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**INFORMAL INSTITUTIONS IN MULTIPLE OWNERSHIP
PROPERTY IN HONG KONG**

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Abstract

Hong Kong's image is often portrayed as a sophisticated financial centre with high value real estate, home to some of the tallest, technically complex modern buildings in Asia. For citizens living in older urban areas outside the CBD the reality is somewhat different. In recent months falling masonry has killed one woman and a balcony collapse has injured two children. The Government is well aware of the poor state of private buildings in multiple ownership and has undertaken a number of initiatives to improve the situation, following a spate of fires in which 63 people died in a six-month period. This paper examines the institutions governing the maintenance and management of buildings held in multiple ownership. The formal institutions of contracts and statutes are outlined. These are contrasted with the informal institutions of social customs and cultural norms that affect the execution of the formal rules, to assess the potential of government initiatives to improve the standard of maintenance in multiple ownership buildings.

Introduction

Institutions are man made rules that govern human interaction by constraining opportunistic or arbitrary behaviour. They serve to reduce uncertainty in transactions between people by providing a structure within societies (North 1990). In creating greater certainty they can be used to reduce the costs of the transaction between parties, such as costs of monitoring and enforcement. The institutions under examination in this paper are those governing the maintenance and management of commercial and residential multi-storey property held in multiple ownership in Hong Kong. The Government of Hong Kong is examining the formal rules of contracts and statutes after a number of fires and injuries to members of the public, all due to poor property management and maintenance. This paper sets out the literature to suggest that informal rules of society are equally important in the outcome and that the formal rules must be compatible with the informal social customs and norms of Hong Kong.

Formal institutions such as laws and contracts have long been understood to affect economic performance (Eggertson 1990). Informal institutions of societal customs and norms have increasingly been studied, particularly by North (1990), as they determine the incentives in formal rules and the methods of enforcement. The latest development in the study of institutions is the impact of culture in determining informal norms (Casson 1993 Greif 1994, 1997, Bowles 1998), which then in turn determine the execution of formal rules. Therefore changes in formal rules must be undertaken in the light of informal societal customs and norms. North comments '...the informal constraints that are culturally derived will not change immediately in reaction to changes in the formal rules.' (45:1990). Ensminger (1997) examines this framework of informal rules impact on changes in formal rules, in a study of changing property rights in the land tenure system in Africa. She concludes '...complementarity between formal and informal institutions, really is crucial to successful property rights change.' (192:1997).

Informal institutions derive from the structure of society, the way in which people relate to each other. One aspect is considered here, that of individualism and collectivism (Hofstede 1980, Bellah *et al.* 1985, Gudykunst *et al.* 1987, Triandis *et al.* 1990, Greif 1997). In summary, individualistic cultures emphasize individual goals and society is integrated in that transactions are conducted by people from other groups and that individuals shift frequently between groups (Greif 1997). In collectivist societies people belong to in-groups or collectivities which are supposed to look after them in exchange for loyalty. In collectivist societies social structure is more segregated with individuals acting within their own social and economic group, where contract enforcement is through informal social means (Greif 1997). For a full account of individualism and collectivism see Early and Gibson (1998).

The culture of Hong Kong has been assessed as being collectivist by a number of studies (Hofstede 1980, Wheeler *et al.* 1989, Triandis *et al.* 1990). Informal institutions rising to deal with uncertainty will rely on a social structure that is collectivist. The existing formal institutions governing property management and maintenance are primarily contracts under the common law system inherited from England, one of the most individualistic societies. The contracts are often badly written and are incomplete (Neild 1990, Walters and Hastings 1998) producing a great deal of uncertainty between the parties which is dealt with through informal social practices. This paper suggests that the collectivist structure of Hong Kong society produces informal institutions which are incompatible with the existing formal institutions. The effect is a failure of management and maintenance on a wide scale. A basis for empirical work is established from the literature.

Background

Hong Kong Special Administrative Region of the People's Republic of China (HKSAR) was occupied by the British as a colony until 1997. As a result many of the formal institutions such as the common law system, property planning and rating systems are modelled on English practice. However in the 1950's Hong Kong introduced what has proved to be an important exception to the British approach, namely a different system for the multiple ownership of property. In the case of buildings, which were to be in multiple rather than single ownership, the owners would become tenants in common holding undivided shares in the property within the common law system.

