Is Leasehold Housing Built on Government Land a Solution to Unaffordable Housing in Honolulu?

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Housing is expensive on Oahu. In the United States, only San Francisco and San Jose have higher single-family home prices. For most middle-class Honolulu households, even buying a median-priced condominium ($415,000 in February 2019) is financially out of reach, mostly due to the difficulty in making a down payment. Some state lawmakers propose to remedy the situation by developing high-density leasehold housing (i.e. condominiums) on state-owned and city-owned land near rail transit stations on the Honolulu rapid transit system now under construction (State of Hawaii 2019 Legislature, S.B. 1 S.D. 2 and H.B. 820 H.D. 1 S.D. 1).[1] The rationale is that condominiums could be much cheaper if buyers only have to lease, and not buy, the land under their homes. In fact, research has shown that for two identical homes, the leasehold home is typically priced lower than the fee simple home.[2] Leasehold housing reduces the initial cost of homeownership because buyers of leasehold homes need to come up with smaller down payments (as they are not buying the land) and enjoy lower monthly mortgage payments. An added benefit of developing homes near transit stations is that people who live near transit stations do not have to depend as much on costly automobiles and may be able to reduce their expenditures on transportation. Honolulu is far from alone in focusing on transit-oriented affordable housing development, as it is a strategy already being used in the San Francisco Bay Area to remedy high housing and transportation costs.

The inspiration for H.B. 820 comes from Singapore, where the national government has developed hundreds of thousands of leasehold condominiums on public lands. Leasehold housing is, however, rarely observed in U.S. housing markets. This could be due to preferences of U.S. homeowners to own both the land and the house, disadvantages to leasehold contracts, or to missed opportunities. Hawaii has a long history of private residential housing being built on leasehold land, but this system was dismantled in the 1980s and 1990s by state and county legislation that provided homeowners with a mechanism to purchase the leased land under their home. Our purpose in this UHERO Brief is to consider whether there may be costs as well as benefits to leasehold vis-à-vis fee simple housing, whether H.B. 820 considers these costs, and whether H.B. 820 will be able to achieve its stated goals.

Brief History of Leasehold Housing in Hawaii

The current proposal (H.B. 820) advancing in the 2019 Hawaii State Legislature that sets up a leasehold housing program on state and city land is a bit surprising because Hawaii has tried and largely rejected leasehold housing before.[3] Roughly 28,000 single-family leasehold homes were built in Honolulu through 1991, with most of them constructed after WWII on lands owned by large landowners, e.g., the Bishop Estate and the Campbell Estate. The 1967 Land Reform Act provided a mechanism for homeowners to buy leased land under their single-family homes.[4] Challenges to the Act were turned back by the U.S. Supreme Court in 1984 and the Hawaii Supreme Court in 1985. By 1991 homeowners had purchased the land under 23,400 of these homes.

A parallel reform agenda played out for leasehold condominiums in Honolulu. After enabling legislation for condominiums was passed in the early 1960s, both small and large landowners began to develop leasehold condominiums. By July 1989, just under 70,000 condominium units had been built in Honolulu, with 58 percent standing on leased land. In 1991, the Honolulu City Council passed legislation closely following the state's Land Reform Act that allowed condo owners to buy the land under their units. Between 1991 and 2004—when the Honolulu law was repealed, the number of leasehold condos fell from 40,916 in 1991 to 23,193 in 2004.

A more recent experiment by the University of Hawaii (UH) to develop leasehold condominiums on state land for sale to UH faculty also has a checkered history.[5] In the early 1990s, the University wanted to develop affordable faculty housing near its flag-ship campus in Mānoa Valley as a way to attract quality faculty to the University. It built 150 (below-market) rental units designed as transition housing for new faculty until they were able to find affordable, permanent housing in the private housing market. As part of this development, the University also built a leasehold condominium project with 30 three-bedroom, townhouse condos intended to be sold to UH faculty members at market prices.[6] The Hawaii Housing Finance and Development Corporation (HHFDC) was tasked to develop, finance and manage the project for the University. The Kauʻiokahaloa Iki condominium project was completed in October 1994 but by May 1996, only 8 of the 30 units had been sold.[7] UH then gradually bought back the handful of units it had already sold and converted them to rental units.

