

HOMEOWNERSHIP
AND HOUSING
FINANCE POLICY IN
THE FORMER
SOVIET BLOC

COSTLY
POPULISM

edited by

RAYMOND J. STRUYK

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The Urban Institute

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Preface

The inspiration for this book came from two sets of discussions in 1997 and 1998. One set was with housing finance consultants and policy advisers working in the central European states of Hungary, Poland, and the Czech Republic and in the Russian Federation. The other set of discussions was with officials and knowledgeable observers in the countries in southeastern Europe and nations other than Russia in the Commonwealth of Independent States (CIS). These conversations illuminated a disturbing pattern. First, the types of homeownership policies and related housing finance policies the bellwether reform states of central Europe were pursuing appeared to have serious limitations. Second, the countries of southeastern Europe and the CIS outside of Russia generally seemed to be strongly influenced by what their colleagues to the north and west were doing. Because these nations had yet to tackle restructuring homeownership policies beyond implementing mass housing privatization schemes, this influence could be decisive.

This book is the result of a careful analysis of the actual situation in the more “policy-advanced” transition countries of the former Soviet bloc. The book confirms that my initial foreboding was justified. By and large, the policies adopted, while a definite improvement over those inherited from pre-transition governments, are nevertheless conspicuously inefficient and wasteful. One hopes that the other countries in the

region that will soon address new homeownership and housing finance policies will learn from the mistakes of their neighbors.

Among the many persons who contributed thoughtful analysis and insights about developments in central Europe, I particularly want to thank Douglas Diamond, Achim Duebel, Jozsef Hegedus, Michael Lea, and Katie Mark. I thank Harold Katsura for a careful reading of the entire manuscript. Eric Zaretsky provided competent research assistance. EEI Communications did an excellent job editing the manuscript. Finally, but certainly not least, I gratefully acknowledge the support of the Urban Institute in writing this book.

Raymond J. Struyk
July 2000

Introduction

A young Hungarian family in 1998 wanting to purchase a newly constructed flat or house was eligible for extensive assistance from the state. The family might have participated in a housing-linked contract savings scheme in which the government provided generous bonuses to increase the effective interest rate on the savings. The price of the apartment might have been lowered because building materials used in housing construction were exempt from the hefty value-added tax (VAT). And if it purchased a modest unit, the family might have been eligible for a downpayment subsidy and for interest rate write-downs on its mortgage loan. After it purchased the apartment, the family could deduct its loan repayments from its taxable income, up to a fairly high limit. While few families qualified for all of this assistance, many did receive benefits from multiple programs. What is it that causes the Hungarian government to be so generous in promoting home purchase?



Three powerful forces have driven some countries in central and eastern Europe to engage in expensive policies to produce more owner-occupied housing:

- The perception of a “housing shortage,” associated in part with lower levels of new construction in the 1990s than in the 1980s.

- An unwillingness on the part of the population to spend a substantial share of their incomes (equivalent to the share spent by new homeowners in the West, for instance) to achieve their objective of improved housing.
- The desire of people for very secure tenure arrangements (through either unit ownership, with a minimum mortgage debt at most, or lifelong rental contracts in state housing). With the privatization of a large share of state housing during the transition and virtually no additions to this housing stock, security in the future will be available almost exclusively through ownership.

The accent in the new policies is on housing production and on fostering homeownership. With a nascent private rental sector, supporting construction of units for purchase (homeownership) is cheaper for the government than building rental units owned and operated by the state. And it may be cheaper than cooperative housing, which was and is heavily subsidized in some countries of the region—for example, Poland. Nevertheless, modest levels of state or municipal support for construction of rental housing continue in some countries.

Naturally long-term housing finance, or mortgage finance, has a critical role to play in fostering homeownership and associated residential construction. Long-term loans multiply the borrower's purchasing power, making it possible for borrowers to contribute relatively more (and the state less) in attaining their housing goals. Hence, the active role of governments in the region in fostering the development of housing finance systems is understandable. Despite these efforts, however, loan volumes are much lower than before the transition began, in part because of higher, market-determined interest rates. In Hungary, for example, the volume of home purchase finance as a percentage of housing investment fell steadily from 22 percent in 1991 to 3 percent in 1997 (Hegedus and Varhegyi 1999, table 3).

