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August 31, 2010

The Causes and Consequences of China's Distorted Real Estate Market

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Article at a glance

- China's soaring housing prices appear largely disconnected from economic rationality; housing prices in coastal cities are 20 times the average household's annual income, effectively pricing the average Chinese citizen out of the housing market.

- Primary culpability for distortions in the real estate market lies with three interconnected players: wealthy investors, complicit local governments, and predatory state-owned enterprises.

- The root cause of China's real estate problem lies in the country's absence of genuine property rights, which the government substitutes with manipulation-prone land use rights.

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Introduction

As China enjoys extraordinary economic growth and showcases exceptional resilience during the worst financial crisis in decades, observers nevertheless note that the country continues to suffer from a number of fundamental economic problems, not least of which is the increasing tension between the rich and the poor. In particular, large segments of the population have started to complain vocally about escalating housing prices in a distorted real estate market. Prominent newspapers echo this criticism and have published a series of articles on the issue.[1] A number of Wall Street hedge fund managers also predict that China will soon suffer a real estate bubble.[2]

Recognizing housing prices' potential destabilizing effects, Premier Wen Jiabao has promised the people that he will make his best effort to maintain property prices at reasonable levels. Yet, soon after Wen's pledge, Beijing recorded the highest bid for a parcel of land in its history, which ironically a centrally controlled state-owned enterprise had placed.[3] Even the government, it seems, cannot greatly influence the overheating property market.

This article discusses the driving forces behind rocketing housing prices in China and identifies the root cause of the problem: the country's absence of genuine property rights. The 1988 Constitution Amendment Act grants individuals the ability to hold long-term leases (or "use rights") for land and to own apartments, buildings, and other structures on that land for the time and purposes that the lease specifies (40 years for commercial usage, 50 years for industrial purpose, and 70 years for residential use). The buyer must obtain proof of land use rights from the Bureau of Land and Resources and a certificate of home ownership from the Bureau of Housing Administration. The government, by law, cannot force certificate-holding residents to move without offering compensation.

Yet, land use rights are not as secure as true property rights because they have a built-in expiration date. The resident may apply for a lease extension when land use rights reach maturity and expire, but the government has yet to finalize the relevant legislation for land use extensions. Consequently, most real estate "sales" in China are in fact transfers of land use rights, which account for most of the business activity in China's real estate market and fuel the current pricing bubble.

The Impact of the Real Estate Bubble

China's soaring housing prices appear largely disconnected from economic rationality; few understand how the Chinese people can afford housing prices similar to those in the United States with only a tenth of per capita income. Indeed, housing prices in coastal cities are 20 times more than the average household's annual income,[4] far in excess of the 6:1 ratio that most real estate experts consider reasonable.[5] As a result, soaring property prices have effectively priced the average Chinese citizen out of the housing market.

Even the worst global recession in decades has proven unable to slow this steep rise. The Chinese National Bureau of Statistics finds that housing prices in 70 of China's biggest cities jumped by 11.7 percent year-on-year in March alone, marking the largest increase since officials first compiled figures in 2005.[6] Housing prices have increased most dramatically in big urban centers. For instance, a Goldman Sachs study concluded that housing prices in Beijing rose 80 percent faster than wages in recent years.[7]

That places enormous pressure on China's emerging middle class, particularly on the new generation born in the 1980s. Modest salaries of those young people often price them out of the housing market. Last year, even a government official conceded that he could not afford an apartment on his salary.[8] Fortunately for him, the government provides most officials with comfortable public housing. The emerging middle class, however, does not have it so easy; media reports show that it is not at all unusual for an ordinary resident of Beijing to spend 80 percent of his or her income on monthly mortgage payments.[9] That leaves little room for discretionary spending, thus crippling the middle class's purchasing power and standard of living while contributing to a widening wealth gap.

The Culprits

While rising property prices are partly a function of demand stemming from the country's rapid urbanization, market distortions have taken prices to another level. Certainly, the drive for home ownership is strong; everyone desires a place to settle down and call their own. Renting is a poor substitute, particularly in China where home ownership is often an important criterion for marriage. As a result, it is not uncommon for ordinary Chinese to purchase an apartment with down payments from parents or even grandparents, as few are able to cover the cost on their own.

Yet, the actions of an emerging middle class alone do not explain the dramatic rise in property prices. Primary culpability for the distortions in the real estate market lies instead with three interconnected players: wealthy investors, complicit local governments, and predatory state-owned enterprises.

