

RENT CONTROL AND ITS REFORM IN CHINA

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ABSTRACT

Rent controls still exist in mainland China and Western countries, and will continue for the foreseeable future. In China, rent controls have resulted in severe housing shortages, poor management and maintenance of the housing stock, and an increasingly heavy financial burden on the state. China has been reforming government rental housing for the last two decades, increasing rents and phasing out government subsidies, promoting home ownership and house commercialization. Western countries have been adjusting their rent-control and housing-subsidy policies over the last three decades.

Key words: *rent control, subsidies, privatization*

1. INTRODUCTION

Following the practice of the former Soviet Union and Eastern European socialist countries, China adopted a low rent-low salary policy in 1952, when the government stopped the wartime allowance system and started paying cash salaries to government employees. Rents for government-owned or public housing units were set at arbitrarily low levels, and were unrelated to the costs of building and maintaining the housing units. The policy caused serious problems--severe housing shortages, poor management and maintenance of the existing housing stock, an increasingly heavy financial burden on the state, and corruption among housing officials. Ironically, rent controls were not born in centrally-planned economies, but in free market economies, such as the United States and the United Kingdom. Rent controls were instituted in the U.S. and many European nations during World War I. The controls were liberalized after the war but were reintroduced at the start of World War II. In developing countries, rent controls were primarily confined to the European colonies during World War II. Since then, governments have used rent control to contain rents during periods of rapid urbanization, and to ensure affordable housing. Strict rent controls in these countries led to declines in new housing construction, deterioration in existing rental housing units, and poor services. To avoid these problems, the governments have replaced strict rent controls with moderate controls or decontrolled rents, have improved the ways in which they provide housing subsidies, and have been privatizing public housing.

This paper analyzes the disadvantages of rent control, reviews the origin of rent control and its evolution in Western countries, examines rent control and its economic consequences in China, and provides our views on rental housing reform in China.

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2. THEORETICAL ANALYSIS

Basic economic theory stipulates that any substantial price effect, i.e., setting a price ceiling below the equilibrium level, will yield a supply effect, which is manifested in lower quality and fewer rental units over the long run. Rent compensates owners and developers for the cost of providing housing units to tenants. Rent fluctuations signal the supply and demand conditions of the housing market; they affect future investment decisions of investors and developers and, consequently, the allocation of resources. The signaling function works only if rents are allowed to rise and fall as the balance between supply and demand changes. Rent controls distort housing markets by depressing the amount by which rents can rise in response to changes of supply and demand in the market.

Rent can be defined as the shadow price, P , of a unit of housing service, multiplied by the quantity of services, Q , generated per period (Moorhouse, 1987). Neither P nor Q is directly observable. "Housing services" include all the abstract attributes such as quality, comfort, and prestige. Rent is the revenue that landlords receive. Any change in rent caused by a change in the shadow price will be offset by the change in rent caused by a change in quantity supplied. Rent or revenue can therefore be represented by a rectangular hyperbola.

Rent control is not direct price control: it is revenue control. Thus, landlords are able to change P and Q . They can change Q by changing the temperature setting on the hot water heater, changing the frequency of garbage pick-up or floor waxing, etc. Rent is not simply the amount tenants pay for housing. There can be a substantial gap between what tenants pay and what landlords receive. This gap is primarily made up of search costs. Of course, tenants at the time rent control is imposed do not incur these search costs; all later tenants do. This does not mean that once somebody moves into a controlled unit, there will be no extra costs. Suppose there is a major change in one's life that would ordinarily cause one to move. With rent control, that move may not occur, i.e., tenants cannot optimally adjust their consumption of housing services to the change in life. In order to enjoy the artificially low rent, one pays in other ways.

Figure 1 shows the effects of rent control in a competitive market. We assume:

- 1) all housing services are homogeneous;
- 2) the rental market is perfectly competitive;
- 3) the market demand curve DD for housing services slopes downward; and
- 4) the market supply curve SS for housing services slopes upward.

In the short run, SS may be perfectly inelastic, because we assume that no new suppliers can enter the rental market and that existing suppliers can only adjust the quality of their services. In Figure 1, the vertical axis indicates the shadow price level P per unit of housing services and the horizontal axis represents the quantity of housing services Q per period. The rectangular hyperbola R represents controlled rent. Rent control imposes a ceiling on rent; it does not control the shadow price of housing services. Without rent control, the market is in equilibrium at E with the shadow price of housing in equilibrium p_e and the quantity of housing services q_e . With strict rent control, or when the control is binding, the ceiling rent level is bound to shadow price p_c , where the rectangular hyperbola crosses the

supply curve at c and the quantity of housing services is reduced to q_c . p_c is below the equilibrium price p_e .