Advantages and Disadvantages of Leasehold Housing

One potential reason for the lack of demand for the UH leasehold housing project is that comparably-priced fee-simple units, unburdened by the presence of a landlord, were available in the market. The UH project raises the cautionary note that Hawaii residents who are aware of the troubled history of leasehold housing in Hawaii may not want to buy leasehold housing if comparable rental or fee simple housing is available. This is because leasehold tenure typically has many disadvantages for homeowners. The homeowner pays lease rent on the land after purchase;[8] there may be uncertainty about increases in future rent; lease rent is not a deductible expense against federal or state income taxes; the landowner may impose restrictions on physical changes to the property and how it is used and maintained; it may be difficult to sell a home that is approaching its lease expiration date or rent renegotiation date because lenders are unwilling to finance the purchase. Under Hawaii state law, a homeowner must be compensated for the value of the home and all other fixed improvements surrendered to a landlord at the expiration of the lease.[9]

One advantage of leasehold tenure is that leasehold homes are typically cheaper than comparable fee-simple homes because the land is not part of the purchase.[10] In their 1984 study, Jim Mak and Max Fry looked at the price differentials between comparable leasehold and fee simple single-family homes in Honolulu. Fry and Mak (p. 544) found that these price differentials were "extremely small," e.g., less than 10 percent in the Waialae-Kahala neighborhood. They concluded that "the empirical results indicate that leasehold has not constituted a solution to unaffordable housing in Hawaii." If the gain from using leasehold tenure rather than fee-simple tenure is less than 10 percent, then how could units developed under H.B. 820 be sold as affordable housing? Before we address this question, let's review the provisions of H.B. 820.

House Bill 820

H.B. 820[11] emulates the housing model developed in Singapore where 80 percent of its citizens live in public housing. The country takes pride in its high homeownership rate of around 90 percent. The government provides loans, subsidies and grants to home buyers, and a government-run mandatory savings program helps residents put aside money to buy a home. That home is necessarily a leasehold home because in Singapore all land is held by the state.[12] Duration of residential leases is typically 99 years. At the end of the lease, the land and improvements are surrendered to the government without compensation.

Singapore is not the only city where government leasehold housing is prevalent. In Canberra, Australia, all the land in the city is owned by the government and homeowners typically lease land for a term of 99 years. The 99-year lease is renewable and does not require additional rent payments. These leases are essentially perpetual and akin to fee-simple ownership. Likewise, all land in Hong Kong is owned by the government. Since 1997, the government has issued new leases that expire in 50 years, with annual rents equivalent to 3 percent of the assessed value of the properties. Leases may be extended at expiration at the discretion of the government. In Vancouver, British Columbia where there are pockets of leasehold residential property on land owned by the city, the Canadian federal government, the University of British Columbia and First Nations, residential leases are also typically for 99 years.[13]

For residents of Canberra, Hong Kong, and Singapore, fee simple or freehold tenure is not a realistic option, as governments have a fundamental commitment to refrain from selling their land. The situation in Hawaiʻi is similar, as there is substantial opposition to the sale of government and crown lands that were absorbed by the U.S. government at annexation in 1898. At statehood in 1959, Congress established a public land trust for these lands and distributed most of them to county and state governments. Revenues from the public land trust are distributed according to provisions specified in Hawaii's constitution. A 2009 law (Act 176, HRS § 171-64.7) requires that a sale of state lands be approved by a two-thirds vote of the Hawaii Legislature. When sales of public lands in Hawaii do occur, they are often accompanied by exchanges or purchases of private land in order to preserve the corpus of the land trust. Residential leasehold represents one way for the corpus of the state land trust to be preserved without having to resort to costly land exchanges or sales.[14]