Government's role in promoting housing finance is not always neutral in its effect on the structure and efficiency of the financial system. External advisers and business interests have had a fundamental impact on the shape of the emerging system. The German-Austrian Bausparkassen associations have been particularly active and effective. The Bausparkassen system is a closed system in which mortgage loans from a specialized housing bank are funded exclusively from the savings of future would-be borrowers. Because it is a closed circuit—only the funds

saved are lent—it is possible for the interest rates on both savings and deposits to be substantially below market levels, with borrowers subsidizing themselves by accepting low interest during the earlier savings period.¹ The result in the Visegrad countries—Hungary, Poland, the Czech Republic, and Slovakia—has been a distinct but partial movement toward a German housing finance system. Under this system, a borrower takes a package of loans—typically two mortgages and sometimes an additional (often unsecured) loan. The first mortgage is usually from a specialized mortgage bank for 40 to 55 percent of the house price. The second is through the borrower’s mortgage-linked contract savings plan, providing a mortgage for another 20 percent of the unit value. The borrower’s equity (downpayment), including the savings accumulated in the Bausparkassen, nearly always exceeds 20 percent and is often substantially more.²

The main step in adopting this model has entailed the creation of new specialty housing finance institutions in the region to operate the mortgage-linked contract savings schemes (Bausparkassen). More recently, some new mortgage banks have also been created. All of this has happened while the dominant international trend was toward universal banking and consolidation (Diamond and Lea 1992b).³

But nowhere in the region is the “German system” fully implemented. Indeed, commercial banks retain primacy as the originators of mortgage loans in almost all countries. And borrowers taking multiple loans are the exception rather than the rule.

An interesting dynamic has been at work in the region regarding subsidies for housing production and home purchase. At the beginning of the transition, government subsidies for housing production were sharply cut in all countries (Struyk 1996b). But around mid-decade, pressure for renewed subsidies for home purchase developed, despite surges in homeownership rates through mass privatization programs. And governments responded, although they sometimes limited assistance to those purchasing newly constructed housing.

The pattern of direct support for borrowers through the banking system was very different. In several countries the jump in nominal and real interest rates that accompanied the freeing of prices at the initiation of the transition produced corresponding severe hikes in the monthly payments of borrowers who already had loans. Governments stepped in with aid to prevent most borrower defaults (and as well to save the big lender, the state savings bank). Budget outlays soared. But this spending

did not produce new housing. The generosity of current support to new purchasers is typically less than the help to borrowers with “old loans.” Government intervention to lower interest rates paid by borrowers is now quite exceptional, but it does happen—in Hungary, for example.

Poor Policies

The analysis presented here documents that the “housing shortage” is a mirage. Compared with inhabitants of countries that have similar per capita incomes, Eastern Europeans are well-housed—but they aspire to the standards of Western Europe. The subsidy programs for new purchasers that were created to address the perceived housing shortage are often inefficient, poorly targeted, and very expensive for these countries—and will become more so in the years ahead as long-term commitments already made come due. Untargeted subsidies through the tax system are especially prominent.⁴ And policies in the Visegrad countries are distorting the banking system and reducing its efficiency through the introduction of specialized housing finance banks. Still, there are bright points. The Russian Federation has shifted away from support for housing construction to more efficient demand-side subsidies to meet its obligations under various laws. A municipal version of the program targets subsidies well to moderate-income families who have been on the waiting list for a dwelling unit.

But the broad negative conclusion remains. And it is critically important because a kind of follow-the-leader mentality has been evident in the region in policymaking in the homeownership and housing finance sphere. Governments have seemed to follow “housing finance trends,” the most recent being the introduction of European-style mortgage banks. Other countries further to the east and south may adopt these policies as a means of taking the modern approach or in response to promotional pressures by certain donors and private banking interests. This would be a costly mistake. The particular lessons to be learned from the Visegrad countries and Russia are detailed in the final section of chapter 1.