In equilibrium without rent control, rent revenue to the landlord is represented by the rectangle $p_e E q_e O$. Under rent control, the rent revenue is $p_c c q_c O$, which is smaller than $p_e E q_e O$. The landlord receives less revenue while the tenant receives less housing service, which means that rent controls impose net losses on society. These deadweight losses consist of aEb (loss in tenants' surplus) and bEc (loss in landlords' surplus). There will be excess demand, or a shortage of $q_1 - q_c$ housing services, which can lead to discrimination against some tenants, more demand for public housing, and homelessness (Albon and Stafford, 1987). Rent controls transfer resources from landlords to tenants: The amount of this transfer is represented by the rectangle with area $p_e b c p_c$, which is the difference between $p_e E q_e O$ and $p_c c q_c O$ and bEc . Any increase in landlord costs will shift the supply curve leftward and lead to a further reduction in housing services to renters. In the long run the effects will be more obvious: the supply curve will tend to become more elastic because landlords have more options, such as converting space allocated to rental housing to other uses, and reducing services, for their strategic gaming.

Figure 2 shows the effects of rent control in a monopoly market, where MC is the marginal cost curve, and MR is the marginal revenue curve. Without rent control, the quantity of housing services supplied is q_e at shadow price p_e . Under rent control, the MR curve will become the bold segment, because the absolute value of the elasticity of a rectangular hyperbola equals to one, and the derivative of it with respect to quantity, or the marginal revenue, is zero. The quantity of housing services supplied is q_c at shadow price p_c : in comparison with a competitive market, a lower quantity of services is offered at a higher shadow price, and the deadweight losses to the society is larger. Hence, the effect of rent controls in a society with a monopoly market is even worse than the effect in a society with a competitive market.

Figure 1.

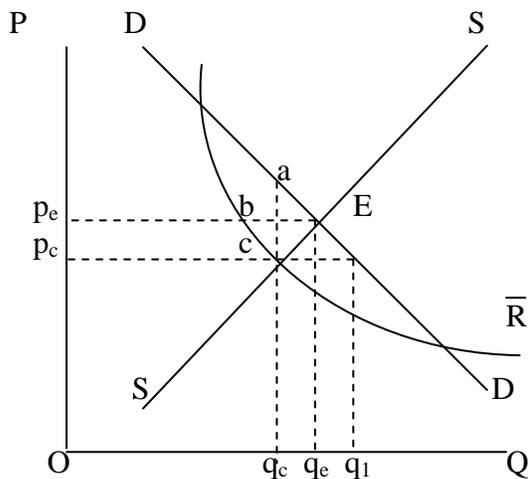
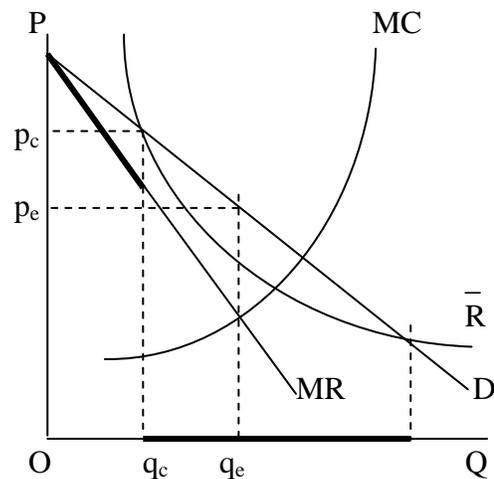


Figure 2.



3. THE ORIGIN AND THE VARIOUS FORMS OF RENT CONTROL IN WESTERN COUNTRIES

Rent controls were instituted in the United States, the United Kingdom, France and other Western countries during World War I, and still exist today in various forms. In the U.S., rent control was first used in a few communities with severe housing shortages during World War I but was phased out gradually after the war. However, during World War II, as part of a general price control program, the federal government adopted nationwide rent control beginning in 1942. After 1949, federal rent controls were removed, and by the mid-1950s New York was the only state that retained rent controls. During the rapid inflation of the 1970s, many cities (e.g., Boston, Chicago, New York, Newark) readopted rent control, and, in 1971, the federal government imposed a 90-day price, wage, and rent freeze, followed by a flexible price-stabilization phase that lasted until January of 1973.

