INTERNATIONAL REAL ESTATE REVIEW
2003 Vol. 6 No. 1: pp. 121 - 135

Mortgage Payment as a Portion of Income: A Better Solution

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We propose a program that would further promote housing privatization in China. In addition to operating its current Housing Savings Fund program, the government could guarantee loans, with payments capped at affordable levels or spread out over workable payment periods. Such a program would balance efficiency with fairness by encouraging market forces, while addressing practical necessities (lenders' rights, corruption, labor mobility) so that privatization could relieve the burden on government and taxpayers. Net benefits would arise through the private market's greater efficiency in managing housing resources.

Introduction

As the rapidly growing Chinese economy moves increasingly towards one with a market orientation, with the development of property rights and greater protections for private ownership, the country is considering instituting policies to further promote home ownership. In fact, the Chinese Government has implemented a series of policies to create incentives for privatizing government housing, including substantial rent increases and a Housing Saving Fund Program. Significant progress has been made, but as of the end of 2001, approximately 30 percent of public housing residents still could not afford to own their dwelling units.[1] Instead, these low-income or

[1] People's Daily, Overseas Edition, March 30, 2000

unemployed households have continued to live in state-owned apartment buildings.

While residents of these properties benefit from low rent payments, and from the government's assumption of maintenance costs, this arrangement is economically inefficient, in that tenants have little incentive to maintain the properties they occupy. The lack of home ownership among low income households might even pose threats to social stability. Advancing home ownership has come to been seen in Western systems as a means of fostering financial security and, at the same time, enhancing social stability by building commitment to owners' communities and broadening access to the political environment. In this paper, we propose a program that would allow larger numbers of Chinese families to purchase the properties in which they reside.

A Brief Review of Housing Subsidies in Developed Economies

A. Government Rental Subsidies

A brief discussion of housing subsidies, including rental subsidies, in other countries is relevant because inefficient provisions found in some countries' policies should not be replicated in the policies we recommend for China. Much of the housing subsidy activity around the world has focused on the providers (supply side subsidies) and occupants (demand side subsidies) of rental property. For example, income-related tenant subsidies are common in many countries. Assistance to builders of rental housing for low-income families is popular as well, in the form of below-market interest rates or favorable income tax treatment.[2]

In the U.S., about five million low and moderate income families currently receive some form of federal subsidy through the Department of Housing and Urban Development (HUD) or Department of Agriculture.[3] The residents need not be destitute; a Chicago family of four with a $52,500 annual income qualifies as "low income" for purposes of Section 8 assistance through the HUD. A low-income family living in an HUD-qualified property pays a monthly rent no greater than 15–25% of its monthly household income, depending on the household's income and size.

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[2] Hendershott and White (2000)

[3] These figures were reported as of 2001 and 1999, respectively, on the HUD and USDA web sites hud.gov and usda.gov.

Other countries also subsidize considerable amounts of their citizens' rental housing expenses. One nation with a long tradition of subsidies is the United Kingdom. After 1979, the Thatcher government began replacing subsidies to local rental housing agencies with income-related housing assistance. In the late 1980s, the Conservative government decontrolled rents and started subsidizing investments in private rental housing. Prior to the 1988 social security reforms, housing benefits were provided in two forms: supplementary benefits and rent rebate/rent allowance programs. More recently, the U.K. has enacted a tax benefit program to attract capital to the country's small private rental housing sector; tax write-offs are provided to investors who purchase shares in new companies that provide new privately owned rental housing.

France also has a long tradition of rental housing assistance. Shortly after the Housing Act of 1948 eliminated rent controls on new construction, a housing allowance program was created for the benefit of families with children. In Australia, where almost 50% of households receive some type of government housing subsidy, public housing rents were increased to market levels in 1981, but a rent rebate was provided to any household if the market rent it paid was more than 20% of its income. Belgium also provides income-related rent subsidies to renters.[4] In Finland and many other countries, governments provide low interest rate loans to builders that participate in low income housing programs.

Germany is another country with rental subsidy arrangements. In 1965, a major new housing allowance program was started in the former West Germany to reduce the rent burden for low-income households, keeping housing costs no higher than 15–25% of total household income. A housing allowance program introduced in the Netherlands on a limited scale in 1970 was substantially expanded in 1975 to support the government's rent harmonization policy, which was aimed at raising rents for existing units to more closely match the rents for new dwellings.