H.B. 820, if passed by the Hawaii State Legislature, authorizes the Hawaii Housing Finance and Development Corporation (HHFDC) to develop leasehold residential condominium units ("ALOHA homes") on state (and city) lands located within one-half mile radius of a public transit station ("the urban redevelopment district") for lease terms of 99 years. Homes in the development district would be priced to be affordable to an individual or family whose income does not exceed 80 percent of the area median income, or at $300,000 (adjusted annually for inflation), whichever is less. Consider a family of three earning 80 percent of the median income that takes out a 30-year mortgage (4.0 percent interest rate) to buy a two-bedroom condo. HHFDC guidelines for Honolulu set the affordable price at $431,100, or just above the median condo price of $415,000.[15] Under the terms of H.B. 820, the price of an ALOHA homes condo would be set at no more than $300,000. At this low price, there would likely be excess demand for the homes built under H.B. 820 and HHFDC would need to establish a rationing mechanism to allocate units.

The bill does not specify the ground rent on these homes, an important omission; presumably the rent will be determined by HHFDC. No preference is given to first-time home buyers and there are no income restrictions placed on buyers or their spouses. Buyers must be state residents who (including spouses) do not own any other residential and non-residential property while owning an ALOHA home. The ALOHA home cannot be used for any purpose other than for owner occupancy. An ALOHA home can only be resold to another eligible buyer provided HHFDC has the first right of refusal to buy the home at a price to be determined by HHFDC that takes into account the homeowner's "cost basis" and inflation. HHFDC may demand a share of the appreciation of the unit. If HHFDC elects not to buy the home, the homeowner may sell the unit to another eligible buyer. In this case, HHFCD receives 75 percent of the net profit from the sale. If the homeowner dies and the heir is not an eligible owner, he/she must sell the home to HHFDC.

While building affordable housing is the primary purpose of H.B. 820, the bill includes a broader mandate than affordable housing. According to the bill, development of the bill's "urban redevelopment districts" must result in communities that permit a mixture of residential, commercial, light industrial, and other uses. All expenses for the development shall be covered by revenues from the sale of the residential leaseholds and from other revenue sources generated from development of the district. The program is supposed to be "revenue neutral" to the State; in other words, the State will not put up a single penny (net) toward the program.[16]

Given the various restrictive conditions imposed on the ownership of an ALOHA condo, a potential condo buyer would surely prefer to buy a comparable fee simple condo or rent rather than buy a leasehold home if the premium paid for the fee simple condo is not too large and the buyer has the requisite down payment and financing.[17] If, however, the choice presented to the buyer is between a median-price, fee-simple condo ($415,000) and a new ALOHA homes leasehold condo priced at $300,000, many buyers are likely to choose the ALOHA homes condo rather than pay a 38 percent price premium for the fee simple unit.

How can the ALOHA homes condos be sold for $300,000 or less?

H.B. 820 mandates that the project's newly developed (2-bedroom?) condos be sold for $300,000 or less.[18] A simple question to consider is whether a 2-bedroom condo can be built on Oahu for less than $300,000. Consider, for example, the estimates produced by StrategicEconomics in its 2016 Report for the City and County of Honolulu, *Affordable Housing Requirement Financial Analysis*. Its estimates of per unit construction costs assume that a number of fees imposed on new developments would be waived or reduced: Dedication Fee, Building Permit Fee, Property Taxes, and Wastewater Facilities Charge. The report develops four different housing prototypes that could be built in Pearlridge (low-rise housing), Kapalama (mid-rise housing), Ala Moana (high-rise housing), and Kapolei (low-rise housing). Development costs include "direct construction costs, indirect costs (including construction financing), land, and developer overhead" (p. 8). The analysis doesn't take into account the cost of new schools, sewers, utilities, parks, etc. that need to be put in place to accompany the new housing.

The report finds that per unit construction costs would amount to $473,095 for a low-rise unit in Kapolei, $467,007 for a low-rise unit in Pearlridge, $559,950 for a mid-rise unit in Kapalama, and between $510,038 and $572,260 for a high-rise unit in Ala Moana. For all of these projects, the land cost varied between 9 percent and 17.1 percent of the total project cost. Assume now that land costs would either be covered by the leasehold rent or the land would be donated to the project by the state or the city. The adjusted per unit construction costs—taking out the cost of land from each project—would be $409,452 for a low-rise unit in Kapolei, $409,892 for a low-rise unit in Pearlridge, $471,603 for a mid-rise unit in Kapalama, and between $462,414 and $474,446 for a high-rise unit in Ala Moana.