By 1986, more than 200 municipalities had some form of residential rent control. More than half of these were in New Jersey, one was the District of Columbia, and all the others were in the states of New York, Massachusetts, Connecticut, and California (Downs, 1988). By the middle of 1988, 14 states had passed laws or constitutional provisions against rent controls. As of 1990, rent controls were still in effect in more than 200 communities in the U. S. (Turner, 1990). The number has been stable since then.

Throughout the U.S., there have been two types of rent control--strict and moderate. Strict rent control which puts a virtual freeze on rents; was imposed during the two world wars and by New York City's rent control programs after World War II. The stabilization programs in Maryland, Massachusetts, New Jersey and Washington D.C. are considered examples of moderate rent controls. Moderate rent controls exempt new construction and "provide for annual rent adjustments to compensate for escalating costs and guarantee a fair and reasonable return on investment" (Turner, 1990). Moderate controls allow landlords to pass the escalating costs for maintenance on to their tenants. With hardship provisions, the landlords can petition for relief in cases of extraordinary cost increases or unacceptably low rates of return.

In the United Kingdom, rent control has existed since World War I. It is systematic and nationwide, and no decisions are made at the local level. The first rent control Act, which was in effect from 1915 to 1922, froze rents for most working-class dwellings at their pre-war levels. There was a period of rent decontrol from 1923 to 1939, during which rent increases were allowed either when the landlord had a vacancy or when the landlord had granted a lease fulfilling certain conditions. During World War II, this policy was abandoned, strict rent control was reintroduced, and it remained in effect from 1939 to 1957. Since then, the U.K. has made significant progress in rent decontrol, especially since 1980.

In the mid-1970s, Canada implemented strict rent controls in response to high inflation, and later tied rent increases to a price index. However, market rents are allowed for vacant units. The Socialist Government in France imposed strict rent controls in 1980, which caused a significant drop in housing construction in 1982 and 1983. In 1986, the new government abolished nationwide rent control, with the exception of high rent areas such as Paris. Finland currently allows landlords to adjust rents for certain

cost increases, and both the landlords and tenants have the right to appeal. Germany and Greece have similar practices.

Rent control has also been common in developing countries. In Egypt, rent control was introduced in Cairo in 1944. Until 1952, rent controls were limited to houses built before 1944, in order to avoid discouraging housing construction. After 1952, rent controls were gradually extended to new construction (Malpezzi, 1986). India, where new construction is exempt for 10 years, has a two-tier system of controls. For units under strict control, the rent controller decides “fair” rent and has the power to allocate units to potential tenants. For units under ordinary control, rent increases are permitted but are regulated (Malpezzi and Tewari, 1991). Brazil first attempted to regulate the private rental market in 1917. Currently, rent controls in Brazil are generally less stringent than controls in other developing countries. Rent increases in Brazil are indexed to inflation, and are reset by negotiation every fifth year or when tenants change, instead of being controlled directly by legislation (Malpezzi and Ball, 1991).

Recognizing that strict rent controls can create net losses to the society, almost every country has reformed its control programs after the world wars and after severe inflation periods. Since 1980, privatization of public housing has been widespread. The U.S. Housing and Community Development Act outlined “right to buy” procedures for tenants in 1987 and the U.S. Congress passed President Bush’s Home Ownership and Opportunity for People Everywhere (HOPE) initiative in 1990. The British government has privatized over ten percent of its council housing since 1980 and, since then, the proportion of households living in state-owned housing has dropped from a peak of one third to under a quarter.

4. RENT CONTROL IN CHINA

The original purpose of rent control in China was to provide minimum and equitable housing for all employees and their families. In the mid 1950s, the central government set guidelines for urban housing rents at arbitrarily low levels that had little to do with the economic costs of housing production and housing service provision. Rents were determined based on the size of the housing unit with quality adjustments (Gu and Colwell, 1997). The local governments implemented the low rent policy. From 1952-1997, rent and utilities accounted for 1.77 percent to 3.7 percent of household income, while 20 percent to 30 percent was a typical proportion in the USA and Western Europe. Table 1 shows the percentage of household income spent on rent and utilities in China from 1952 to 1997. Because of the low rent-low salary policy, rents collected were not sufficient to cover maintenance costs, let alone the cost of new housing construction. In the early 1980s, the estimated average maintenance cost was about 0.17 *yuan* per square meter per month, while the prevailing monthly rent was 0.13 *yuan* per square meter. The estimated construction costs of building high-rise apartments ranged from 300 to 600 *yuan* per square meter (Fong, 1988a). Rent could only cover 25 percent of maintenance and management and related costs (Carlson, 1987). The cost of building could not be recouped.