Obviously, the objectives of government subsidies can differ. Denmark, France, Finland, Germany, and Sweden have programs that target both renters and owners; whereas the British, Australian, and Dutch systems provide assistance primarily to renters. Indeed, the move in some countries from housing subsidies oriented toward producers to those directed at consumers has been an interesting phenomenon. France, for example, has introduced an additional renters' allowance as part of a policy to shift assistance away from "bricks and mortar" toward personal subsidies.[5] This type of shift reflects governmental efforts to use public money more

[4] See Kemp (1990)
[5] Ibid.

efficiently, based on the view that giving housing allowances to consumers can help bolster the market, whereas the act of subsidizing producers, especially if coupled with rent controls, tends to subvert the market. Academic research has shown that direct assistance to tenants is almost always more efficient than assistance based on the property occupied, for reasons that include avoiding disincentives for maintenance, and keeping all related costs easily measured and "on-budget."[6]

Finally, as in the U.S., certain forms of housing assistance in some other countries are provided to needy tenants by local governments, rather than at the national level. Several of the Canadian provinces operate their own housing allowance programs; Ireland is another country where local authorities administer different rental assistance plans, while similar schemes exist in some Swiss cantons.[7]

B. Government Subsidies to Ownership[8]

In addition to assisting renters, many western nations have long followed policies of subsidizing home ownership. Income tax deductibility of mortgage loan interest appears in some form in most industrial countries (although Australia, Canada, Iceland, New Zealand, and the U.K. are exceptions). Indeed, the untaxed imputed rental value of an owned residence – a valuable benefit of home ownership (true in most countries, with the Netherlands applying a slight tax as a counter example) – is made stronger by the fact that home owners in the U.S. and most of Western Europe can claim business-like deductions on the expense side, while not having to claim the rental value on the income side. The supportive environment surely plays a role in fostering high home ownership percentages (more than 67 percent among U.S. households).

Other limited subsidies to home ownership sometimes arise. In the U.S., for example, an income tax credit was proposed, although not implemented, for first-time home buyers nationwide in 1992 (a credit for buyers in Washington, D.C. was temporarily implemented later), and first-time buyers can withdraw up to $10,000 without penalty from tax-sheltered Roth IRA retirement savings plans. Australia, Finland, and Ireland are other countries that have provided first-time home buyer subsidies in the form of down payment assistance or reduced loan payments. The U.S. federal government helps non-affluent home buyers obtain financing for which they might not otherwise qualify, while local U.S. communities have made limited use of

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[6] See, for example, Olsen (2000)
[7] See Hendershott and White (2000)
[8] Among the sources for information presented in this section on housing subsidies outside the U.S. were Hendershott and White (2000)

their municipal borrowing powers to borrow money at low interest rates and re-lend it to low or moderate income home buying families.

C. Private Housing Subsidies

Subsidies for housing purchases are sometimes provided by private parties. In the U.S., for example, some educational institutions and employers in high-cost housing areas have begun programs to sell homes at below-market prices to their workers, just as major companies have long helped transferred employees with financing during periods of high interest rates. The U.S. military's provision of housing subsidies to its "employees" is an interesting hybrid of employer and government assistance.

Private assistance may, on the other hand, be motivated purely by charity. Religious organizations have provided housing assistance in forms that include below market rents (in properties owned by a church or one of its members) and favorable financing. Better known is a large private charitable organization such as Habitat for Humanity International (HFHI), which makes extensive use of volunteer labor and donated material in building or rehabilitating homes for low income families. Yet, even (or perhaps especially) when the subsidy is charitable in nature, the provider of the assistance should consider taking steps to prevent the recipient from behaving in ways that would thwart the subsidy's intentions.

The Effects of Housing Subsidies

Consider, for example, the steps HFHI takes to prevent buyers from purchasing homes at below-market prices and then "flipping" (immediately selling) them at higher market prices. A common practice is for a local HFHI chapter to share any profits that result from resale, perhaps until ten years after the subsidized home purchase. A profit sharing arrangement helps create a useful balance: an owner who could keep all resale profits would be motivated to flip, thereby undermining HFHI's goal of providing needy families with housing (rather than monetary benefits). But an owner with no claim on resale profits would have no motivation to maintain the property, thereby undermining the integrity of the neighborhoods where HFHI homes are built. To further prevent owners from withdrawing their equity by refinancing, HFHI may hold a "soft" second mortgage on the property, which requires no direct payments unless the home is sold in the first several years (perhaps ten) after the purchase.