If per unit construction costs exceed the sales price of $300,000 by between $110,000 and $174,000, is the state planning to pick up the excess of construction costs over the sales price? And would the homeowners pay a market lease rent on the state land under their homes or does the state plan to subsidize the lease rent? H.B. 820 leaves these two important questions unanswered. Perhaps homeowner subsidies could be covered by other revenues generated by business development of these "urban redevelopment districts" around transit stations, but H.B. 820 is unclear on these issues. Answers to these two questions would make it a lot easier for legislators, policy makers, and citizens to evaluate H.B. 820.

Conclusion

Residential leasehold tenure has end game problems. As lessees face the prospect of higher renegotiated leases or giving up their housing assets at the end of the lease, they organize to try to get leases changed via the political process. If there is unanticipated price appreciation, lessees have incentives to get lease provisions changed to obtain some of the windfall profits. In Hawaii, homeowners were able to exert political pressure on state lawmakers to pass the 1967 Land Reform Act, which provided a process for them to purchase the leasehold land under their homes even when the land owner did not want to sell.[19]

Some of the end game problems associated with leasehold tenure can be deferred by establishing long leases (e.g., 99-year lease instead of a 55-year lease) as with ALOHA homes. But long leases eventually expire. Singapore is facing the lease expiration problem right now as the oldest public housing projects near the half-way mark of their 99-year leases, raising fears that homeowner investments will soon begin to depreciate in value. One Singapore housing agent noted that 70 percent of his customers are not interested in buying units older than 30 years. Homeowner fears were further stoked recently when the government announced that it would take back land occupied by 191 private houses when their leases expire in 2020. Singapore's prime minister noted that "[n]inety-nine years is a very long time. This is the only way to recycle the land."[20]

The problems with the end game in leasehold housing are succinctly captured in one Vancouver leasehold homeowner's advice when he said, "Make sure there's a minimum of 30 years on the lease when you plan to exit so that someone else can have a successful run with it, and the next buyer will have to deal with the exit plan."[21] For many owners of leasehold properties in Vancouver, choices regarding their exit plan will be coming soon. For example, leasehold housing units on Vancouver city-owned land in the False Creek South area have leases of 60 years, and hundreds of them will be expiring between 2036 and 2046. The Vancouver city government has begun discussions with tenants on end-of-lease issues.[22]

Is government land leasing the solution to unaffordable housing in Hawaii? It could certainly help by facilitating the use of State- and city-owned land around transit stations for affordable housing. And the government in its role as the master developer of leasehold projects on public lands could insist that lower-quality, more-affordable units be built on these lands rather than units oriented towards the upper third of the market. H.B. 820 is, however, silent as to how a (2-bedroom?) condo could be priced as low as $300,000 when per unit construction costs are likely higher. It is far from obvious how per unit construction costs ranging from $409,000 to $474,000 would be covered if the units are to be sold for $300,000.

If the State is planning to contribute $109,000-$174,000 per unit to construction costs, taxpayers should be aware that the bill implies these types of subsidies. Another important unanswered question is whether homeowners would be charged lease rents linked to the market value of the land or whether lease rents would be subsidized by the State. Right now it's unclear whether H.B. 820 is just a well-meaning but impractical venture or whether the new ALOHA homes program is counting on hundreds of millions of dollars of subsidies from the State.

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Endnotes

1 The City and County of Honolulu and the State are among the largest landowners along the rail line. The State of Hawaii has developed a set of maps showing city and state landownership in the areas around the transit line's stations. See http://planning.hawaii.gov/lud/state-tod/station-area-and-corridor-maps/.

2 Maxwell J. Fry and James Mak, "Is Land Leasing a Solution to Unaffordable Housing: An Answer from Fee Simple versus Leasehold Property Price Differentials in Hawaii," *Economic Inquiry*, October 1984: 529-549.