Table 1. Rent and Utilities as a Percentage of Income

Year	Rent and Utilities	Year	Rent and Utilities
1952	3.7	1975	2.0
1953	2.8	1976	2.0
1954	2.8	1977	2.2
1955	3.2	1978	2.2
1956	2.8	1979	2.1
1957	2.1	1980	2.1
1958	2.4	1981	2.1
1959	2.3	1982	2.2
1960	2.1	1983	2.1
1961	2.4	1984	2.5
1962	2.5	1985	2.3
1963	2.6	1986	1.91
1964	2.6	1987	2.05
1965	2.2	1988	2.83
1966	2.1	1989	2.77
1967	2.0	1990	2.28
1968	2.0	1991	2.28
1969	2.2	1992	2.38
1970	2.1	1993	3.28
1971	2.3	1994	2.76
1972	2.3	1995	4.33
1973	2.1	1996	4.48
1974	2.1	1997	4.51

Source: 1952-1985, Zhongguo Chenzhen (China City and Town), Vol. 2, 1987, P.48;
1986-1997, Statistical Yearbook of China, 1991-1998.

As the theoretical analysis in Section 2 indicates, rent control causes a shortage of housing and housing services. The systematic rent control under the government monopoly has caused serious problems in China. Four of these are particularly relevant and well documented:

A. Severe housing shortages. A survey of 237 cities conducted in 1982 revealed that the average living space per urban resident was 4.4 square meters, even lower than the 4.5 square meters in the 1950s (Carlson, 1987). Throughout the 1980s, twenty-five percent of urban families had living space of less than 2 square meters for each member (Tolley, 1991).

B. Poor maintenance and massive deterioration in existing housing units. There were large numbers of dilapidated buildings in most cities until recently. In 1980, there were approximately 30 million square meters of dilapidated housing (Lin, 1989). In 1982, about 11 million square meters of residential housing space were demolished (Shang, 1986), further aggravating the shortage but improving average quality.

C. Reduced quality of housing accommodations. In cities, most households had to share a kitchen and a bathroom with at least one other household. Many families even had to use public toilets outside their buildings. In 1985, over 30 percent of all urban households had no kitchen or running water in their housing units, and about 70 percent of all urban households had no flush toilet in their housing units (Lin, 1989).

D. Heavy financial burden on the government. The state was solely responsible for urban housing construction and maintenance. The state also provided housing subsidies to all urban employees because their salaries were not enough even for the low rents. Consequently, as more public housing was built, more funds for subsidies were needed. Total housing subsidies, explicit as well as implicit, have been large. These are difficult to measure accurately because most of the subsidies are implicit, in the form of low rent. Although implicit subsidies are equal to the difference between market rent and actual rent, they are difficult to estimate for this period, because the market rental price was invisible. One study shows that the higher the occupational rank of the head of the household, the higher the implicit subsidy (Gu and Colwell, 1997), but no complete estimate of implicit subsidies has been found. We are left with two measurements: one measurement is the government's expenditure on housing construction; the other is the government's expenditure on maintenance. From 1950 to 1979, governmental investment in residential house construction was 37.4 billion *yuan*. In the 1980s, the state spent 24 billion to 36 billion *yuan* each year on housing construction and nearly 10 billion *yuan* on housing maintenance and rent subsidies (Lim and Lee, 1993).

5. RENTAL HOUSING REFORM IN CHINA AND ITS ACHIEVEMENTS

The serious housing problems have spurred widespread social discontent. For the last two decades, China has been reforming government rental housing as part of its broader economic reforms. The reform started with rent increases, intended to 1) at least cover the costs of construction and maintenance, 2) maintain the current level of new housing construction, 3) improve the quality of housing management and maintenance, and 4) promote home ownership. In 1990, the government started raising rents incrementally in Shanghai, Beijing, Tianjin, Shenyang, Guangzhou, and many other cities. In Shenyang, the goal was to raise monthly rent for a housing unit with a water supply, heat, a private kitchen, and bath to 1.98 *yuan* per square meter by the year 2000. As a first step, rent was increased from 0.15 *yuan* in 1991 to 0.27 *yuan* in 1993. Rent was increased to 0.38 *yuan*, in 1994, and thereafter by increments to reach the target rate of 1.98 *yuan* in the year 2000. Additional rent was charged for higher quality or special features. For example, a hard-wood floor would cost an additional 0.02 *yuan* per square meter per month; wall paper 0.01 *yuan*, and aluminum doors or windows 0.19 *yuan*. Finally, there

was a surcharge if a family occupied more space than the officially established amount. As of May 1998, the average rent per square meter was 1.20 *yuan* in Shenyang, nearly as high as the average rate of 1.30 *yuan* in Beijing. Rent accounts for about 6 percent of household salary income.