In many places, such as Australia, Singapore and Malaysia, property in multiple ownership is managed on a statutory basis through a system of strata title (Khuball 1995). On purchasing a flat unit, an owner acquires three indivisible rights (Van der Merwe 1994), the right to occupy the unit, the right to a share in the common parts and a right (or obligation) to participate in the management of the building. Hong Kong has not adopted this approach for a number of historical reasons, including a tenure system based on leasehold, the absence of a strata surveying system and the speed with which multi-storey development took place in the 1950's; all of which created 'a need for an immediate legal

solution to protect purchasers within the existing deed system' (Sihombing and Wilkinson 1994).

As a result Hong Kong introduced a system whereby each co-owner, whilst having the right to the exclusive use of their unit, does not own the unit but rather a share of the whole building, as a tenant in common with equal shares in the government lease. The contract document, which is normally used to formalise this agreement, is known as a deed of mutual covenant (DMC). The terms of the DMC are agreed by the first purchaser of a unit, the developer and a property manager appointed by the developer. Although not party to the DMC any subsequent purchasers are bound by the terms. The DMC sets out the rights and responsibilities of the owners, the details of the management of the building and allows for the employment of a property manager. Unlike a statutory system, the rights and responsibilities of owners to participate in management depend on the private contract of the DMC. If there is no clause to that effect then owners have no obligation to participate. Owners wishing to participate in the management of common property must join together in some form of collective action with all the other owners, which is often difficult to achieve (Olson 1965).

Government Initiatives on Building Maintenance

Hong Kong has struggled with problems of poor property maintenance and management for a number of years. Ho (1993) reviewed the situation following the collapse of a building in 1990 and a Government initiated survey of all private buildings in urban areas by the Buildings Department, to identify their condition. Ho identified the main problems as being no legislation requiring owners to have their buildings inspected and maintained regularly, low rental returns on older property and apathy towards maintenance by owners. In 1998 the Government once again commissioned various government departments to investigate the condition of around 27,000 private buildings in urban areas, this time as a result of a spate of fires in which 63 people died in six months (see Walters and Hastings 1998 for details of the fires). The findings showed the majority (72%) of private property inspected was unsafe with respect to fire safety (Hong Kong Government 1998a). The government departments identified the cause of majority of fire safety offences as resulting from poor property management. In the same survey the findings were that where a central management body was present in a building, only 14% of properties were unsafe.

More recently the Government's attention has once again turned to property management and maintenance following the death of a woman in August 1999 when a piece of concrete fell from a private building and hit the woman killing her. This incident was closely followed by the injury of two children in October 1999, when an illegal structure balcony on which they were playing collapsed.

The Government first considered a mandatory building safety inspection scheme in 1997, but so far it has only been implemented on a voluntary basis. The Government is also considering imposing professional managers on buildings it considers to be

unsatisfactory. This paper reviews the likely effects of these measures in improving the urban environment in Hong Kong.

Institutional Systems and Collective Action Problems

Institutions in societies may be defined as the set of laws, customs and societal norms that determine property rights, which in turn define the range of privileges granted to individuals with specific assets (Eggertsson 1996). The term property rights in this paper, includes benefits and restrictions in relation to the use of the asset. Institutions affect the cost to parties in negotiating the use and control over assets. These costs are termed transaction costs and have been described as 'the cost of using the price mechanism' and 'the cost of carrying out a transaction by means of exchange on the open market' (Coase 1937, 1960). The field of transaction cost economics has been extended by Williamson (1975,1985), through the examination of the costs of conducting transactions in markets through negotiations and within organisations (hierarchies). The costs of the transaction relate to information and search costs, bargaining and decision costs, and policing and enforcement costs. Coase suggested that transaction cost economics explain that a transaction will take place either within the market or within a hierarchy dependant on where the transaction costs are lower.

Institutions affect the bargaining and decision costs and policing and enforcement costs of a transaction by setting out the rules that govern the conduct of the parties to the transaction. Given the constraints of bounded rationality and opportunism, parties have incentives to find ways to lower the costs of controlling assets, whether through a market control structure or organisational control structure, in order to lower transaction costs and to put the assets to more valuable uses. The economics of institutions examines how different control structures emerge in different cultures, survive and decay and the implications of control structure on contractual arrangements and economic results (North 1990,1996, Eggertsson 1996).

