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# FACILITATING URBAN RENEWAL: CHANGING INSTITUTIONAL ARRANGEMENTS AND LAND ASSEMBLY IN HONG KONG

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## Abstract

**Purpose** – The paper examines the operation of the Land (compulsory sale for redevelopment) Ordinance, one of a series of urban renewal policy initiatives introduced by the Hong Kong Government. The new institutional arrangement was mooted as a means to facilitate greater private sector participation in the renewal process by overcoming existing constraints on land assembly, which arise as the result of a system of common property ownership. The paper investigates whether the legislation can achieve the objective of encouraging private sector participation in the urban renewal process.

**Design/methodology/approach** – The paper adopts a transaction cost framework, drawn from literature and applied in the context of real estate, to examine the effects of a new Ordinance. In addition to publicly available data, semi-structured interviews were conducted with professionals involved in urban renewal and representatives from the property development companies. The apparently low usage of the new approach is explored in the context of the various alternative mechanisms for land assembly available to the private sector and the effects of transactions costs on developer behaviour.

**Findings** – The paper identifies that the relatively low usage of the Ordinance may be explained by institutional constraints and limitations in the legislation, which, in its current form, fails to provide sufficient incentives, but that developer behaviour may also be affected by other external factors.

**Research limitations/implications** – The research is limited in that any commentary on the effectiveness of the legislation in achieving its objectives is restricted by the inability to clearly identify those incidences where the threat of legal action was sufficient to achieve a negotiated acquisition of the necessary property rights. Further research might explore the implications and the inter-relationships between the various urban renewal initiatives introduced by the Hong Kong Government.

**Practical implications** – The recent experience of the Hong Kong Government in designing a new institutional mechanism to overcome problems of private sector land assembly for properties in multiple-ownership may offer more general lessons for those in similar environments who wish to use the resources of the private sector to contribute to the urban renewal process.

**Originality/value** – The paper adopts a transaction cost approach to examine the working of a new policy initiative for facilitating land assembly in Hong Kong and may be of interest to academics and practitioners involved in the area of urban renewal.

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## **Keywords**

Hong Kong, Urban areas, Regeneration, Private companies, Land

## **1. INTRODUCTION**

A number of authors (Fong, 1985; Yeh, 1990; Lai, 1993; Adams and Hastings, 2000, 2001) have examined the urban renewal process in Hong Kong. In each case the authors identified the problem of land assembly as an underlying constraint of the success to redevelopment projects.

In Hong Kong, the major public agency involved in the urban process is the Urban Redevelopment Authority (URA), a statutory body, established in 2001 to replace the Land Development Corporation which, constrained by institutional arrangements, was seen as ineffective (Adams and Hastings, 2001). But in addition to the public agencies, the Government has always encouraged private sector involvement in the renewal process. However, by the 1990s there was an increasing awareness that the difficulties of assembling sufficiently large sites for redevelopment projects in the urban areas was making urban renewal a much less attractive option for the private sector developers.

The Government, recognising the need for a rethink, embarked on a complete review of institutional arrangements and policies and in 1999, as part of the wider changes to the institutional environment, introduced the Land (compulsory sale for redevelopment) Ordinance Cap545 which, it was believed, would facilitate land assembly by the private sector and thereby encourage greater interest in the area of urban renewal.

This paper investigates whether the new institutional arrangement can meet the objectives of encouraging private sector participation in the urban renewal process. The paper adopts an institutional framework, drawn from literature and applied in the context of real estate, to examine the effects of existing property rights structures on the land assembly process and the implications of the new institutional arrangement. The apparent low usage of the new mechanism is explored in the context of the various alternative mechanisms for land assembly available to the private sector and the effects of transaction costs on developer behaviour. The paper considers whether, in light of the findings, the new institutional arrangement provides sufficient incentive to encourage the desired private sector involvement in the renewal process. In addition to the publicly available data, semi-structured interviews were conducted with professionals involved in real estate and urban renewal and representatives from the property development companies.

