land as well.

If things work out this way, however, there could easily be housing shortages. In cases where, subsequent to the land auction, demand turns out to be higher than expected, developers will be unable to raise prices to clear the market. Instead, as invariably happens under such disequilibrium conditions, the available supply will go to those with the best connections or willing to pay the highest bribes.

Trapped cash

On July 24, six ministries jointly issued regulations designed to reduce the influence of foreign investors on the property market. Foreigners purchasing properties that are not for their own use are now required to set up a local investment vehicle for this purpose and register it with the tax authorities. Also, for property investments of US\$ 10 million or more, no more than 50% of the total may be borrowed, compared to 65% formerly. The rules also call for "strict controls" on repatriation of real estate profits, though exactly what this is supposed to mean in practice is left unspecified.

As foreign developers have always been required to establish an onshore company, these changes will have the greatest impact on property investors, who often prefer to transact through special purpose vehicles domiciled in offshore tax havens. Such entities allow for more efficient repatriation of profits and also enjoy a tax advantage, being liable for only a 10% withholding tax rather than the 33% corporate income tax they would owe if incorporated locally.

According to the August 11 issue of Deloitte, Touche, Tohmatsu's *China Tax News*, problems may arise in repatriating funds from an onshore company due to two so-called "trapped cash" issues. First, the amount that can be transferred abroad is based on accounting profit, which may be less than the cash available because of non-cash expenses such as depreciation. And second, distributable profits for wholly foreign owned enterprises may be further reduced by mandatory transfers into statutory reserves.

It's hard to see the motivation for discouraging foreign investment in this way. Aside from the high-end sectors in a few big cities, foreigners (whether as end-users or as speculators) have never been more than a very marginal part of the demand for residential housing. Nor have foreign developers ever provided much of the supply. In 2005, their investment came to US\$ 5.5 billion, a mere 3% of the total. And while reducing investors' forex inflows reduces demand for local currency and thus makes it easier to control the exchange rate, this effect is also very small. US\$ 5.5 billion is just a drop in bucket compared to China's almost US\$ 1 trillion in foreign exchange reserves.

#### Unintended consequences

In a classic article published in 1936, "The unintended consequences of purposive social action," sociologist Robert K. Merton identified five factors that tend to produce policies with unintended consequences. Two of these seem particularly relevant here. The first, which he referred to as "error," is simply faulty analysis of the situation. The second, "imperious immediacy of interest," is the tendency for "paramount concern with the foreseen immediate consequences" to exclude "consideration of further or other consequences of the same act."

The "error" that the policy makers appear to have committed in this case is to conclude that speculation is the root cause of the rising trend in China's housing prices. Thus the new taxes, land auction rules, and restrictions on foreign participation are all designed make it harder to profit from future price increases.

The problem with this analysis is that speculators' expectations of higher prices, in the absence of more fundamental driving forces, could hardly be sufficient to sustain a multi-year trend. What is more likely is that property values are being pushed up by excess liquidity resulting from the monetization of a rising foreign account surplus, exactly as occurred during the Japanese asset bubble of the late 1980's. If this is the case, the policy makers ought to be more focused on the exchange rate than anything else.

The “foreseen immediate consequence”— more affordable housing—has also led to policy making that overlooks the “further consequences” both of a less efficient market and increased policy risk. The tax changes, insofar as they reduce speculation, interfere with the intertemporal allocation of resources; the 90-70 requirement replaces private decision making with state planning; the auction rules make it more difficult for developers to set market-clearing prices. And while the share of lower cost units may eventually rise, the new regime and the uncertainty surrounding its implementation will slow growth in total supply.

It thus seems likely that China’s housing policy will soon be providing students of the “unintended consequences of purposive social action” with some interesting case studies. While the new regulations may eventually make it easier for the ordinary person to afford a place to live, it will be surprising if they work out as well in practice as they sound on paper.

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