

Rule of Law in China: Chinese Law and Business

Recent Policy Changes in China's Real Estate Sector

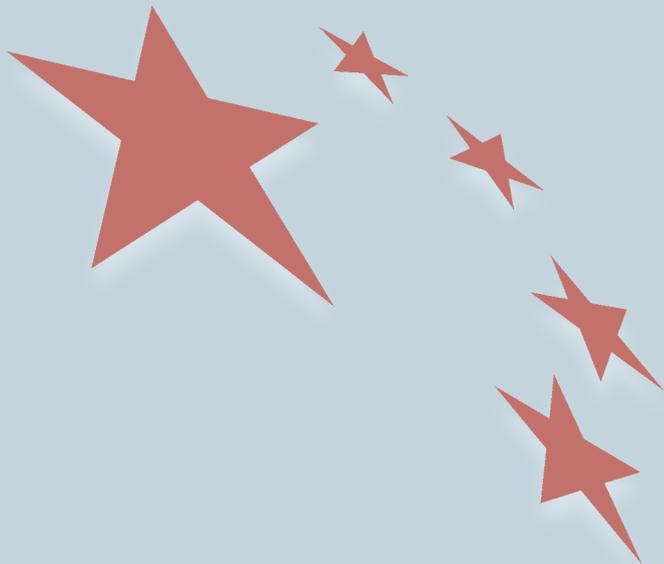
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Executive Summary

- The reform of the urban housing system, begun in the late 1980s, has resulted in a general improvement in accommodation for most of the urban population in China. In less than twenty years, the government has managed to provide new and reasonable quality owner-occupied housing to as much as eighty per cent of the urban population. This achievement was made possible by the transition to a market economy and the rapid economic growth that followed.
- Unlike market-driven real estate sectors in most Western countries, the real estate market in China has been established and fostered by the government, which views it as a tool to implement its housing policy. When the government decides to provide more housing to low- and medium-income urban families, it intervenes in the market without hesitation.
- By 2004, a three-tier system had been established:
 - High-income and upper-middle-income families purchase at market prices commodity housing with transferable granted land-use rights.
 - Middle-income and low-income families purchase, at cost price, affordable housing with non-transferable allocated land-use rights.
 - The lowest-income families are provided with subsidized low-rent housing.
- In response to shortcomings in each of these three areas, the government has issued numerous policies, regulations and rules to control the supply of housing and land, to regulate the sales and purchase of real estate, and to curb speculation. Restrictive regulations on foreign investment and purchase of real estate by foreigners have also been introduced. In addition, there have been reforms to the housing security system, and changes to tax policies.
- Traditional wisdom supports government regulation as a necessary response to market failures. Whether market failures alone justify the recent government interventions is debatable, however. Given the heavy administrative control of the market, it is safe to conclude that the problems with China's urban housing system are due to both market failure and government failure.

Recent Policy Changes in China's Real Estate Sector

Introduction

The reform of the urban housing system, begun in the late 1980s, has resulted in a general improvement in accommodation for most of the urban population in China. In less than twenty years, the government managed to provide new and reasonable quality owner-occupied housing to as much as 80 per cent of the urban population. This achievement was made possible by the transition to a market economy and the rapid economic growth that followed. However, unlike real estate markets in most Western countries, China's was established and fostered by the government, which views it as a tool for the implementation of its housing policy. When the government feels the need to provide more housing to low- and medium-income urban families, it intervenes in the market without hesitation.

This policy brief investigates the recent changes in housing policy, the reasons for them, their effectiveness, and the implications for the future development of the real estate market. It provides a brief summary of the three-tier structure of the urban real estate market, assesses the major issues affecting the housing market, and explores the recent responses to these problems, including restrictions on foreign investors.

The evolution of the three-tiered urban housing system

China's three-tier urban housing system evolved from the former public welfare housing system directly or through its agencies. In the former system, the government directly or through its agencies built and held title to most urban housing, including housing directly managed by the local government and self-managed housing built, distributed and managed by state-owned enterprises and institutions for their employees and families. Most urban families resided in public housing, benefiting from heavily subsidized rents.

Although the public welfare housing system functioned effectively at first, over time, problems emerged. With the expansion of the urban population, and the government's limited ability to invest in new housing, the housing shortage intensified. In 1976, for example, the average floor space per capita dropped to about two square metres. Moreover, because the nominal rent could not cover the cost of maintenance and management, the welfare housing system became a fiscal burden. A 1978 report concluded that, '[h]ousing has become a critical problem throughout the country. It has severely affected not only people's daily working, studying, living and leisure, but also production and the stability of the nation as well as the relationship between the Party and the people.'

With the transition to a socialist market economy, the government turned to the market as a solution to the urban housing problem. Public housing began to be privatized. Citizens were encouraged to construct their own housing. Rents were increased to cover the costs of housing. And the government progressively shifted from in-kind distribution of housing to distribution through sales.