## **2. INSTITUTIONS, TRANSACTION COSTS AND REAL ESTATE**

Assembling the necessary site for redevelopment is dependent upon the ability of the developer to acquire and control all the property rights and therefore, development proposals may be constrained by the actions and behaviour of owners (Adams, 1996). Ownership or property rights are the rights of the individual in relation to ownership, use and exchange of an asset. The nature of the right, whether private or held in common with others, affects owner choices in the control of the asset. The nature of the property right and the degree of control is therefore, an important consideration in a transaction, particularly given the opportunity to put the asset to a more valuable use (Eggertsson, 1995). Property rights do not necessarily remain constant, but may be changed as economic conditions change (Barzel, 1997).

The concept of examining the costs incurred in a transaction of property rights originated with Coase (1937) followed by the other authors (Williamson, 1985; North, 1990; De Alessi, 1991; Furubotn and Richter, 1991; Barzel, 1997). In his analysis of transactions, Williamson (1985) identified five elements of a transaction, which he defined as the characteristics of uncertainty, frequency and asset specificity and the behavioural assumptions of bounded rationality and opportunism, all of which create friction and affect the cost of a transaction.

The costs in relation to a specific transaction will be determined by the particular circumstances and institutional arrangements and are often categorised into those relating to search and information, negotiation and decision-making and supervision and enforcement. But as Hong (1998) notes, Williamson (1985, pp. 390-1) recognised that, in practice, transaction costs are not always measurable.

Institutions or 'the rules of the game' (North, 1990) are transaction governance systems or arrangements, designed to reduce the imperfections and uncertainties which increase the cost of interaction in the market. The study of institutions is important since, as Seabrooke et al. (2004) argue, they create a "public ordering context within which private ordering decisions occur". Although North (1990) suggests institutions are devised to reduce uncertainty and provide structure for society, there may be no rationale for the prevailing institutional structure (Ball, 1998). A review of the literature provides a number of explanations as to why inefficient institutional arrangements may exist, including the complexity of relationships and the high costs of effecting institutional change (North, 1990), the reflection of influence and power within society (Keogh and D'Arcy, 1998; Foss, 1995). But institutions change, as groups identify that existing institutions ignore benefits which could be secured by different arrangements and lobby Governments to alter the framework (Feeny, 1988). Hence the choice of institution is determined by the desire to minimise transaction costs.

Real estate markets are generally regarded as both institutionalised and inefficient. They are highly complex entities but weak transparency, substitutability and adaptive elasticity are all sources of uncertainty resulting in high transaction costs. In this case, using Williamson's (1985) approach of transaction characteristics and behavioural assumptions, an examination of the transaction costs of land assembly allows for a later assessment of the effects of the new legislation

In terms of land assembly, all Williamson's transaction characteristics will have a substantial effect on the cost of transaction. Uncertainty is important since it occurs as a result of an individual's limitations in knowledge and information in relation to both the asset and the preferences and information of the other party. The higher the element of uncertainty, the higher the transaction costs that will be incurred. The introduction of new institutional arrangements will, at least initially, increase the uncertainty of the operating environment and, until 'operationally' tried and tested, may add rather than reduce uncertainty to the process. Frequency may also be an issue in terms of land assembly, since the circumstances of each transaction will be different, and if large scale or high value may also be relatively infrequent. Acquisition of land in site assembly transactions is also highly asset-specific and, given the high value and competitive nature of real estate development, Williamson's behavioural assumptions of bounded rationality and opportunism will be demonstrated in the land assembly process.