One question that must be addressed is whether housing is subsidized simply to improve housing availability and affordability, or whether policymakers are attempting to address broader social or economic issues through a housing program. For example, some countries in Europe have, in the past, used housing subsidies to promote labor mobility, directing the movement of workers to areas where policymakers felt they were needed. Sweden's National Labor Market Board is a case in point. The agency buys workers' houses to assist them in liquidating their investments, so they can purchase new residences in the areas to which they relocate. In the U.K. and France, "new town" policies were enacted by the British and French governments to encourage workers to move away from major population centers, such as London and Paris, to centers of new economic growth and development. The General Labor Market Board in the former West Germany provided migrant workers with low interest rate loans, and Norway has provided migrant workers with 100% financing to purchase new homes. Israel has provided its citizens with generous terms on mortgage loans, to promote growth in the country's less developed areas, and the Netherlands has periodically given families money toward meeting the costs of equipping new homes. Because the Chinese Government has stated, as a major goal, the development of the country's northwest and inner areas, policymakers have considered offering generous housing subsidies as a way to attract people to move to those regions.

Another question relating to housing subsidies is whether unintended effects, particularly inequality, might arise. In the U.S., for example, 70 percent of renters with incomes below the poverty line receive no governmental subsidies, while 43 percent of families assisted by HUD programs have incomes above the poverty line (a family of eight could qualify for Section 8 assistance with an income approaching $70,000). Still another issue is that the government's subsidy activities, be they on the supply side or the demand side, can have an upward impact on the market, thus causing potential confusion over what constitutes the "market rent" used as a benchmark in further subsidized transactions. Indeed, most subsidy programs, regardless of the country of origin, have been tremendously costly; governments routinely pay much more for program beneficiaries to obtain subsidized housing than the housing services would seem to be worth. One estimate holds that 20 percent, on average, of the money spent on such programs as public housing, or HUD's Section 236 (existing residential rental property) and Section 8 (new or rehabilitated rental housing) undertakings, is wasted, even excluding administrative costs.[9]

Concerns over rampant corruption also plague programs that provide subsidies to suppliers of housing, since developers who meet program qualifications are often accused of making excessive profits, and therefore

[9] See Olsen (1992).

would be willing to bribe officials for the privilege of getting their projects approved. Actual or potential corruption problems prompted the U.S. Government to end all direct subsidies to housing producers in the early 1970s, while the British Government ended certain producer subsidies in 1981. Perhaps even more troubling is that the benefits are uncertain, in that there is no evidence indicating that tax savings programs have helped solve the housing affordability problems faced by low income families. The costs are uncertain as well, in that a reduction in tax revenues is "off-budget," so the true cost (in terms of distortions in economic activity) is effectively out of the public eye.[10] While subsidy programs are sure to generate at least some controversy no matter what form they take, it seems that they should at least be designed in ways that allow their costs to be easily identified and measured.

Our Proposed Program

Globally, the most common subsidy to residential ownership is the lack of (or very light) taxation of the imputed rents and capital gains that homeowners must support.[11] We believe that private homes should enjoy similar treatment as China's private tax system emerges. For reasons of efficiency, the home ownership assistance program that we propose would probably have to be administered at a national government level, with a nationwide interest rate set by the central bank. Local jurisdictions might lack the needed resources, and a national program administered locally could lead to overspending in the hope of passing costs along to other jurisdictions. A benefit of local administration, however, would be to allow different communities to serve as laboratories in learning what specific provisions work best. In addition, more explicit features of the type of housing subsidy appropriate to China would be:

A. The government should sell all publicly owned properties to residents

Turning properties over to their current occupants would promote efficiency, in that a private owner has an incentive to protect his investment (both in the property and in its surroundings) from physical decay and adverse social conditions. (Note that publicly owned multi-family housing in the U.S. became the locus of the country's worst crime and other social problems.) In fact, simply giving public housing units to their current occupants would prevent some problems that would accompany prices tied to income or wealth measures: falsely understating income or seeking jobs with low cash

10 See Gyourko (1990)

11 See Hendershott and White (2000).

incomes but high non-cash benefits (such as opportunities to engage in self-help activities). Placing the housing stock into private hands would also allow for property taxation, an outcome that meshes well with the Chinese Government's goal of expanding the tax base.[12] However, fairness questions would arise over the amount of money each current tenant would pay for his or her unit, with greater unfairness present at a higher difference between an objective measure of the market value and the transaction price. Practicality issues might dictate that not all current public housing residents could buy their units.

