The Role of Government in Housing Policy in Transition Countries

– Current Practices and Principles -

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Outline of the Presentation

- Mortgage market policy case studies from Central Europe, based on author’s book publication: Housing Policy in Central Europe (CLC/Vienna) of 2003
- Rental sector policy review (recent World Bank study, yet unpublished)
- Overall housing policy picture
- Public support policy principles, including those derived from the EU Treaty (Amsterdam version)
Developing the Housing Sector

...Sure, this is how it starts... Today a settlement, tomorrow a City, next thing you know we'll be moving to the suburbs...
**The Mortgage Market – Differing Stabilization Results trigger..**

Successful mortgage products need stabilization, FX/indexed products widely practiced, but limited due to risk content.

First successful stabilizers in Baltics and Central Europe.

However, also inflation persistence in Hungary, Slovakia, Latvia.

Russia, Bulgaria & Turkey approaching critical inflation threshold.

Romania late-coming.

Source: Economist Oct 7, 04.
... Varying Rate Dynamics and ..

Interest rate convergence in Central Europe

Observations

- Poland: stabilization finally succeeded – the ratio of financed residential transactions rose from 30% in 2001 to 90% in 2003!
- The price to pay were temporarily high real interest rates (10% and more).
- Czech Republic: reverse risk of real interest rate undershooting, likely due to strong mortgage market subsidization.

Sources: Central Banks, Stewart Title Insurance, Hans-Joachim Duebel.
Note: Discount rate, real rate = discount rate minus next year inflation.
.. The Temptation to Subsidize Mortgage Rates ..

Data for Central Europe as of end 2003

<table>
<thead>
<tr>
<th>Country</th>
<th>Multiple of Income</th>
<th>Interest Rates</th>
<th>Debt Service Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>no repayment</td>
</tr>
<tr>
<td></td>
<td>House price</td>
<td>Loan Volume</td>
<td>Mortgage Bond Rate</td>
</tr>
<tr>
<td>Poland</td>
<td>5.5</td>
<td>3.9</td>
<td>6-7%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>6.0</td>
<td>4.2</td>
<td>5.1%</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>6.0</td>
<td>4.2</td>
<td>4.5%</td>
</tr>
<tr>
<td>Hungary</td>
<td>7.0</td>
<td>4.9</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

Source: Central Banks, Hans-Joachim Duebel. Assuming 60% loan-to-value ratio.
.. Resulting in Mortgage Market Growth that Noticably differs by Subsidy Levels

Observations

- Zero or negative real mortgage interest rates trigger strong growth in the Czech Republic (subsidized) and Hungary (strongly subsidized)
- High real mortgage interest in Russia, Romania and Turkey, temporarily Poland. Large FX share = slower growth.
- Past EU Accession Countries Spain, Portugal started catching up from 10-15% GDP levels by the late 80s

Source: Central Banks, Dubel.
Quality of Practice Differs – Mortgage Interest Rate Subsidies in the Czech Republic were Reasonable..

### Interest Rate Buy-Down in the Czech Republic

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market rate</strong></td>
<td>n.a.</td>
<td>11.4</td>
<td>12.9</td>
<td>14.2</td>
<td>10.3</td>
<td>8.8</td>
<td>7.9</td>
<td>6.8</td>
<td>5.5</td>
</tr>
<tr>
<td><strong>Rate buy-down</strong></td>
<td>n.a.</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>2.0</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Ex-post rate</strong></td>
<td>n.a.</td>
<td>7.4</td>
<td>8.9</td>
<td>10.2</td>
<td>6.3</td>
<td>4.8</td>
<td>5.9</td>
<td>5.8</td>
<td>5.5</td>
</tr>
</tbody>
</table>

- **Interest rate buy-down program**
  - Subsidy formula: \( s(t) = r(t-1) - r_{\text{norm}} \), \( r = \) market rate, \( r_{\text{norm}} = 7\% \)
  - Subsidy cap: \( \max (s(t)) = 4\% \), upward rounding of \( s(t) \) to higher integer

- **Pro**
  - Sustainable since rate decline triggered elimination of subsidy (2003).
  - Cap on subsidy limits fiscal risk.

- **Con**
  - Lag structure of formula leads to unintended variations in after-subsidy rates.
  - There is risk that rates rise again, rather than drop (here cap on rates), perpetuating an untargeted subsidy program.
While Bauspar Subsidies Got Out of Control

**Bauspar Premium Levels and Deposit Growth**

**Observations**

- No adjustment of deposit subsidy between 1992 and 2004 → huge overinvestment in CSH deposits
- Fiscal costs of 0.55% of GDP when total formal housing policy budget does not exceed 0.9% (03)
- Bausparkassen underinvested in loans due to strong growth, hence buying mortgage bonds & driving down mortgage rates.
- CZ has now with lowest ‘market’ mortgage rates in Europe (with Spain)

Source: Hans-Joachim Duebel, for World Bank
In Hungary, Mortgage Market Subsidies Cumulated to Record Levels