Cultural beliefs are the ideas and thoughts of groups of individuals that govern their interaction within societies (Greif 1997). These beliefs govern people's expectations of how others will behave in a given situation and allows them to make choices about their own behaviour based on these expectations. The culture of the society in which the rules operate will affect the formation and enforcement of institutions. Societies have been described in terms of as either having individualist or collectivist cultures in social sciences for about a century (Triandis *et al* 1990). In recent years Hofstede (1980) worked with IBM employees from 66 countries to identify the cultural traits of different societies including one factor of 'collectivism -individualism'. The major difference can be outlined collectivists think of the groups as the basic unit of analysis whereas individualists think of individuals as the basic unit of analysis (Nakane 1970). Triandis *et al.* (1990) replicated the results of some of Hofstede's work relating to this particular aspect of culture, using samples of from 5 different cultures,

Illinois USA,
 Athens Greece,
 Hawaii (students of European and Asian background)
 Hong Kong
 People's Republic of China.

Their research developed attributes defining individualism and collectivism, as well as their antecedents and consequences. A summary is reproduced in figure 1.

<i>Antecedents</i>	<i>Attributes</i>	<i>Consequence</i>
Individualism		
<ul style="list-style-type: none"> • Affluence • Cultural complexity • Hunting/food gathering • Upper social class • Migration • Urbanism • Exposure to the mass media 	<ul style="list-style-type: none"> • Emotional detachment from in-group • Personal goals have primacy over in-group goals • Behaviour regulated by attitudes and cost-benefit analyses • Confrontation is okay 	<ul style="list-style-type: none"> • Socialisation for self-reliance and independence • Good skills when entering new groups • Loneliness
Collectivism		
<ul style="list-style-type: none"> • Unit of survival is food in-group • Agriculture • Large families 	<ul style="list-style-type: none"> • Family integrity • Self defined in in-group terms • Behaviour regulated by in-group norms • Hierarchy and harmony within in-group • In-group is seen as homogeneous • Strong in-group/out-group distinctions 	<ul style="list-style-type: none"> • Socialisation for obedience and duty • Sacrifice for in-group • Cognition: Focus on common elements with in-group members • Behaviour: Intimate, saving face, reflects hierarchy, social support, interdependence

Figure 1 Attributes defining Individualism and Collectivism and Their Antecedents and Consequence

(Source Triandis McCusker and Hui 1020:1990)

In collectivist societies, people pay particular attention to their 'in-group', the group with which the most readily identify. It is usually the family unit, but can be any group that is

perceived to have a common fate (Triandis *et al.* 1990) and so can include work groups or religious, ethnic and other social groupings. Greif (1997) suggests that collectivist societies are more segregated in that each individual is closely tied to the in-group where contract enforcement is achieved through informal social institutions, 'whereas non-cooperation characterises the relations between members of different groups' (58:1997). Triandis *et al.* (1990) drew a similar conclusion in their work and found that in collectivist societies attitudes towards in-groups and out-groups were found to be more markedly different than in individualist societies. In individualist societies individuals identify with in-groups and out-groups but '..do not see as sharp a contrast and do not behave as differently toward in-group and out-group members as do collectivists' (Triandis McCusker and Hui 1007:1990).

Gudykunst *et al.* (1987) studied communication patterns between in-groups and out-groups in both individualistic societies and collectivist societies. They hypothesised that communication between strangers in individualistic societies would be less difficult than in collectivist societies. In a study of the USA, Japan and Korea, they found that as predicted the least difficulty was found in individualistic USA, and the most in collectivist Korea. They conclude that their framework and findings are consistent with other major cross-cultural studies in social psychology (Bond *et al.* 1982,1985, Leung & Bond 1984,1989).

Over time, some societies appear to become more individualistic as people grow more affluent and financially independent of their in-group. In Hofstede's original study in 1980, Hong Kong was found to be collectivist but that study was based on data collected in the late 1960's. Hong Kong's exceptional growth over the last thirty years lead Triandis *et al* to suggest that Hong Kong would move to a more individualist society. In their study in 1990, Hong Kong was rated as more collectivist than Greece, which is traditionally highly collectivist (Triandis 1972), but less collectivist than the People's Republic of China. The increased prosperity from the 1960's to 1980's had not significantly reduced the collectivist nature of Hong Kong.

The structure of society - whether more individualistic or more collectivist- has implications for the way institutions are formed and enforced. Individualists prefer 'co-ordination by voluntary exchange within a framework of rules whereas collectivists incline to central ordering and planning by directive' (Kasper and Streit 155:1998). Enforcement of rules in individualist societies is through the attitudes of the individual's likes and dislikes towards a rule, whereas in collectivist society enforcement is regulated by in-group norms. Where rules are aimed at the community at large that forms part of the out-group, the extent to which it will be obeyed depends on the degree to which obeying the rule is perceived to benefit the in-group in collectivist societies. In individualistic societies the treatment by individuals of in-groups and out-groups is much less marked and less likely to influence the adherence to rules.