Wealthy Investors

"Hot money" from wealthy investors has garnered most of the blame in the press and from the government; however, speculative investment money continues to flood the market despite such denouncements. Investment in property development grew to an astronomical 659.4 billion yuan ($96.7 billion) in the first quarter of this year alone, representing a 35.1 percent increase from the same period last year.[10] Additionally, an estimated 26 percent of properties in Beijing do not have occupants because they are held solely for investment purposes, further evidencing this trend.[11] To put that in perspective, a 10 percent housing vacancy rate in the United States would set off alarms domestically and internationally.

Real estate continues to be among the more attractive investment vehicles for the rich, particularly given the immaturity of more sophisticated financial instruments, the instability of the stock market, and the constraints on private enterprise. The gravity-defying rise in property values has only fueled the appeal of real estate investments. Housing prices in Beijing have grown three-fold in just the past 5 years[12] and prices in 2009 have increased by 25 percent.[13] Besides pushing prices out of reach for many professionals, the perverse impact of increased speculative property investments has also biased the market in favor of high-end rather than affordable housing.

> It should surprise few, then, that scholars and the public widely believe that local governments tacitly encourage the ballooning real estate market, despite orders from the central government to the contrary.

Local Governments

Local governments also play a significant role in fanning the real estate frenzy and may well deserve the most blame for begetting the real estate bubble. Because the government constitutionally owns all land, the local governments—and corrupt officials—are able to generate significant revenue from the sale of "land use rights." Individuals and companies do not "own" land in perpetuity in China, as is typical in a market economy, but rather "lease" land from the government for a maximum of 70 years (for residential use). The central government continues to administratively allocate urban land to local governments, who then typically sell the land use rights at an auction to the highest-bidder for a fixed term and purpose.

A wide range of social obligations burdens China's local governments because they are constrained in their ability to generate and collect revenue. Therefore, the sale of land use rights to the highest (or best-connected) bidder offers a crucial source of funding. The City of Hangzhou, for instance, relied on land-related taxes and revenue from selling land use rights for a total of $18.5 billion in 2009.[14] In Shanghai, sales of land use rights contribute on average a substantial 100 billion yuan ($14.9 billion) to the city's coffers each year.[15] According to the Ministry of Finance, revenues from selling land use rights constituted 43.7 percent of local governments' annual budget in 2009.[16]

It should surprise few, then, that scholars and the public widely believe that local governments tacitly encourage the ballooning real estate market, despite orders from the central government to the contrary. Indeed, the actions of local governments have at times led to the growing phenomenon of glittering new ghost towns consisting of shiny, new, and virtually unpopulated high-rise apartment buildings.[17]

Improving the supply of land would require wholesale reform of China's real estate system and property rights; few officials dare tread on such a sensitive topic that touches upon some of the most fundamental principles of the Communist Party and the country's constitution.

State-Owned Enterprises (SOEs)

SOEs have also garnered widespread blame from the public for driving up the price of land. Enjoying easy access to state resources—including much of China's massive stimulus spending—state-owned enterprises have barged into the highly profitable property market. In fact, SOEs obtained 8 out of the top 10 highest cost transactions in 2009 and also acquired 8 out of top 10 highest per unit cost land sales.[18]

In fact, SOEs – backed by implicit state guarantees – have taken part in the purchase of many of the most notorious "land kings," which are properties in prime locations with record high prices per square meter. By contrast, private enterprises face higher interest rates and far more risk when acquiring capital and funding for construction projects. Many among the public and the media criticize these practices as unfair competition and claim that SOEs use profits from the real estate market to cover up inefficiencies and low returns from their main operations.

Recognizing the detrimental influence of SOEs, the central government has commanded certain SOEs to exit the real estate market.[19] Experts point out, however, that the 16 SOEs which are real estate companies are exempt from this official order and that the total assets of these 16 companies equal 85 percent of the 94 SOEs that the state controls.[20] Many thus view the order as a symbolic action to soothe the public outcry. Besides, local SOEs, in collusion with lower levels of government, will almost certainly continue to distort the real estate market and exploit their advantageous access to capital for vast profits.

The Government Response

Considering the threat of a real estate bubble and increasing unrest among the public, the Chinese government launched a concerted effort earlier this year to regulate the skyrocketing housing market. Following repeated statements of concern from the government's top ranking officials, the State Council released a series of new real estate policies in January to moderate rapidly escalating housing prices, primarily by discouraging property speculation.

Seeing little impact, the government further tightened regulations on second home purchases. By mid-April, the government raised the down payment ratio required for second home purchases to 50 percent and authorized banks to refuse loans to third home buyers in areas suffering from soaring property prices. To further dampen the housing market, the government has also raised mortgage interest rates to 1.1 times the benchmark rate.

