

The Role of Government in Housing Policy in Transition Countries



– Current Practices and Principles –

Hans-Joachim Dübel

Financial Services & Policy Consulting, Berlin

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- Rental sector policy review (recent World Bank study, yet unpublished)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



The Mortgage Market – Differing Stabilization Results trigger ..

Latest Growth & Inflation



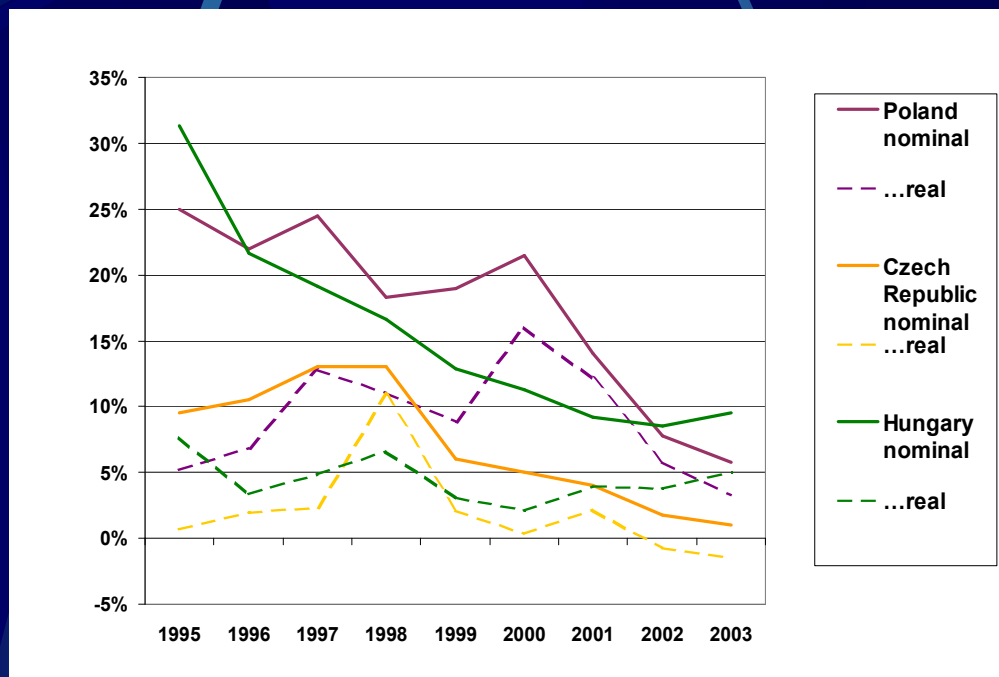
Observations

- 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 doubled from 13.8% in 2001 to 27.6% 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

Country	Multiple of Income		Interest Rates			Debt Service Year 1	
	House price	Loan Volume	Mortgage Bond Rate	Market Rate	Rate after Support	no repayment	1% repayment
Poland	5.5	3.9	6-7%	8.1%	6.4%	24.6%	28.5%
Slovakia	6.0	4.2	5.1%	7.1%	5.3%	22.3%	26.5%
Czech Rep	6.0	4.2	4.5%	6.0%	4.5%	18.9%	23.1%
Hungary	7.0	4.9	8.0%	10.5%	3.0%	14.7%	19.6%

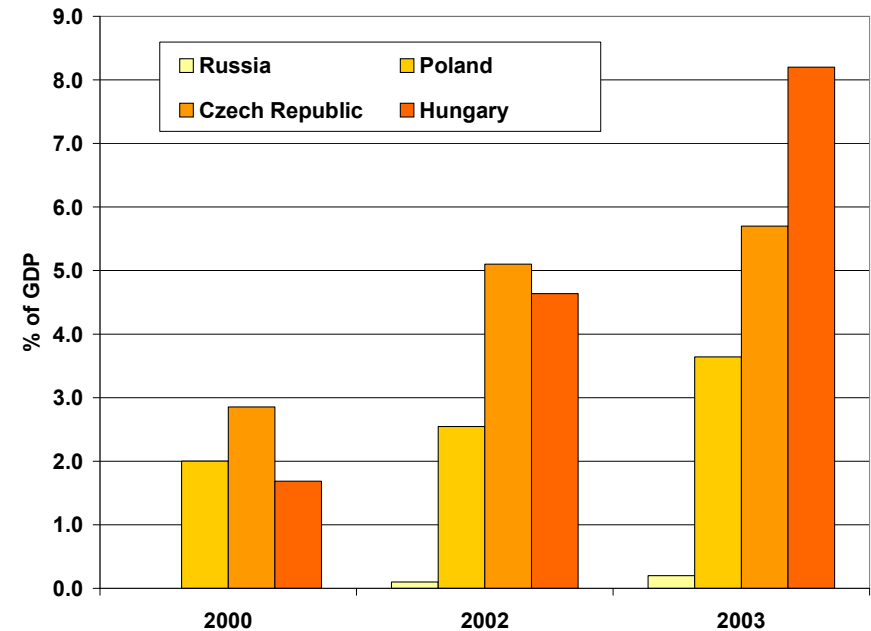
Source: Central Banks, Hans-Joachim Duebel. Assuming 60% loan-to-value ratio.