Transaction costs in the land acquisition or assembly process involve searching and analysing information as to site availability, ownership and property rights and the institutional arrangements, since if the latter are well defined and understood, transaction costs will be lowered but, if either is poorly defined or in the process of being changed, then there is greater uncertainty. Depending upon the nature of the property rights, negotiating an agreement between the parties

may be a relatively speedy and straightforward process, but, in the case of assets held in common, the likelihood of hold-ups increases since each individual has to accept the proposal and, as Olson (1965) notes, individuals in larger groups may group together only when it is in their personal, rather than collective, interest to do so. The enforcement of exchange normally falls within the rule of law, but existing institutional arrangements have resulted in an expensive system of adjudication. All these factors affect the cost of any transaction of land assembly, making redevelopment in these circumstances a more costly and less attractive option

### **3. HONG KONG: INSTITUTIONAL ARRANGEMENTS AND LAND ASSEMBLY**

In Hong Kong the Government holds the freehold interest in land, assigning property rights to individuals through a system of leasehold interests. For properties in multiple ownership, these rights are structured as a co-ownership system of tenants-in-common, whereby each co-owner holds undivided shares in the whole. (Kent et al., 2002).

The adoption of a tenants-in-common property rights system has had far reaching implications for the process of assembling land held in multiple ownership. In order for redevelopment to take place, it is necessary to acquire all the interests in a property, but for the private sector this is entirely dependent on negotiating agreement and any individual owner can prevent the process by refusing to vote their block of shares. In these circumstances, private developers often face extended negotiations and unrealistic highly expectations as to values, resulting in delays in the land assembly process.

In order to address the difficulties of acquiring properties held in multiple ownership, the Government introduced the Land (compulsory sale for redevelopment) Ordinance Cap545. The Ordinance is designed to make the process of land assembly for redevelopment easier by allowing “the majority owner” of the undivided shares in a lot to make an application to the Lands Tribunal for an order of sale of all the undivided shares. Providing the Lands Tribunal is satisfied that the conditions specified in the Ordinance have been met then the property can be publicly auctioned and the proceeds divided between the owners.

Although the public acquisition of private property rights for the subsequent disposal to private developers has precedent in a number of jurisdictions (Adams, 1996; Ulen, 1992) as can be seen from the restrictions placed on the Land Development Corporation (Adams and Hastings, 2001), the use of Government resumption powers for non-public purposes is a politically sensitive issue in Hong Kong. But, as Cruden (1999) notes, the introduction of a specific institutional arrangement to allow the private compulsory acquisitions of private property rights raises an even greater number of issues. It is not however, the intention of this paper to address the legitimacy of the infringement on private property rights, but rather to examine the transaction cost implications of the new arrangements on developers’ choice and behaviour in the land assembly process.

Although there is no available information as to how many parties have successfully agreed a negotiated settlement on the grounds that the legislation would apply, it is possible to investigate the number of applications to the Lands Tribunal as an indicative measure of the extent of interest in using the legislation.

An analysis of the Lands Tribunal records indicates that four applications were submitted immediately the legislation became operative in 1999 and, by the end of 2003, a total of eight applications had been submitted. As a matter of public record, the Tribunal has granted an order

for sale in two cases and the representatives of the developers confirm a further three reached negotiated settlement before the completion of the hearing. The remainder are currently in abeyance. On the basis of this information it appears that, despite the acknowledged difficulties of acquiring properties in multiple ownership, few developers have chosen to institute proceedings under the new Ordinance.

#### 4. LAND ASSEMBLY: A TRANSACTION COST FRAMEWORK

The Government's intention in changing the institutional arrangements in relation to the control of property rights was to provide an additional incentive for the private developers by reducing uncertainty in the land assembly process. However, it should not be assumed that land assembly through the acquisition of properties held in multiple ownership is the only strategic option for property developers seeking to acquire development sites.

The paper therefore looks at the other major options available to the private sector property developers for acquiring land for development purposes in Hong Kong. Adopting the arguments in Hong (1998), a modified transaction cost framework can be devised to examine the relationship between the private developers' strategic options for land assembly and the extent to which the level of transaction costs incurred in each of the options will affect the behaviour of the developer. Accepting that each organisation's knowledge and information may be different and assuming Williamson's transaction characteristics and behavioural assumptions are exogenous variables of a transaction then, in overall terms, the level of the transaction cost between the different options will depend upon the transparency of the information, the numbers of parties involved in the negotiation and the available enforcement mechanisms.