Observations

- High market rates due to fiscal problem, exchange-rate policy
- But high homeownership rate, large power of mortgage lenders and weak housing policy formulation
- Family/social investment allowance & income tax credit for entire mortgage debt service
- Support for mortgage banks buying mortgage portfolio (1%), tax support for mortgage bonds.
- Mortgage-bond related system of interest rate buy-down, but here the affordable rate was set at 5% (new), 6% (existing). Lowest in all TC’s – for comparison: in Poland 9%

Interest Buydown in HU over Time

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>mid-2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market rate</td>
<td>22–25 %</td>
<td>22–19 %</td>
<td>16–19 %</td>
<td>8–16 %</td>
<td>10–11 %</td>
</tr>
<tr>
<td>Buy-down</td>
<td>6–7 %</td>
<td>3 %</td>
<td>4,5–7 %</td>
<td>8–10 %</td>
<td>5–6 %</td>
</tr>
<tr>
<td>Average rate</td>
<td>16,5 %</td>
<td>12,0 %</td>
<td>9 0 %</td>
<td>4,0 %</td>
<td>5,0 %</td>
</tr>
<tr>
<td>Burden after tax</td>
<td>9,9 %</td>
<td>7,2 %</td>
<td>5,4 %</td>
<td>2,4 %</td>
<td>3,0 %</td>
</tr>
<tr>
<td>Inflation level</td>
<td>9.8 %</td>
<td>9.2 %</td>
<td>5.3 %</td>
<td>4.7 %</td>
<td>4.5 %</td>
</tr>
<tr>
<td>Average real interest rate</td>
<td>-0.1 %</td>
<td>-2.0 %</td>
<td>0.1 %</td>
<td>-2.3 %</td>
<td>-1.5 %</td>
</tr>
</tbody>
</table>

- ‘Mistakes’ in the formulation of the buy-down lead to rate drop to 3% in 2002, leading to cohort costs of the 2002 vintage ALONE of 1.5-2% of GDP.
- Mismatch with housing sector problems, which center largely on modernization & rental & rural
- Due to lax fiscal discipline and large deficits, Hungary is seen as jeopardizing her access to the EMU
Mortgage Interest Deductibility has Become Widespread in TCs – At Variance with Best Practices in Taxation & Cutback in the West

**Observations**

- Huge potential fiscal liability as market grows, often unbudgeted
- Not suited to fight high inflation or real interest levels; might be even self-defeating as contributing to fiscal deficits
- Inconsistent with either consumption or investment good concept of housing
- Social imbalance as main incidence lies on on high-income households
- Cutback in Western Europe related to Maastricht convergence

**Source:** Hans-Joachim Duebel, for World Bank
Mortgage Industry Lobbyism: Caveat Emptor!
Rental Housing – the Overlooked Residual?

Observations

- Rental sector has pivotal importance for mobility and affordability. Problem in many transition countries.
- Young households are private renters (see Chart).
- Public rental housing offers diminished choices, often slumification
- Rental housing policies require:
  - Rent reform
  - Legal reform (tenant-landlord relations)
  - Tax reform (see above), to tap new investor classes
  - Support strategies for vulnerable households
- Poland most active transition country.

Share of Young Households Living in Private Rental Units, %  
- Six Transition Countries

Source: Hans-Joachim Duebel, for World Bank  
(with Jan Brzeski/Ellen Hamilton)
Overall Housing Policy Picture – Program Landscape in Central Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>Support to Finance</th>
<th></th>
<th>Income Tax Support</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Grants</td>
<td>To Contract Savings for Housing</td>
<td>Mortgage Bonds</td>
<td>Mortgage Loans</td>
</tr>
<tr>
<td></td>
<td>General</td>
<td>Young Borrowers</td>
<td>(X) (1)</td>
<td>Tax Deduction</td>
</tr>
<tr>
<td>Poland</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Slovakia</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Hungary</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Support to Investment</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Loans</td>
<td>Grants</td>
<td>Income Tax Support</td>
</tr>
<tr>
<td></td>
<td>Young Borrowers</td>
<td>Construction Costs</td>
<td>Value-added Tax</td>
</tr>
<tr>
<td>Poland</td>
<td>(X)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Slovakia</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Hungary</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Source: Hans-Joachim Duebel/CLC Vienna.
Overall Housing Policy Picture – Insufficient Spending & Institutional Weakness

- Transition countries simply do not spend enough on housing.
- This refers both to the private sector (housing costs/income ratios) and the public sector (housing policy budget/GDP).
- The exception are the young and mobile, which are pay the price for policies geared to sitting owners/tenants.
- Cross-subsidies, esp. on energy, and tax subsidies create large unbudgeted housing policy costs.
- Housing policy makers are weak viz finance & other sector ministries. There is little independent program evaluation capacity.