.. Resulting in Mortgage Market Growth that Noticeably 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

Mortgage Outstandings as % of GDP



Source: Central Banks, Dubel.'

Quality of Practice Differs – Mortgage Interest Rate Subsidies in the Czech Republic were Reasonable ..

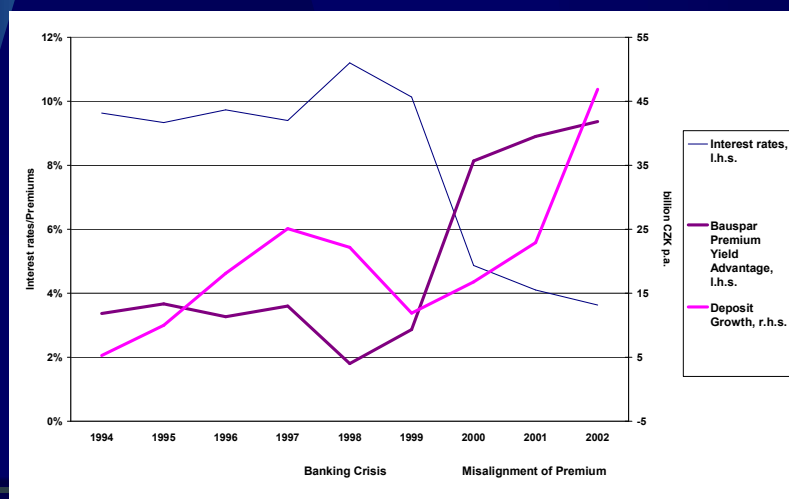
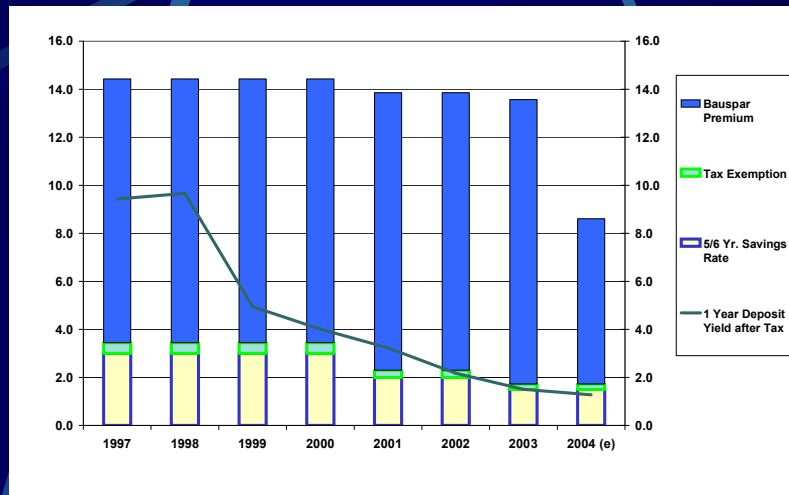
Interest Rate Buy-Down in the Czech Republic

In % p.a.	1995	1996	1997	1998	1999	2000	2001	2002	2003
Market rate	n.a.	11.4	12.9	14.2	10.3	8.8	7.9	6.8	5.5
Rate buy-down	n.a.	4.0	4.0	4.0	4.0	4.0	2.0	1.0	0.0
Ex-post rate	n.a.	7.4	8.9	10.2	6.3	4.8	5.9	5.8	5.5

- 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)

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

In % pa	1999	2000	2001	2002	mid-2003
Market rate	22–25 %	22–19 %	16–19 %	8–16 %	10–11 %
Buy-down	6–7 %	3 %	4,5–7 %	8–10 %	5–6 %
Average rate	16,5 %	12,0 %	9 0 %	4,0 %	5,0 %
Burden after tax	9,9 %	7,2 %	5,4 %	2,4 %	3,0 %
Inflation level	9,8 %	9,2 %	5,3 %	4,7 %	4,5 %
Average real interest rate	0,1 %	-2,0 %	0,1 %	-2,3 %	-1,5 %

- '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

Income Taxation Concepts in Housing

TENURE NEUTRAL TAXATION					
Investment Good Concept			Consumption Good Concept		
	Homeowners	Landlords		Homeowners	Landlords
Rent/imputed rent	T	T	Rent/imputed rent	NT	NT
Costs of capital	T	T	Costs of capital	NT	NT

..CONSISTENT WITHIN SECTOR (SECOND BEST)					
Consumption/Investment			Investment/Consumption		
	Homeowners	Landlords		Homeowners	Landlords
Rent/imputed rent	NT	T	Rent/imputed rent	T	NT
Costs of capital	NT	T	Costs of capital	T	NT

INCONSISTENT (FREQUENT EXAMPLES)					
Mortgage Interest Deductibility			Gross Rent Taxation		
	Homeowners	Landlords		Homeowners	Landlords
Rent/imputed rent	NT		Rent/imputed rent		T
Costs of capital	T		Costs of capital		NT

Source: Hans-Joachim Duebel, for World Bank

Mortgage Industry Lobbyism: Caveat Emptor!