Logic of collective action

Mancur Olson's classic book 'The Logic of Collective Action, pinpointed the problem of whether groups with a common interest would act together to fulfil a common goal. Olson's insight was to suggest that rational self interested individuals in large groups will not automatically join together to solve a collective action problem, despite it being in their best interest to do so. Individuals will only band together when they have an incentive to do so. The incentives to join together are markedly different in large and small groups. Hovi and Foss (242:1995) define a collective action problem as '..one where a number of decision makers has to decide unilaterally whether or not to contribute to the provision of some collective good'. The characteristic of a collective good is the non-excludability which means all members of the group will benefit whether or not they contribute to the cost, allowing the possibility of group members free riding on the contribution of others.

In the case of collective action for property management, the collective good is the provision of building maintenance and management. The structure of the problem is how to provide an incentive for owners to contribute towards building management and maintenance. The point of Olson's book is that groups will not automatically group together to provide collective goods despite it being in their best interest to do so. The problem of free riding implies that without some authority to ensure participation by all group members, action will be doomed to failure. The provision of an authority to provide solutions to collective action problems can rely on formal external authority or informal institutions of social norms and customs internal to the group to ensure compliance.

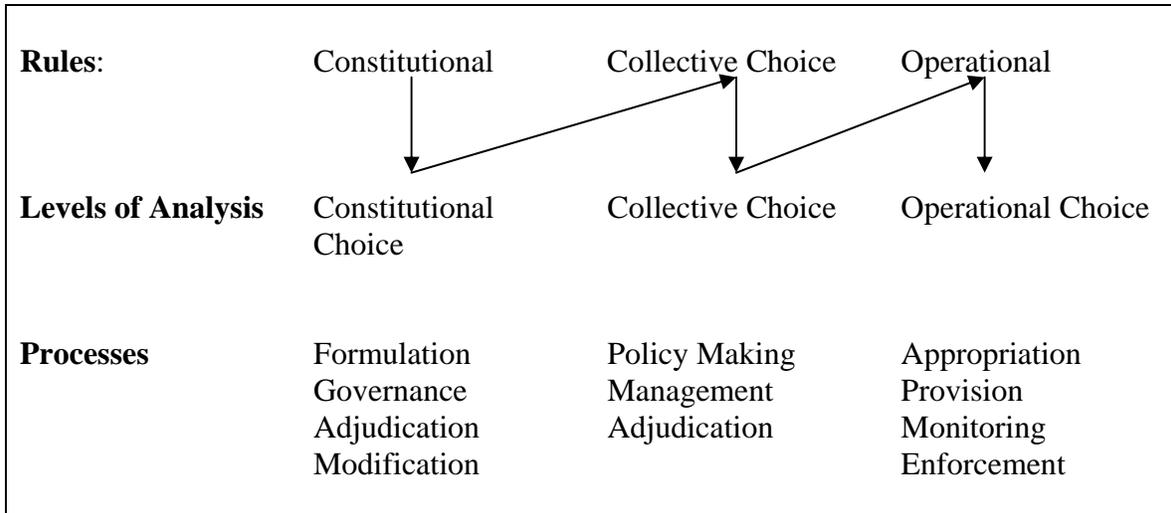
Hovi and Foss (1995) and Elster (1989) have split solutions to collective action problems into two categories, 'decentralised' where the alternative decisions are made by the group themselves without the support from a central agency, and 'centralised' where decisions are enforced by a central body. The distinction between 'centralised' and 'decentralised' is important in the recognition of other factors that motivate people to act for the greater good of the group. Decentralised groups function on social grounds with people acting for altruistic reasons for the common good of the group, where deterrence to free riders are through suspension of co-operation, or through reliance on social norms for co-operation. In order for decentralised solutions to work, groups have to be small and sufficiently enduring to allow people to form social groups that encourage voluntary contributions to collective goals.

Formal Institutions of Multiple Ownership in Hong Kong

The current system of multiple ownership of property in Hong Kong is governed by a set of formal institutions made up of

- the assignments and deeds of mutual covenants (DMC)
- the provisions of statutes, particularly the Building Management Ordinance (BMO)
- common law cases

Ostrom (1990) and Kiser and Ostrom (1982) identified a method of analysing institutions to identify the different levels of decision making rules governing the owners of common property. The rules at each level stem from the rules at the higher level. Operational level rules deal with day to day matters and stem from a collective choice level. Collective choice level rules determine how operational level rules should be made and enforced. These depend on the constitutional level of societal rules outside the particular common property system.