To facilitate the development of market housing, a 1988 constitutional amendment allowed for the transfer of land-use rights. Land for urban housing could be obtained either by purchasing this new form of 'granted land-use rights' with a renewable fixed-term, or by applying for allocated land-use rights (mainly for the construction of affordable housing) for no charge. While granted land-use rights may be leased, mortgaged or transferred, allocated land-use rights must be converted into granted land-use rights before they could be transferred.

The innovation of the granted land-use right sparked the development of real estate markets. To finance the development and purchase of housing, banks

started issuing development and housing loans in the mid-1990s. In addition, housing funds, a new system of compulsory long-term savings for housing, were established nationwide in 1996, based on a successful experiment that began in Shanghai in 1991. The housing fund system requires employers and their full-time employees each to deposit a certain percentage (eight per cent as of 1999) of the employee's salary into a personal account to be used to purchase a home.

By the mid-1990s, commodity housing with granted land-use rights became the major form of urban housing. To supplement the market, in 1995 the government established an affordable housing system for low-income families and middle-income families experiencing housing difficulties (including dangerous living conditions and overcrowding). Local governments were required to sell ten to twenty per cent of newly built houses each year to qualified families at construction cost. In most localities, local governments allocate land for affordable housing and provide various forms of tax relief.

Affordable housing is still out of reach for the lowest-income population, especially redundant or laid-off workers who do not have access to the housing fund. In addition, many low-income residents who had their houses taken for urban development have been unable to afford alternative housing with the limited compensation provided by the government. To help those lowest-income urban households, a system of subsidized low-rent housing was introduced in Shanghai and Beijing in 1999. In 2004, the low-rent housing system was extended nationwide.

In short, by 2004, after more than two decades of urban housing reform, a three-tier system had been established:

- High-income and upper-middle-income families purchase at market prices commodity housing with transferable granted land-use rights.
- Middle-income and low-income families purchase, at cost price, affordable housing with non-transferable allocated land-use rights.
- The lowest-income families are provided subsidized low-rent housing.

Major issues affecting China's urban housing system

The establishment of the three-tiered housing system was initially proclaimed to be a success. In September 2003, China's vice-minister of construction said: 'Real estate has become a pillar industry in China's economy, directly and indirectly fueling a two per cent growth in the country's annual GDP ... and play[ing] a significant role in improving people's living conditions, energizing the economy, generating job opportunities and speeding urban development ... In the past five years, the proportion of commercial housing purchased by individual residents has increased from 54.5 per cent to 95.3 per cent in the gross sales volume of national commercial housing.'

The honeymoon period did not last long. In the commodity housing market, complaints about rapidly rising prices, malpractice by developers and speculation peaked in 2005. Meanwhile, affordable and low-rent housing also proved inadequate.

Criticisms of commodity housing projects centred on overpricing. In Beijing, Shanghai and Guangzhou, many properties were sold at per square metre prices exceeding RMB 10,000 (US\$1200). The spiralling prices were the result of many factors, including:

- intensive speculation;
- high land prices resulting from government auctions;
- possible price-fixing by developers: the small number of developers relative to the number of housing units being produced makes it possible for developers to control the supply stream of new housing and collude on pricing;
- lack of market information and inexperienced buyers: many first time buyers lack the experience and ability to bargain for lower prices with major developers.

The affordable housing system, while designed to provide housing for low-income families, has failed to benefit many of them, while many middle-income or even high-income families have purchased affordable housing at subsidized prices. The failure of the affordable housing system is due to many reasons, as outlined below:

- Ambiguity in government objectives: it is unclear whether the goal of the affordable housing plan is: (a) to provide security for middle- and low-income families, and/or (b) to stimulate the housing market.
- Poor monitoring of the development and sales of affordable housing. Many affordable housing units were sold to those who could provide 'satisfactory' documents concerning their income. This poor monitoring is not only because of the government's lack of experience in supervision, but also because some local governments tend to use affordable housing projects to stimulate local real estate markets.
- Conversion of affordable housing to commodity housing, creating incentives for developers to develop large units and for investors to speculate. Buyers of affordable housing were allowed to re-sell the affordable housing, two years after purchase, as commodity housing by paying ten per cent of the sales price to the government to convert allocated land-use rights to granted land-use rights.

At the very bottom, despite the fact that the low-rent housing system was introduced nationwide in 2004, there is still a dearth of low-rent housing, and insufficient funds are available to subsidize all families in need.

Recent changes to regulate the sector

The shortcomings of the three-tier urban housing system, especially the overheated markets, not only led to complaints among the public, but also aroused concerns on the part of government officials. Since 2005, the central government has gradually increased intervention in the urban real estate sector. The State Council and its subsidiary agencies have issued numerous policies, regulations and rules to control the supply of housing and land, to regulate the sales and purchase of real estate, and to curb speculation. Restrictive regulations on foreign investment and purchase of real estate by foreigners have also been introduced. In addition, there have been reforms to the housing security system and changes to tax policies, which are described in more detail below.