This Book

To provide an accurate assessment of the current situation in the former Soviet bloc, this book critically surveys developments in home purchase

(mortgage) finance and the policies and subsidy commitments made to stimulate home purchase in countries in the region that represent different approaches and different levels of housing finance system development. Prominence is given to Poland and the Russian Federation. Poland—like other Visegrad countries—has embraced the “German housing finance model” to a degree. Most borrowing for home purchase is from banks (rather than from real estate developers or “savings clubs”). There are several high-volume lenders who are beginning to compete for business. Russia is included primarily because it has chosen a very different approach from the Visegrad countries—one that assigns mortgage lending to universal banks and intends to stimulate bank lending by creating a liquidity facility to purchase mortgages that banks originate that meet the facility’s standards. At the same time, a smaller share of home purchases are financed through the banking sector; developers run incremental purchase programs of various sorts, and these may account for half of all units purchased with some form of finance. The contrast between Poland and Russia in economic stability and economic growth in the past decade has been dramatic. Russia’s instability has had an extremely adverse effect on the development of mortgage lending.

Chapter 1 of this book summarizes and compares the situation in the region. Separate chapters follow on Poland (chapter 2) and Russia (chapter 3)—each representing a distinct model of homeownership and housing finance policy. These chapters cover a common set of topics. The discussion begins by tracing developments in homeownership, including mass housing privatization. It turns next to the topic of housing shortages and economic developments during the transition. It then examines the arrangements for home purchase finance, highlighting those instances in which government policies are influencing loan terms, who qualifies for a loan, or other aspects of mortgage transactions. The chapters next address government support for homeownership. Seven different types of support are covered:

- Interest bonuses on savings when the savings are part of a housing purchase-related contract savings scheme, along the lines of the German-Austrian Bausparkassen system.
- Subsidies on interest payments on mortgage loans.
- Personal income tax benefits: deduction of some or all interest payments on home purchase mortgages or home purchase costs from

the borrower's income subject to tax, and partial or full sheltering from tax of capital gains realized on the sale of the unit.

- Government guarantees of mortgage loan repayment and interest payments to investors on mortgage-backed securities.
- Construction subsidies, including exemption from VAT or other taxes, gift or discount on land for construction, subsidized construction period finance, direct construction subsidies, and infrastructure subsidies.
- Downpayment subsidies.
- Government support for secondary mortgage facilities.

The efficacy of these various policies is analyzed from both conceptual and financial perspectives. The chapters address why loan volumes remain low and why the generous ownership subsidies have been so widely adopted.

While the authors made strong efforts to develop comparable information for the countries, this was not always possible. Often, the problem was the lack of official statistics. Particularly problematic is that information on home purchase mortgage lending is not collected by the central banks.

The authors' analysis serves as the basis for conclusions about these countries and recommendations for others in the region whose policies are still under development. Indeed, the countries in the Commonwealth of Independent States other than Russia and the transition countries of southeastern Europe are just beginning the development of their housing finance systems. They are examining the possibility of redefining homeownership policies in light of mass housing privatization already implemented and the introduction of borrowing on market terms to finance home purchase.

Still, the countries of the CIS and southeastern Europe can learn much that is positive from the experience of the Visegrad countries and the Russian Federation, especially in their efforts to develop a housing finance system. These countries have done well in establishing the legal foundation for mortgage lending. Banks generally originate and service loans following international standard practices. Poland is creating a credit bureau to improve loan underwriting, and Russia is supporting the development of a mortgage liquidity facility. It is important to remember that when the Visegrad countries and Russia embarked on their voyages of creation there was little specifically relevant experience

on which to build. Especially in this light, they have done a remarkable job. But it is now clear that substantial inefficiencies are built into their housing finance and homeownership subsidy systems, inefficiencies that should be addressed.