Source Ostrom 1990:53

Figure 2 Linkages among rules and levels of analysis

Operational rules refer to day to day matters of boundary rules and allocation. These specify who has access to the property and for how long. They also consider input and output rules, specifying the type and size of contribution from owners and the penalties and sanctions for non-compliance. These rules are set out in the DMC specific to each development and the house rules made under the resolutions of the DMC. The operational rules stem from the collective-choice level rules. The collective choice rules deal with policy and management. The detail of these rules are also set out in the DMC but have been modified by statutory intervention through the BMO. In many cases the situation is very confused, there is uncertainty surrounding the rules governing the management of the buildings, for example rules to pass resolutions and the scope of sanctions and penalties available. The operational rules, (the DMC and house rules) control the use of the common property, but without the rules of the collective choice level, they become unenforceable, leaving owners back to the route of private bargaining amongst themselves for enforcement. The free rider problem implies this route will never be effective.

Collective choice rules establish the ‘..institutional arrangement to enforce the operational rules, resolve any conflicts, enforce decisions, and subsequently monitor and modify the existing set of operational rules’ (Edwards and Steins 1998: 361). This makes the collective choice rules extremely important in the use and management of common property. It is this level of institutional rules that appears to fail due in part to the poor drafting of the DMC and ad hoc or piecemeal amendment of the DMC by legislation.

The constitutional level rules determine who is eligible to participate in the system, and the specific rules used to form collective choice rules (Edwards and Stein 1998). The constitutional level rules consist of the common law system of previous case law as well as statutes introduced to govern collective choice rules. The current common law system at this level fails to set out a complete picture of all the rules required at the collective choice level to allow for the management of property at the operational level. The current system does not require mandatory management by a managing agent, nor does it require owners to participate in any form of organisation.

In many countries Governments have provided constitutional rules to require managing agents at the collective choice level, in an attempt to provide this co-ordination mechanism for owners in multiple ownership property. It often takes the form of statutory intervention through a strata title system which requires a management mechanism to be set up to resolve conflicts between owners.

In Hong Kong there is no statutory requirement for such a mechanism. Private property rights of owners in these jurisdictions are based on common law, which leaves owners to choose how to agree the detail of the transactions between themselves. The existing DMC system allows owners to group together as a ‘decentralised’ group to enact collective decisions. The evidence from the condition of property found in government surveys, and the number of registered owners corporations is that owners have difficulty banding together to make decisions in a decentralised form. Out of 60,000 private buildings, only 5000 have formed ownership committees (Hong Kong Government 1998b). The groups of owners are too large, frequently not owner-occupiers and are not sufficiently enduring to form a sense of community in a high growth environment.

Informal Customs and Cultural Norms

The solutions adopted to the organisational problem of co-ordinating the collective action of owners depends on the on culture of society (Grief 1997). Hong Kong's formal institutions derive from an individualistic culture of British common law. There is no compulsion for owners to group together to form a central body to control the management of the building, it is left to the owners to decide whether to form an owners committee participate in the management of the building. These formal institutional rules operate in a culture that is collectivist. In 1946, the population of Hong Kong was 500,000, in 1999 it is six and a half million. In approximately 50 years 6 million people have arrived in Hong Kong from mainland China or born here producing a society that is 98% ethnic Chinese. The culture is based on Chinese collectivism with the in-group being

the family unit (Triandis McCusker and Hui 1007:1990). Other groups such as workplace or neighbourhood communities are much less dominant in a fast-moving high-growth environment such as Hong Kong.

Solutions to collective action are based on either a centralised solution where authority to act is enforced by an outside agency such as the state, or decentralised solutions where authority to act is enforced by group norms. In collectivist cultures, neighbours in high-rise blocks are unlikely to be perceived as part of the in-group. Social structures in high-rise blocks have been found to be anonymous in many countries, lacking in community identity. In a collectivist culture, the interaction between neighbours is likely to be even more limited where the distance and communication between the treatment of people forming in-groups and out-groups is even more marked (Gudykunst *et al* 1987).