The government is also trying to tackle the problem by vowing to provide more public housing. Traditionally, the state reserved affordable low-cost houses for government officials or their relatives, who would sell the houses quickly for profit.[21] While a commitment to expanding public housing would appear to provide some relief, the government would still control who benefits from such policies, creating significant opportunities for corruption and favoritism. To-date, the government has consistently fallen short of its social housing targets due to a lack of funds and political incentives. Officials plan to address these shortcomings by devoting more political capital to the issue.[22]

Perhaps most dramatically, the authorities are now also considering a nation-wide property tax plan. This plan would extend property taxes, which the state currently levies only on commercial properties at an average rate of 1 percent, to residential properties. According to state media, the government may soon apply this residential property tax on a trial basis in Beijing, Shanghai, Chongqing, and Shenzhen. The city of Shanghai, searching for additional sources of revenue, has been particularly anxious to impose a residential real estate tax and is currently weighing the options for the implementation of this tax.

Inherent Limitations of the Government Response

Many commentators have criticized the government's plan to levy residential property taxes. A recent in-depth article in the Guangzhou-based newspaper *Southern Weekend* featured interviews with several experts who concluded that the real estate market would be better off by raising interest rates and addressing the root causes of artificially limited land supply.[23] Yet, local governments have an obvious reason for preferring taxation: it provides a potentially rich new source of revenue. Local governments need additional revenue streams to address their mounting debt burden. As the head of the National Audit Office, Liu Jiayi, points out, 7 provinces, 10 municipalities, and 4 counties hold debts that exceed more than 100 percent (in one case, up to 365 percent) of their disposable funds. Raising interest rates is not an appealing option because the government fears it would threaten the GDP growth on which its legitimacy rests.

Despite the government's enthusiasm for a real estate tax, the fact that residents do not legally own but instead "lease" land from the government complicates the taxation plan. Moreover, a number of scholars, including Professor Zhiwu Chen of the Yale University School of Management, have stressed that a unilateral decision to levy property taxes without the consent of the people (for instance, through approval from the National People's Congress) would be a very unpopular violation of citizens' most basic rights.

The government shows little interest in addressing the root causes of rising housing prices in China. Improving the supply of land would require wholesale reform of China's real estate system and property rights; few officials dare tread on such a sensitive topic that touches upon some of the most fundamental principles of the Communist Party and the country's constitution. A rare exception is Representative Jiyang Lian who during the Political Consultative Committee in March 2010 argued strongly—and to much applause—that outrageous housing prices are the result of the government's monopoly over the supply of land.[24]

Monopoly over land supply also creates opportunities for collusion between developers and officials, and this imbalance of power is the source of numerous bribery cases. In 2009 alone, 15 provincial officials were charged with accepting bribes from developers.[25] Managers of construction companies widely complain that it is impossible to get a contract without paying a bribe. The "commission" rate is typically five percent of the project's total cost, contributing to high housing costs.[26] As a result of such corrupt practices, well-connected property tycoons' profits create an even heavier burden on the cash-strapped middle class.

Conclusion

Real estate bubbles come and go; they are an unfortunate but common trait of most economies, particularly those experiencing high levels of growth. What makes China's case so perplexing is the largely unspoken but very real fact that individuals and firms cannot fully own land but merely lease it from the government. Given this fact, one would expect the value of land to fall over time as a lease approaches its expiration date (the first instances of which will occur in about a decade). Yet, prices have exploded in the opposite direction.

What can explain such seemingly irrational behavior? The public and the government seem to have reached an implicit agreement that the state will protect land use rights, either through wholesale reform of China's land rights or, more likely, through extensions of land use rights for a fee. Since actions to the contrary would risk the collapse of the real estate market with dramatic consequences (particularly for the well-connected), the government's hands are tied for fear of inciting public opposition on a scale sufficient to risk its grip on power—and real estate players understand this position. For now, the issuance of extensions remains largely theoretical as few land use rights have yet reached maturity. Chinese authorities first issued land use rights in 1982 in the Shenzhen Special Economic Zone. National policy did not officially condone these rights until 1988, and most land use rights from 1982 extend for 40 years.

Informal arrangements, promises, and assumptions are a poor substitute for the secure property rights that are the hallmark of a genuine market-based economy. In fact, given the absence of formal policies and rights—and local governments' insatiable need for funding—disputes and confusion will inevitably arise and will almost certainly have a destabilizing effect on the real estate market. China's overeager real estate investors are bound to discover that the hard way.

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