Emphasis on medium and small housing units at moderate or low prices

Emphasizing the scarcity of urban land, the government has sought to increase the supply of medium and small housing units. In 2005, apartments with a floor space of less than 120 square metres and an offering price 1.2 times lower than that of those comparable apartments in the area were defined as 'qualified homes'. Tax incentives were introduced to encourage people to hold on to qualified homes. The definition of a qualified home was tightened in 2006. In addition, apartments with a floor space of less than ninety square metres must now account for at least seventy per cent of the total development in any new residential housing project.

Control over land supply

The central government issued new regulations to control the land supply and ensure that those from whom the land was taken received adequate compensation. The new regulations increased compensation to farmers when land was requisitioned, separated the receipt of revenue from the sale of granted land-use rights from spending (thus decreasing the incentive for local governments to requisition the land), and set a minimum price for granted land-use rights for industrial land in various cities.

Credit control

To cool the market, the People's Bank of China raised interest rates four times in less than two years. The requirements to secure loans for development and housing were also tightened. Developers do not qualify for a loan unless their own invested capital in the project has already reached thirty-five per cent of the total investment. The down payment for housing loans for home purchasers was also increased from twenty per cent to thirty per cent of the total price, except for properties with a floor space of less than ninety square metres. Moreover, pre-sale is no longer allowed before the majority of the structure and the roof of a residential project are completed.

Regulating contracting behaviour

Requirements on information disclosure and punishments for irregular conduct were introduced to combat price-fixing. To curtail speculation, new restrictions were imposed on the resale of contract rights by advanced buyers. Buyers who purchase housing before the project is complete are prohibited from transferring the property before the delivery of the property and the registration of title.

Tax policies

In an attempt to limit speculation and to discourage purchase of larger properties, many new tax policies were introduced in the past two years. On 1 June 2005, a business tax based on the full resale price was imposed on the sale of homes held for less than two years. In 2006, the period was extended from two years to five. Later the same year, on 1 August, a new tax policy was brought in to collect income tax on profits from the sale of housing.

A tightening of the regulation of value-added taxation (VAT) imposed on the transfer of land-use rights also occurred in this period. Although a 1995 regulation imposed a VAT on individuals who resold property, the VAT was never seriously collected until 2006. Now, owners are charged the full VAT rate if they transfer the property within three years of purchase, and a fifty per cent rate if they transfer property they have lived in for three to five years. Lastly, the tax rate for urban land-use was doubled in 2006. Foreign and foreign-invested enterprises, which used to be exempt from the tax, are now required to pay urban land-use tax.

Regulating foreign investment and purchase

The increase of foreign investment in China's real estate sector and the purchase of property by foreign entities or individuals were considered to be among the forces behind rapidly escalating housing prices. A series of policies was issued in 2006 to regulate foreign investment and purchase:

- Foreign-invested real estate development companies investing more than US\$10 million are

required to have registered capital of no less than fifty per cent of the investment.

- Foreign-invested real estate development companies do not qualify for development loans unless their own invested capital in the project is equal to thirty-five per cent of the total investment, either from domestic or foreign lenders.
- Partners in foreign-invested development companies are not allowed to guarantee fixed returns.
- Transfers of projects or stakes in foreign-invested real estate companies, or acquisition of domestic property companies, must first be approved by the government.
- Foreign entities or individuals are not allowed to buy residential or office property that is not for their own use or habitation. Foreign individuals who wish to purchase property must also have lived in China for at least one year prior.

New housing security system policies

To increase the supply of low-rent housing, every city or county government is now required to use at least five per cent of its income from granted land-use rights for low-rent housing construction. The government has also increased supervision of the development and sale of affordable housing. In cities such as Beijing, there are now proposals that owners of affordable housing units can only sell those units back to the government rather than to private buyers.

Conclusion

Traditional wisdom supports government regulation as a necessary response to market failures. Whether market failures alone justify the recent government interventions is debatable, however. Given the heavy administrative control of the market, it is safe to conclude that the problems with China's urban housing system are due to both market failure and government failure.

This round of reforms has focused on efforts to control the supply, with some improvements in the housing security system as well. However, the supply side adjustments seem more likely to reduce the

supply. The tax increases and stronger regulation of tax collection undoubtedly discourages property owners from selling their property. The increasing of prices for granted land will only lead to higher housing prices. Even the requirement that seventy per cent of new housing be less than ninety square metres has led to price increases for larger units. In short, the policies do not seem to have accomplished the intended objective. According to statistics, the average per square metre housing price in Beijing rose RMB 2227 last year.

This leads one to question whether the central government is really targeting over-pricing, or is actually more interested in achieving other goals.

While the cooling of the overheated real estate market may have been one of the government's objectives in this round of reforms, it has clearly also had other intentions in mind; namely, to regain control over the use of land and the spending of the revenues generated by the sale of granted land-use rights. The government has adeptly diverted opposition from local governments and the general public, who would otherwise object to the higher prices for land (and therefore housing) and the higher taxes and restrictions on resale of housing, by portraying this round of policy changes as a scheme intended to curb speculation and improve the urban housing situation. Its real motivation remains far more open to question.



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