The effect is that in finding solutions to collective action problems, the culture, composition and views of the group forming the collective must be examined. If the group do not perceive themselves as a group sharing the same fate, then a decentralised solution is unlikely to work. If a group member disobeys the rules in a group that believes the dissenter to be one of them, i.e. within their in-group, social norms and coercion can be used to bring the dissenter back in line. Where the dissenter is part of the out-group, there is very little the remaining group can do to ensure the dissenter complies. This problem may be more marked in collectivist societies where the difference in the treatment of in-group and out-group members is greater. In addition to the first order free rider problem that the collective group solution seeks to overcome, a second order free rider problem occurs in the shape of who, within a decentralised group solution, should be responsible for the enforcement of rules.

On the basis of this literature, it is hoped to conduct structured interviews to examine the attitudes of owners towards their neighbours. The aim is to establish if there is a link between the degree to which owners believe themselves to belong to a group sharing a common fate, and their willingness to participate voluntarily in building management. Owners may be willing to participate in management but unable to provide a decentralised group solution, due to the difficulty in self-enforcing rules amongst out-group members. Transaction costs of using the market bargaining to agree a decentralised solution, may differ for individualistic and collectivist societies. Williamson's original view that transactions will take place where ever transaction costs are lower, can be extended. The point at which it is cheaper to use a hierarchical (state centralised) solution rather than a market solution to collective action problems may differ in different societies, dependant on the individualist- collectivist nature.

North (1990:43) comments that people will include altruistic and other social motives within their choice set when the price they have to pay for them is sufficiently small. The price paid depends on the institutions governing the transactions between parties. If transaction costs are high, owners will have little incentive to co-operate and are unlikely to include social motives within their choice sets. If a way can be found to reduce transaction costs and the relative price of including social motives in choice sets then people may be more likely to alter their behaviour. In choosing to participate in building

management for social reasons, the current transactions costs may be simply too high due to the formal rules which leave owners to make up their own mind and require them to communicate with strangers. If the state were to provide a structure for owners to participate in management and more importantly, a mechanism for enforcement of dissenters, transaction costs to owners may be reduced.

Safe Urban Environments - Barriers to Change?

The Hong Kong Government's initiatives of building safety inspection schemes and mandatory professional managers for problematic buildings try to remedy the existing poor maintenance and management of private buildings. What they do not do is examine the underlying failure of owners to participate in the management and maintenance of what is most families most valuable asset, their home. In addition, the majority of commercial buildings outside the CBD are also held in the same multiple ownership system, and have the same for safety and maintenance standards. In the 1998 Government survey, 15,000 residential and commercial mixed use buildings were investigated, only 11% were found to be in a safe satisfactory condition (Hong Kong Government 1998a).

From an analysis of the formal institutions governing property management, it would appear that the failure of the system stems from the collective action level. The existing system allows owners to choose a market negotiation choice whether to participate in decentralised collective management group. The free rider problem is such that unless all can be encouraged to participate, little is likely to be achieved (Olson 1965). In addition there is a second order free rider problem of who should carry out enforcement action against group dissenters. It is suggested that the collectivist nature of society in Hong Kong makes this problem more difficult to overcome than in individualistic society. The difference in treatment of in-groups and out-groups in collectivist societies may result in owners having greater difficulty in using a decentralised solution. If someone dissents from the group rules, if the dissenter feels himself to be outside the group, no amount of social norms or coercion will work.

The government's latest report on the problems of the Hong Kong 's urban environment are contained in the consultation document attached to the Urban Renewal Authority Bill. It estimates that buildings over thirty years old should be targeted for renewal and estimates this will take twenty years to complete. In addition to dealing with the existing dilapidated property, the government must look beyond the immediate problem to examine why owners do not repair. If they do not, the current stock of ten to twenty year old property will be in need of whole scale renewal once the current batch is completed in 2020.

The existing formal rules appear to fail to encourage owners to repair. The government is prepared to impose managers on owners and has considered mandatory maintenance schemes. What it does not appear willing to provide, is a formal framework through statute to allow owners to participate in management. It is suggested that a formal

mechanism provided by statute would reduce transaction costs between owners thereby encouraging management and maintenance by owners. Mandatory management and repair schemes will not tackle the problem of owners co-ordinating between themselves to undertake the mandatory repair or provide a mechanism for owners to instruct managers imposed upon them.

The empirical work to be developed from this is to identify a connection between willingness to participate in management and the extent to which owners identify themselves as having a common fate with their fellow owners. If owners do not perceive other owners as being within the same group then decentralised solutions are unlikely to work. This may encourage the government to consider providing a centralised solution of support from formal institutions of outside agency through statute.

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