### Observations

<table>
<thead>
<tr>
<th>Country</th>
<th>Housing Policy Budget</th>
<th>Scale of Tax Support</th>
<th>Budget Trends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>0.60 %</td>
<td>0.40 %</td>
<td>0.30 %</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.46 %</td>
<td>0.60 %</td>
<td>0.60 %</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.86 %</td>
<td>0.88 %</td>
<td>0.88 %</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.91 %</td>
<td>0.61 %</td>
<td>0.68 %</td>
</tr>
</tbody>
</table>

### Housing Policy Budgets and Private Housing Spending in Selected Transition Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Rents in LCU</th>
<th>Rent-to-income*</th>
<th>Housing costs-to income***</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>public</td>
<td>private</td>
<td>public</td>
</tr>
<tr>
<td>Armenia</td>
<td>11000</td>
<td>154</td>
<td>199188</td>
</tr>
<tr>
<td>Poland</td>
<td>15044</td>
<td>124</td>
<td>79947</td>
</tr>
<tr>
<td>Romania</td>
<td>136.5%</td>
<td>80.5%</td>
<td>399.4%</td>
</tr>
<tr>
<td>Russia*</td>
<td>23.1%</td>
<td>6.3%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Serbia</td>
<td>27.1%</td>
<td>7.3%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Private/public</td>
<td>117.5%</td>
<td>87.7%</td>
<td>188.1%</td>
</tr>
</tbody>
</table>

Policy Principles
**Principles - The Fiscal Perspective**

- **IMF Code on Good Practices on Fiscal Transparency**
  - Tax support should be booked as expenditures
  - Future commitments should be noted and discounted, as in corporate balance sheet
  - Contingent liabilities (guarantees) should be quantified, where possible, or at least described.

- **Fiscal sustainability**
  - Fiscal stop and go does not help the mortgage sector, examples Czech Republic and Hungary with large expenditures and need for fiscal reform
  - Tax policy: EU requires minimum taxation of interest and unified VAT

- **Co-ordination between policy institutions**
  - Crucial problem in Czech Rep, Slovakia and Hungary is lack of co-ordination between Ministry of Finance and Housing. Example Bauspar subsidies in CZ. PL good performer, but conflicts between Ministries.
  - Housing Ministry should be responsible for total budget & programs. Finance Ministry should be able to object, but not design programs.
Principles - The Social Policy Perspective

- Opportunity Costs
  - Is Housing Sector a Priority? If yes, proceed →
- Housing Sector
  - Rental Housing Support? In PL → TBS
  - Low-income mortgage finance system realistic?
- Homeownership Subsidies
  - Effectiveness?
  - Distributional Impact? Often problematic, see Hungary →
## Hungary – Tax Credit and Income Distribution

<table>
<thead>
<tr>
<th>Income/year *1.000 HUF</th>
<th>Distribution Income Tax Payers</th>
<th>Distribution Tax Credits</th>
<th>Average Tax Credit * 1.000 HUF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 300</td>
<td>14.40%</td>
<td>1.00%</td>
<td>42</td>
</tr>
<tr>
<td>300-600</td>
<td>23.20%</td>
<td>9.10%</td>
<td>63</td>
</tr>
<tr>
<td>600-1000</td>
<td>23.90%</td>
<td>13.50%</td>
<td>68</td>
</tr>
<tr>
<td>1000-1500</td>
<td>16.60%</td>
<td>17.70%</td>
<td>84</td>
</tr>
<tr>
<td>1500 - 2000</td>
<td>8.80%</td>
<td>14.30%</td>
<td>93</td>
</tr>
<tr>
<td>2000-4000</td>
<td>9.80%</td>
<td>26.20%</td>
<td>110</td>
</tr>
<tr>
<td>4000 und over</td>
<td>3.20%</td>
<td>18.10%</td>
<td>150</td>
</tr>
<tr>
<td>Total</td>
<td>100.00%</td>
<td>100.00%</td>
<td>92</td>
</tr>
</tbody>
</table>

Source: Jozsef Hegedues of Metropolitan Research Institute Budapest.
Principles - EU Competition
Policy Perspective is Linked to Social Aspects

- Example EU Acquis Communautaire. Article 87 EU Treaty allows state aid, if
  - aid has a social character and is granted to individual consumers (always)
  - aid promotes regional economic or infant sector development (requires permission)
- Consequence:
  - Untargeted, permanent subsidies are unlawful! ➔ Member States and Central European accession countries to change some subsidy policies
  - Public institutions need to demonstrate special focus on economic promotion, otherwise split into market and promotion entities. ➔ Fannie Mae and other monopoly/duopoly structures outlawed, if permanent. Low-income agencies ok.
Principles – The Institutional Perspective

Needed public functions
- Policy formulation, for example in rent control or tax policy
- Program design
- Budget, commensurate with the task (2-3% GDP as long as emergencies persist)
- Implementation capacity
- (Independent) Evaluation capacity

Needed private sector infrastructure
- Private rental investors, including to take out millions of ‘owner-occupiers’ in apartment buildings that have no capacity/willingness to invest.
- Non-profit rental investors, co-operatives
- Property management companies
- Mortgage banking, including for rental
END

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