Adopting a deductive approach, it is therefore possible to devise a modified transaction cost framework, which identifies the likely level of transaction cost that will be incurred in each of the above categories, for each of the principle options available to a developer wishing to assemble land in Hong Kong.

As indicated in Table I, it may be deduced that the highest levels of transaction costs will be found in private negotiations with individual co-owners. Such transactions are likely to involve extensive information searching and prolonged negotiations with large number of parties, which may, in turn, increase the need for increased supervision and enforcement.

<b>Principal options for land assembly in Hong Kong</b>					
	<b>Market</b>				<b>Portfolio</b>
	Individual negotiations with private owners	Individual Government land sales programme	Joint venture with statutory bodies	Acquisition of companies (with property assets)	Land bank (internal asset holdings)
Searching & Analysing	High	Low	Low	Medium	Low
Negotiation & decision making	High	Low	Medium	High	Low
Supervision & enforcement	High	Low	Low	Medium	Low
Source: Compiled by the authors					

**Table 1: Modified transaction costs framework for land assembly in Hong Kong**

As an alternative to the direct acquisition of individual sites, developers may attempt to acquire companies which own substantial real estate assets as part of corporate resources. In this case, although the initial acquisition of the company will involve information search and negotiation costs, the level of transaction costs may be lower than those associated with the assembly of multiple ownerships and, if successful, the developers will acquire a portfolio of redevelopable assets.

Where the level of information search and negotiation costs are high, other alternatives such as acquiring land offered under the Government's land sales programme (see Table II) will become more attractive. In this case, the clearly defined property rights and exchange process will lower the search information costs, and the increased transparency of the auction or tender arrangements will reduce the requirement for extensive negotiation with numerous parties. It is likely that monitoring and enforcement costs will be lower than those incurred in private transactions as the Government is unlikely to withdraw from the transaction.

Land sales and tenders						
	Hong Kong Island		Kowloon		New Territories	
Date	Number	Area (m <sup>2</sup> )	Number	Area (m <sup>2</sup> )	Number	Area (m <sup>2</sup> )
2001-2002	–	–	4	39,473.00	10	46,222.00
2002-2003	3	5,795.80	3	27,455.00	2	20,658.80
2003-2004	3	5,034.00	3	14,737.70	4	7,464.20

Source: Lands Department, Hong Kong Government

**Table II: Government land sales: 2001-2004**

Although negotiations with a joint venture partner will create higher levels of transaction costs than acquiring land at a Government auction, joint venture transactions with a statutory body will have similar advantages of greater transparency over private negotiations. Table III shows the number of joint venture projects offered by the URA.

Date	Location	Site area (m <sup>2</sup> )	Use	Parties tendering to joint venture	Successful developer
26.07.02	New territories	2,030	Residential/commercial	7	Sino Land Co.
29.08.02	HK Island	73	Residential	4	Kowloon Developer
26.04.04	New territories	7,782	Residential/commercial	14	Sino Land Co.
10.06.04	HK Island	2,120	Residential/commercial	14	K. Wah Holdings

Source: Compiled from Urban Renewal Authority press releases (various)

**Table III: Joint venture projects: Urban Renewal Authority**

Given the high asset specificity of real estate, some developers may prefer to operate within a hierarchical governance structure, which allows for a great degree of control and lower transaction costs. Many developers in Hong Kong hold extensive real estate portfolios or land banks (see Table IV) and at certain times may choose to carry out development activities by utilising their existing portfolio assets in preference to acquiring land in the market.