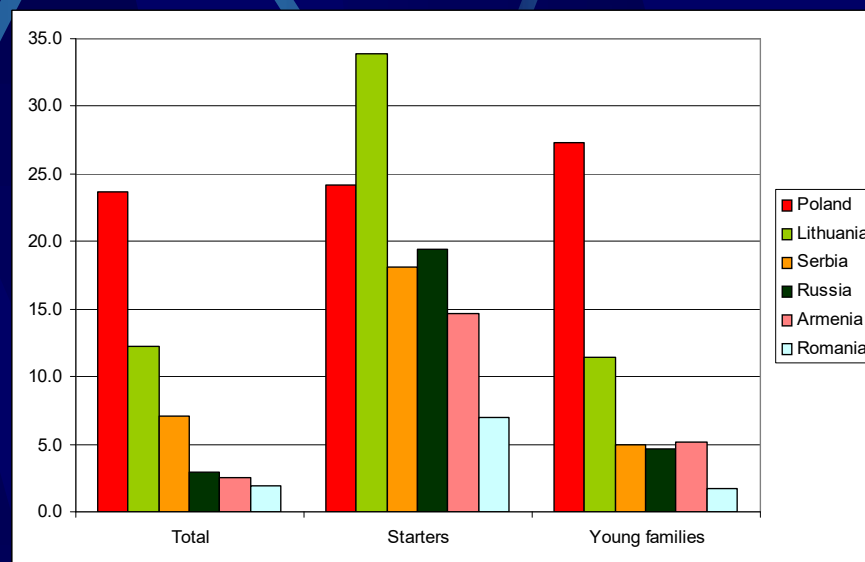


Rental Housing – the Overlooked Residual?

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

Country	Support to Finance					
	Grants			Income Tax Support		
	Interest Rate Buy-downs		To Contract Savings for Housing	Mortgage Bonds	Mortgage Loans	
	General	Young Borrowers		Tax Deduction		Tax Credit
Poland			(X) (1)			X
Slovakia	X	X	X	X		
Czech Republic		X	X	X	X	
Hungary	X		X	X		X

Country	Support to Investment			
	Loans	Grants	Income Tax Support	
	Young Borrowers	Construction Costs	Value-added Tax	Property Tax and other Taxes
Poland		(X)	X	
Slovakia	X		X	X
Czech Republic	X		X	X
Hungary		X	X	

Source: Hans-Joachim Duebel/CLC Vienna. Note PL mortgage interest deductibility scheme classified as tax credit, due to binding restrictions on max tax reduction.

Overall Housing Policy Picture – Insufficient Spending & Institutional Weakness

Observations

- 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 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.

Housing Policy Budgets and Private Housing Spending in Selected Transition Countries

Country	Housing Policy Budget			Scale of Tax Support	Budget Trends
	1998	2000	2002	2003	2003
Poland	0.60 %	0.40 %	0.30 %	Medium	Rising
Slovakia	0.46 %	0.60 %	0.68 %	Medium	Constant
Czech Republic	0.86 %	0.88 %	0.88 %	High	Rising
Hungary	0.91 %	0.61 %	0.68 %	Very High	Falling

	Armenia	Poland	Romania	Russia*	Serbia
Rents in LCU					
- public	11000	154	200188	381	nil
- private	15044	124	799487	646	4645
Private/public	136.8%	80.5%	399.4%	169.6%	n.m.
Rent-to-income**					
- public	23.1%	8.3%	4.7%	5.7%	nil
- private	27.1%	7.3%	8.9%	9.7%	18.8%
Private/public	117.5%	87.7%	188.1%	172.4%	n.m.
Housing costs-to-income***					
- owners	11.0%	n.a.	13.2%	17.4%	9.1%
- public rental	34.3%	n.a.	16.8%	17.6%	10.1%
- private rental	35.5%	n.a.	21.6%	19.4%	27.6%
Private/public	103.4%	n.a.	128.9%	110.1%	273.4%

Source: Hans-Joachim Duebel, World Bank.

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

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

Source: Jozsef Hegedus 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



Hans-Joachim Duebel
Financial Services & Policy Consulting
Esmarchstr. 15
D-10407 Berlin
Aduebel@attglobal.net