B. The government should provide assistance in the mortgage borrowing process.

One type of such assistance would be for the government to guarantee mortgage loans issued by commercial banks, since each buyer would need financing, and a purely private market might have trouble providing it (at least in the market's developmental stages). Among problems that a lending community would face, at least while this new market was taking shape, would be ongoing questions over true collateral values, and lenders' inability to underwrite effectively where there has been no societal tradition of private borrowing in recent decades. (One aspect of China's attempts to strengthen its banking system has been to expand asset-based lending.[13]) These problems are, perhaps, not unlike those that motivated the creation of the now-mammoth secondary mortgage market in the U.S. – a market that required governmental involvement in its early years, and which has evolved into a major force both in making possible home ownership and in generating creative investment products.

Another form of assistance to mortgage borrowers would be a benefit (such as income tax deductibility) for the interest paid. One argument in favor of loan interest benefits is that lower-income families are the ones that must borrow to buy housing, so those of low and moderate means are strongly represented among program participants. However, fairness concerns might arise if the government sells public housing units to their occupants at favorable prices and then subsidizes the loans, at the expense of other taxpayers (though if the loans were small, the benefits would be small as well). Efficiency concerns can also arise, especially with a benefit not limited to the poor, if the subsidy serves to increase the demand for housing relative to that of other goods (or if greater investment in housing crowds out needed industrial capital spending in a growing economy). An argument against income tax-based subsidies is that they are more valuable if marginal

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[12] See Moreno (2002)
[13] *Ibid*

tax rates are higher, perhaps reducing incentives for citizens to resist growth in an inefficient public sector. Finally, it should be noted that that some countries, particularly Australia and Sweden, have reduced or terminated their home ownership subsidy programs; one concern is that a subsidy such as lower financing costs, especially for properties located in a developed urban area, might simply be capitalized into a higher purchase price.[14]

C. A family's monthly mortgage loan payment should be determined as a portion of its monthly household income.

This provision is based on practical considerations. The family must be able to afford the payments or the program will fail. One approach might be to sell a public housing unit to its occupant at a price that would, under reasonable mortgage lending terms, keep the periodic housing payment at a level near 25% of periodic income (a figure close to developed countries' payment guidelines under both government rental assistance programs and private mortgage lending plans). An attendant benefit would be the ease of adjusting across higher and lower cost housing areas. An alternative, or perhaps accompanying, feature could be to allow the length of the payment stream to differ from one case to another, based on the household's income and the amount of money borrowed (which, in turn, would reflect the property's value and the amount of equity the government conferred on the borrower).

D. The household should be able to sell the property, but the proceeds should have to be used to pay off the loan first.

The concern here would not be the same as the concern faced by HFHI in the U.S. Whereas HFHI fears damage to its reputation and its volunteers' morale if home owners sell for quick profits, and thus the organization requires equity sharing, the Chinese Government would have no reputational concerns, as it would be getting out of the activity of having to own and maintain residential property. An equity-sharing requirement could be imposed, but even without a sharing of built-in price appreciation, a sale would lead to an efficient allocation of resources in a Coasian sense. The reason for requiring a "due-on-sale" clause in the arrangement is the same as its reason for existing in the U.S. private lending market: to protect the property rights of lending organizations and the investors who finance their activities (such as being able to examine the new occupant's financial situation).

[14] This issue is discussed in Hendershott and White (2000).

E. The government should specify the maximum price it would guarantee for future transactions (and the properties eligible for such guarantees).

The illiquidity of an investment in home equity could cause two potential problems in an emerging private housing market. One is that fears over liquidity issues would reduce the initial prices that buyers could justify paying and the amounts they would be willing to spend on ongoing maintenance. Another is that the inability to sell quickly and without high transaction costs could reduce homeowners' willingness to move to new regions, even when they have lost their jobs. Thus, there is a view (backed by some empirical evidence) that home ownership interferes with labor mobility and thus contributes to unemployment.[15] The possibility of such an outcome should be of special concern if the public sector provides generous benefits to those who have lost their jobs. This last provision of our proposal would effectively create a put option for each buyer, thereby creating liquidity in a market that otherwise would be very uncertain during its developmental stages.

The advantages of a program with these features would be as follows:

A. It would not alter market forces/prices in the housing market, in that the properties that would be conveyed by the government to private owners are already occupied by those private parties. Furthermore, an ownership assistance program would not suffer from the potential "crowding out" of better tenants that can plague rental subsidy programs;[16] all home owners would have an incentive to maintain their properties and communities. There could be market effects, however, if the termination of public housing caused the current residents to alter their preferences for housing services, especially if the amount of equity conveyed on the new private owners (i.e., the price discount relative to an objective market value measure) were substantial, or if the payment of the mortgage loan interest generated taxes or other benefits that might accrue disproportionately to higher income households.