<b>Land bank of property companies' portfolio holdings in Hong Kong (million feet<sup>2</sup>)</b>			
<b>Developer</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
Sun Hung Kai	54.1	50.4	45.3
Henderson	21.3	20.9	19.0
New World	17.0	20.0	18.7
Cheung Kong	21.8	21.9	18.6
Sino	12.3	16.1	15.8
Swire Pacific	14.7	14.7	15.3
Hang Lung	9.2	9.1	10.0
Hongkong Land	5.3	5.3	5.1
Notes: Compiled as square feet attributable gross floor area			
Source: Companies annual reports			

**Table IV: Hong Kong Developers: portfolio holdings**

As is indicated in Table I, in the absence of any specific institutional arrangements facilitating land assembly, the highest level of transaction costs for a private sector developer will be incurred in negotiation with individual owners. Given the new institutional arrangements are specifically designed to address this situation, it might be anticipated that the developers would choose to invoke the legislation in order to reduce the transaction costs associated with this form of land assembly.

One explanation for the lack of interest may be institutional uncertainty. The introduction of new institutional arrangements will not immediately guarantee a more certain environment and until such time as it becomes clearer as to how the Court will interpret and enforce the new legislation, there may be a degree of operational inertia. Hence the relatively low usage of the new arrangement may be the outcome of developers' uncertainty as to the level of transaction costs which will be incurred. Therefore, although the legislation has been successfully implemented in two cases, the period of time since the introduction of the legislation may simply be too short for developers to feel comfortable with the new arrangements.

It should not be assumed that the introduction of new institutional arrangements will automatically generate more interest in urban renewal projects. Over time different developers will have gained experience and developed their own areas of expertise. Since operating in a familiar environment increases the frequency of operation and reduces transaction costs, the introduction of a new institutional mechanism may be of little interest to developers who do not chose to assemble land in this way.

Although the introduction of majority ownership thresholds will lower the transaction costs, it may also be argued that the requirements of the legislation are such that the reduction in transaction costs is too small to provide sufficient inducement for developers to choose this method of land assembly over other alternatives. The requirement for acquisition of at least 90 per

cent of the interests and proof of attempts to acquire the remainder on fair and reasonable terms will still involve protracted negotiations. The legislation does however, contain a provision for the chief executive to reduce the threshold to 80 per cent, but to date this option has not been exercised.

Comparisons can be made with Singapore, where in 1999 the Singaporean Government adopted a similar approach to the difficulties of assembling land in multiple ownership and amended the Strata Title Act to allow collective sales of strata title property where (for properties over ten years old) a minimum threshold of 80 per cent of the owners wished to sell their interest (Christudason, 2003). Richard (2003) notes that the amendment has increased interest in collective sales for redevelopment, resulting in eight sales in 2003.

The way in which the legislation is enacted may also create a situation in which a developer is unable to utilise the mechanism to assemble a project site. The Ordinance requires the acquisition of 90 per cent of the interests in a “lot”. But in practice, if a lot contains four interests then it is technically impossible to acquire 90 per cent of the interests and so the Ordinance will not apply. The problem may be compounded in the case of larger scale redevelopment projects which may cover several lots, demonstrated by a proposed redevelopment project for which the site has been assembled piecemeal over a period of some 20 years. The total site area is 118,800 sq. ft (11,037 m<sup>2</sup>) of which the developer has acquired 73,000 sq. ft (6,782 m<sup>2</sup>) by negotiation and agreed a further land exchange of 45,000 sq. ft (4,180 m<sup>2</sup>) with the Government, but is unable to reach agreement with the owners of two remaining units (totalling 800 sq. ft/74 m<sup>2</sup>) and unable to invoke the legislation (The Standard, 2003)

<b>Project</b>	<b>Percentage of interests acquired by negotiation</b>	<b>Commencement date of project (Under LDC)</b>	<b>Resumption approved</b>
Cherry Street, Kowloon	86	1999	February 2003
Fuk Wing Street/Fuk Wa Street Kowloon	84	1999	February 2003
Johnston Road, Hong Kong	92	1999	December 2003
Po On Road/Shun Ning Road, Kowloon	89	1999	June 2003
Reclamation Street, Kowloon	80	1999	June 2003
Source: Urban Renewal Authority Annual Report 2002-2003			