3 Sumner J. La Croix, James Mak and Louis A. Rose, "The Political Economy of Urban Land Reform in Hawaii," *Urban Studies*, 32(6) 1995: 999-1015.

4 Eric Maehara, *Real Property Leases*, Hawaii Legislative Reference Bureau, Report No. 5, 2003, at http://lrbhawaii.org/reports/legrpts/lrb/rpts03/realp.pdf. For alternative explanations, see Sumner La Croix, *Hawai'i: Eight Hundred Years of Political and Economic Change* (Chicago and London: University of Chicago Press, 2019): chapters 10 and 11.

5 Both private and public universities in the United States offer housing assistance programs to faculty. Some are rental programs while others offer opportunities to buy at a subsidized price. For example, Stanford University has developed a large number of leasehold homes on university land for sale to eligible faculty and staff. Similar ownership programs exist at University of California campuses.

6 More details about this project can be found at http://hawaii.gov/dcca_condo/reports/3231S.pdf.

7 We note that the UH leasehold condominium project involved pre-paid annual lease rents of just $1 for the full term –55 years–of the lease.

8 Homeowners prepay lease rents upfront on some leasehold projects. This mitigates advantages of a lower down payment on the mortgage.

9 The bill is silent regarding how on-site buildings and other on-site assets will be dealt with at the end of the lease.

10 A portion of the price discount may also stem from some of the disadvantages of leasehold tenure outlined in the previous paragraph.

11 See https://www.capitol.hawaii.gov/measure_indiv.aspx?billtype=HB&billnumber=820&year=2019 for the text of H.B. 820 and testimony on the bill.

12 See https://thelawreviews.co.uk/edition/the-real-estate-law-review-edition-7/1167965/singapore.

13 See https://www2.gov.bc.ca/gov/content/housing-tenancy/real-estate-bc/buying-selling/long-term-residential-leases.

14 In its testimony on Senate Bill S.B. 1, the Office of Hawaiian Affairs (OHA) expressed concern about locking up valuable state lands for 99 years and potential lease rent subsidies that would reduce payments to OHA from the land trust. See https://www.capitol.hawaii.gov/Session2019/Testimony/SB1_SD1_TESTIMONY_WAM_02-20-19_.PDF and https://www.capitol.hawaii.gov/Session2019/Testimony/SB1_TESTIMONY_HOU-WTL-GVO_01-31-19_.PDF.

15 See https://dbedt.hawaii.gov/hhfdc/files/2019/02/2018-HUD-Income-Limits-All-Counties.pdf for U.S. Dept. of Housing and Urban Development limits on income to purchase affordable housing for each of Hawaii's four counties.

16 Whether or not the Hawaii Housing Finance and Development Corporation has the capacity to carry out such a broad and complex mandate in a timely and efficient manner is beyond the scope of this brief.

17 While the lower price facilitates purchase of homes by first-time and low-income buyers, the profit-sharing provisions in H.B. 820 limit buyers from using the condo's appreciation to move up into better housing. Instead, these provisions lock them into their affordable homes. At some point down the road, leasehold home owners can be expected to organize politically to change the terms of their leases so that they can accumulate more equity to move up in the housing market.

18 Specifying a fixed price for an ALOHA Homes condo is somewhat problematic, as condos near the Honolulu downtown would likely be worth more than those located in Kapolei.

19 See La Croix, Mak and Rose (1995) and La Croix (2019).

20 Kok Xinghui, "Singapore's homeowners have 99 problems (and the lease is No 1)," *This Week in Asia*, August 22, 2018 at https://www.scmp.com/week-asia/politics/article/2160662/singapores-homeowners-have-99-problems-and-their-lease-no-1.

21 Kerry Gold, "Leaseholds, Great deals or potential nightmares?" *The Globe and Mail*, updated May 2, 2018 at https://www.theglobeandmail.com/real-estate/great-deals-or-potential-nightmares/article1378285/.

22 See https://council.vancouver.ca/20170712/documents/cfsc1.pdf and https://www.straight.com/news/935136/city-vancouver-faces-complex-negotiations-717-expiring-strata-leases-false-creek-south.