B. It would create incentives to work and learn skills for higher wages, in that the availability of better housing increases both the set of goods available to consumers and the set of savings/investment vehicles from which to select.

[15] See Hendershott and White (2000)
[16] See Benjamin, *et. al.*

C. It would create incentives for the new home owners to maintain their properties, in that their home equity would become an important component of their private wealth. This situation argues in favor of conferring a higher amount of equity (i.e., for the government to more aggressively discount the price relative to an objective market value measure) in each transaction.
D. It would lower costs for the government and taxpayers, in that the public housing experience internationally has demonstrated that the lack of incentives for efficient management, and for the parties most affected (the residents) to assume personal responsibility, leads to extremely high operating costs, not to mention high levels of crime and other social problems (while studies suggest that home ownership has a desirable effect on education, crime, and other societal issues). A private party, such as an association of the owners of the units in a multi-family building, could meet the costs of management services (staff salaries, benefits, taxes, maintenance and repair costs, and office and equipment outlays) more efficiently than a governmental agency could. (One study has estimated that China's government enterprises are only 60% as efficient as the country's privately financed enterprises.[17]) The money thereby saved across the society could be used to provide low-income households with greater assistance in paying for maintenance, or for mortgage financing.

A Simple Framework for Cost-Benefit Analysis

The desirability of this approach can be seen in a comparison with the cost effectiveness of housing subsidies in the U.S. and other developed economies, such as giving property away to its occupants, charging below-market rents, charging rent based on income, or creating housing vouchers. The net benefit of our proposed program can be represented as:

$NB = f(GM,GS,PS)$
where NB = the net savings benefit to society;
GM = government management costs, a deadweight cost that results from the need to oversee programs that would be unnecessary if publicly owned housing became privately owned;
GS = the government's cost of providing maintenance and other services; and
PS = the cost to private owners of providing those services after purchase.

[17] See Moreno (2002).

Specifically, the net benefit can be estimated as the net present value of the cash flows:

$$\mathrm{NB} = \int_{t=0}^{T} GM_t e^{-rt} \partial t + \int_{t=0}^{T} GS_t e^{-rt} \partial t - \int_{t=0}^{T} PS_t e^{-rt} \partial t$$

where T represents the duration of the program and r represents the appropriate discount rate.

Based on empirical evidence, GS>PS because of the cost savings that would result from private parties' incentives to operate more efficiently. Of course, this program would not be without costs of its own. For example, the savings from dismantling the government ownership agencies would be offset, at least to some degree, by the costs of operating a huge government apparatus to provide loan guarantees. Among the ongoing costs to the government, therefore, would be those of dealing with default rates that would surely be high, while prepayment rates would likely be low. Such costs would have to be expected in the transition from an entitlement-based to a market-based housing system. (Depending on the broader intent of the program, the government might create additional incentives, such as reducing a family's mortgage loan payments if all school age family members attend school regularly and do well in it, or reducing the proportion of payments relative to income for those who graduate from educational programs and find better jobs; such offerings would lead to still higher costs.) But because of the incentives to behave efficiently toward building greater personal wealth, a loan guarantee program would have to be much cheaper than the government's direct operation of a large scale housing system.

The costs of supporting a loan guarantee program would also be offset by the gains that society would enjoy through the development of a secondary mortgage market. These gains would not be limited to enhanced liquidity in the housing market; because a market for the sale of mortgage notes would help open the door to a more sophisticated financial marketplace overall. The secondary mortgage market in the U.S. has paved the way for a range of asset-based lending products, and for derivative instruments that greatly enhance investment and risk management choices. Recently, the Chinese Government announced an interest in establishing a secondary mortgage market, which will help pave the way for a range of asset-based lending products, and for derivative instruments that greatly enhance investment and risk management choices in China. Financial modernization of this type is important, since many experts believe that China's financial sector has limited the economy's ability to grow.

Some Final Comments

Our recommendation (convey public housing to its current residents, with assistance in financing, and with appropriate limitations and assurances regarding disposition in resale) is quite general; specifics would likely have to emerge as different approaches are tried. But experience with rental and, more importantly, home ownership subsidies that have existed in many developed and developing countries over many decades indicate the most important issues to address when designing a system that balances efficiency questions with fairness concerns. Our hope is that the need for features such as financing assistance and the accompanying limitations on borrowers would be phased out as the market matures and private ownership becomes widespread. However, the progress is sure to be slow, because the goal of moving to universal home ownership and a fully privatized financing system is one that still eludes even the most developed countries.

The authors thank two anonymous reviewers for providing many helpful comments.

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