**Table V: Urban Renewal Authority Projects (2003)**

It is also important to appreciate that the Land (compulsory sale for redevelopment) Ordinance is not the only recent change in institutional arrangements affecting urban renewal. In creating the Urban Renewal Authority, the Government has introduced an alternative and more comprehensive supply-side mechanism which may be a more realistic instrument to implement the objectives of urban renewal outlined in the Urban Renewal Strategy (2001). Although the Urban Renewal Authority chooses to negotiate with affected parties, the power to implement resumption procedures without the requirement of meeting a 90 per cent ownership threshold ensures that land assembly is less of an issue (see Table V). The framework set out in Government's strategy document, requires the authority to produce a series of five-year Corporate Plans

identifying projects that will start during the period. This arrangement is likely to deter any private sector interest in assembling sites in an “identified” area since there is no guarantee that the authority will later agree to any joint venture partnership arrangements.

Although developers have not chosen to make extensive use of the new mechanism, Ball (1998) argues that it cannot be assumed that any private sector activity (or inactivity) is directly related to the new arrangements since development activity may be more the result of external changes in the economy than the introduction of new institutional strategies. This view may well be applicable in the present case, where developers’ current lack of interest in utilising the new arrangements may have more to do with the carrying of up-front costs in a deflationary as opposed to an inflationary economic climate.

## **5. CONCLUSION**

By applying a transaction costs approach, the paper identifies that the acquisition of land by negotiation from individual owners in properties held in multiple ownership results in higher levels of transaction costs than the alternative methods of land assembly for private sector developers.

However, an examination of the available records provides little indication that private sector developers have chosen to take advantages of the new institutional arrangement. Further investigation indicates that the limited usage of the Land (compulsory sale for redevelopment) Ordinance may have a number of underlying causes, all of which will affect the transaction costs of the operating environment and hence the developers’ behaviour.

First, the design and structure of any new institutional arrangement must, in reality, involve compromise. An obvious difficulty for any government in devising new institutional arrangements is to achieve the desired objectives whilst balancing the claims of individual property rights and wider public interest. As Ball (1998) suggests “Potential for institutional change must reflect what is feasible rather than what is ideally desirable and changing institutional arrangements in the law might have the potential to enhance market efficiency but be unfeasible from the viewpoint of social attitudes to property rights”. The new Ordinance falls clearly into this category. The Government is well aware of the difficulties created by the common ownership property rights structure since this not only affects redevelopment but also another area currently undergoing policy review, the management of such properties. The issue of whether the new Ordinance would contravene the Basic Law, Hong Kong’s constitution, was also discussed during the debates in the Provisional Legislative Council.

As the paper identifies, in its current form, the legislation has inherent defects as an institutional mechanism. The threshold is set at a level which is difficult, and in certain situations, impossible, to achieve. The experience of the Urban Renewal Authority appears to indicate that even the offer of generous ex gratia payments is insufficient to achieve negotiated acceptances and resumption powers are invoked before the 90 per cent threshold level. In practice, although the majority ownership provision will assist in certain cases, at this threshold level it appears not to provide sufficient incentives to make it of interest to the developers. The legislation is also designed to apply only to the acquisition of an individual lot but acquisition on a lot by lot basis may be of limited benefit to developers in assembling a site. This has resulted in further lobbying for more direct incentives.

The research also identifies that limited utilisation may have little to do with the design of institution mechanism per se, but is rather the result of more general factors such as institutional

uncertainty, developers preferences for operating in more familiar arenas or the economic climate in Hong Kong at the present time.

Finally, the research indicates that the Ordinance is not a panacea for the difficulties experienced by the private sector in land assembly process. In the long run it appears likely that with a much wider remit and powers, the newly created Urban Renewal Authority will dominate redevelopment activities in the urban areas. In these circumstances assembling multiple ownership sites will become increasingly less attractive, private sector participation will take the form of joint venture arrangements as an easier and cheaper option and the Ordinance is unlikely to be anything more than a minor weapon in the armoury of institutional devices.

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