Another reform measure made the implicit subsidies (through low rents) explicit. Rents were raised significantly and the subsidies became part of the regular income. In the pilot city of Yantai, monthly rent in 1987 was raised from 0.13 to 1.28 *yuan* per square meter, with a comparable increase of 23.5 percent of basic salary in the form of vouchers. If the value of the voucher was less than the rent, the household had to make up the difference; if it was more, the household could deposit the balance in an interest-bearing account and use it to pay for rent, housing construction and repairs, or the purchase of dwelling units (Fong, 1988b; Gu, 1988; Lim and Lee, 1993). In another city, Tangshan, rents were raised to 1.08 *yuan* per square meter, accompanied by a monthly housing subsidy of 24 percent of the basic salary.

To help low-income households, the government started the *Anju* ['Secure Housing'] Project in 1995. Under the project, 150 million square meters of housing were built by 2000 on government grant land and sold to low-income households at cost. This may help to alleviate the problems of inequality and affordability, particularly for the many low-income households that do not have rationed public housing and are not able to buy even at the ration price.

Housing commercialization or privatization is the ultimate goal of the reform. The government initiated new housing sales in 1979; the buyer usually pays one-third of the construction cost, with the remainder being paid in equal parts by the State and the buyer's employer. The amount paid by the buyer goes to a fund that the State uses for new housing construction. Housing markets are regulated by municipal governments following the central government's guidelines.

In 1995, a public Housing Saving Fund Program (HSFP) was started in most cities. Under the program, about 5 percent of an employee's salary is set aside for the program. This amount is matched by the employer, and the state then contributes funds equal to two thirds of the combined contributions of the employee and employer. That is, if an employee contributes 30 *yuan*, the employer makes a matching contribution of 30 *yuan*, and the state provides 40 *yuan*. The funds are deposited in an interest-bearing bank account, and the employee may use the money in the account only for housing purchases within the city. A participant of the program can buy the public housing unit at a reduced price, and obtain a low rate mortgage loan from a state bank. We believe that the explicit subsidies and low-cost financing instituted by the program can alleviate the affordability problem. The program does not, however, solve the existing problem of lack of purchasing power.

Foreign investment in residential housing is encouraged, through tax deductions and exemptions. In Shanghai, as much as ten percent of the new construction in 1994 was funded by foreign investors. These units are for-profit projects, typically of higher quality than those built by the government and provide an alternative for the wealthy.

On May 15, 1998, the government decided to "stop the welfare housing ration" and announced that the "housing ration will all be commercialized" (*People's Daily*, 1998), which means that the

government will no longer ration housing and households will purchase their housing in the free market. We believe that this represents the appropriate direction because free market economies have been proved to be more efficient than government controlled economies. Recently, rent increases have been accelerated in order to promote home ownership. However, the rent increase is not applied full-scale to laid-off households, which comprise over 30 percent of the households in industrial cities.

In recent years, more individuals have purchased their housing units under the HSFP, the reduced house price, the employer's match and government contribution, and the low rate mortgage loan proved to be helpful. By the end of 2000, around 60 percent of urban households had bought their formerly public apartments, while about 25 percent still lived in public rental units. Private rental markets have also emerged; about six percent of urban residents rent private housing. The average living space per urban resident reached 20 square meters. Starting on December 15, 2001, housing units purchased through government programs may be sold in the free market without limitation in Beijing. Shanghai had lifted the limitation in late 1997. Previously, homeowners had to wait at least five years to sell housing units that were bought under government programs. There has been no such limitation on housing units bought in the free market.

6. COMMENTS AND SUGGESTIONS

Raising rent is a prerequisite for market-oriented housing reform but it is not sufficient to accomplish full reform. Raising rent across the board will not transform the planned housing system into a market housing system. It may reduce price distortion to some degree since rents were artificially low, but it will still distort housing prices. Rent increases should be based on a proper estimate of rent determinants and available market data. For example, charging a flat rate per square meter does not reflect the market housing value of housing. Due to the declining marginal utility and marginal cost of additional space (the area occupied by walls does not, for instance, increase proportionally), increases in housing value are less than proportional to increases in area. Other factors being equal, if the value of a 65 m² apartment is 65 *yuan*, that of a 75 m² one should be less than 75 *yuan*.

To eliminate implicit rent subsidies and add the commensurate amount to wages is an appropriate reform because the welfare gain produced by a price subsidy can be achieved at lower costs by a cash transfer. However, in the Chinese system of state rent control, an employee's actual income includes both monetary income and implicit rent subsidies. Because the size of implicit rent subsidies varies according to occupational rank (Gu and Colwell, 1997), the effective housing price is not the same for all individuals. This means that the value of the different subsidies must be properly estimated. Since the right balance between rent changes and concomitant relative wage changes can be established as housing is privatized, an efficient housing allocation will be achieved.

The major problem in the housing market in China is the suppressed demand for housing units. Buying an apartment is still beyond the reach of many people. During the last few years, housing prices have been very soft, declining in most cities after sharp increases in the mid-1990s. While weak housing prices help make housing affordable, they reduce the investment value of owning one's home and make

buying less attractive. This has caused high vacancy rates in many cities. The high vacancy rate of new housing units not only represents a huge waste of resources but also creates financial strains on the builders and financial institutions that financed these projects. Because state enterprises are laying off employees in the ongoing privatization, it is hard to envision that the government will raise rent sharply and that these laid-off workers will be able to buy their homes. Because it is politically impossible for the government to withdraw completely from the housing sector, some form of rent control, and some form of government subsidies, will remain in the future.

Secondary housing financial markets need to be developed. These will provide significant funds to the housing sector by offering a variety of investment instruments to individual and institutional investors. These financial services will create many employment opportunities, thereby increasing household income. This, in turn, will stimulate the development of the housing sector. Mortgage-backed securities will be feasible as the amount of mortgage loans increases. Bonds may be issued against the funds (provided by employee, employer, and State in a 30/30/40 ratio) in the public housing savings program. These savings accounts will provide secured sources for interest and principle payments to bond holders. Regular interest and principle payments from borrowers can be used to pay interest on, and to retire, the securities.

For these reforms to be effective, private ownership and property rights, such as right of use, right of possession, and right of disposition of the property, must be secured by law and law enforcement. Full ownership rights provide sufficient incentives to guarantee the success of privatization efforts. Existing property rights, which are ill-defined and unsecured do not encourage participation in housing privatization, because they do not secure an owner's right to maximize expected future benefits. The private rental market, moreover, cannot function unless the right to evict non-paying tenants is secured by law and law enforcement. Property lacking the protection of these rights loses value, which in turn, jeopardizes housing privatization. Finally, there is still no provision for land ownership for private housing. Legally, the state owns all the land, homeowners rent the land from the government. This presents a major obstacle to housing privatization, and needs to be addressed by future reforms.

A variety of government-supported housing programs should be developed for low-income families. There will still be low-income families for the foreseeable future, and their housing problems could grow as housing is privatized. But the example of Western countries proves that housing programs entirely controlled by government are economically inefficient. Assistance programs that do not interfere with the market have been more efficient. For instance, governments have issued housing vouchers or coupons to the poor, who use them to pay rent to private landlords.

7. SUMMARY AND CONCLUSIONS

In China, urban housing rent control caused severe problems from the 1950s through the 1980s. The experience with rent control, decontrol, housing subsidies and housing privatization in both Western countries and non-communist developing countries can therefore provide points of reference as China continues to reform its housing system.

Housing reform in China has made undeniable achievements over the last 20 years. Private housing and rental markets are emerging, the cost of building and maintaining new housing units is no longer entirely borne by the government, more than 60 percent of households have purchased their homes, and living conditions are better than they have been during any period since the establishment of the People's Republic. However, China cannot eliminate rent control and the housing subsidy soon. Even in very affluent and developed countries, such as the United States or United Kingdom, there are sizeable populations living in rent controlled or subsidized housing.

We recommend appropriate estimation of rental determinants, development of secondary housing markets and sources of housing finance (such as mortgage-backed securities and public housing savings bonds) and legal guarantees of the security of private ownership. Because some forms of rent control and housing subsidies for low-income households will continue to exist, effective and efficient rent control and housing subsidy policies remain an important issue for further research.

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