NOTES

1. There are variations on this basic model. The systems used in the Visegrad countries are discussed in this book. Also see Lea and Renaud (1995), Chretien (1986), and Rischke (1998).
2. A further description of the German system appears in the next chapter of this book and in chapter 4 of Diamond and Lea (1992a).
3. Whitehead (1998) examines the evolution of housing finance in the European Union to see if convergence is occurring. She finds that there is more convergence in outcomes—for instance, interest rates and degree of risk—than in institutions. The general trend is toward greater efficiency and away from special circuits.
4. Of course, the West is no stranger to wasteful subsidies to stimulate the housing sector generally and homeownership in particular. In the United States, for example, the 1997 federal tax losses from the deduction of mortgage interest payments from income in computing personal income taxes totaled \$53 billion, equivalent to about 6 percent of the federal budget. Other housing-associated tax benefits nearly double the tax losses (U.S. Office of Management and Budget 1997, 1998). As is often documented, these benefits are regressively distributed.

A Regional Policy Report

This chapter focuses on developments in residential homeownership, home purchase finance, and related government policies in Eastern Europe and the Russian Federation. Greater detail is provided on Russia and Poland, based on information especially assembled for this project. The chapter also takes advantage of particularly complete data available for Hungary. The story has a number of facets, which complicates the presentation. But a clear picture emerges in the end.

The chapter begins with a discussion of the policy context, including changes in homeownership rates brought about through privatization programs, developments in new construction, and the extent of shortages in these countries. Then it critically assesses developments in housing finance systems and government policies. The chapter also explores the probable reasons for the low rate at which home purchasers are using formal mortgage finance. Toward the end of the chapter are a number of conclusions for the Visegrad countries and the Russian Federation, as well as a set of lessons for other countries of the region that are less advanced in the development of policies in this area. The lessons are critically important to the people in these countries who are responsible for developing the countries' homeownership policies, and to their advisers, if these policies are to be more effective than those of the region's "fast starters."

The Basics

This section develops several sets of facts that are essential to judging the appropriateness of the finance-ownership policies adopted in the three countries. Where necessary it draws on data for selected industrialized and other middle-income countries¹ to provide a frame of reference. The discussion begins with an overview of current levels of homeownership and a brief review of homeownership policies under the old regime and during the transition. It then moves on to indicators of possible housing shortages and the volume of new construction in recent years that might be reducing it. Affordability—that is, the purchase price of a unit a family can afford—is also an essential piece of the puzzle. Data are presented on the share of incomes households generally spend on housing and the ratios of housing prices (the price of an apartment or home) in selected metropolitan areas to median or average family incomes.

Homeownership

Homeownership rates and the surge in those rates produced by mass housing privatization programs in some countries are key to this discussion for two reasons. First, higher ownership may suggest less urgency for a government to address the issue of increasing it. Second, higher ownership rates signal large equity holdings by the population (given the low volume of mortgage debt) that can be used for financing further home purchases—both “trading up” to a larger unit and using the equity to help an adult child purchase a dwelling.

The hallmark of the Soviet housing system was the large share of units owned by the state. The figures in table 1.1 on the distribution of ownership in selected countries illustrate how entrenched the Soviet system was in the republics of the Soviet Union compared with the countries of eastern Europe. To help focus on the differences between the two sets of countries, this table is organized with the constituent republics appearing first and the countries of eastern Europe second.

The table has four categories. “State rental” is a comprehensive title that includes both municipal rental housing and enterprise housing leased to workers. Directly or indirectly, the state paid for the construction and maintenance of both types. The two systems of developing, maintaining, and allocating housing existed side-by-side. The develop-

ment of the “enterprise channel” was part of the centralized industrial policy that allocated more resources, for everything, to favored industries. Priority sectors received not only more inputs and funds for expanding productive capacity, but additional resources for housing, clinics, rest houses, and other benefits to attract and retain better workers. The allocation of resources for municipal housing was part of a broader social housing policy, with the level of funding depending in part on the bargaining ability of regional leaders with the central planning and housing ministries.²

Cooperative housing, while heavily subsidized, generally required significant contributions from purchasers. This type of housing occupies a middle group between owning and renting, because in eastern Europe the difference between living in a cooperative and a state rental was often slight. Cooperative “owners” had quite limited property rights, including restricted rights of disposition. “Individually owned” units were almost exclusively single-family units in smaller cities, towns, and rural areas. Private rentals did not exist for practical purposes, although in every country there was an illegal market in subleases of state units.

Table 1.1 demonstrates the enormous diversity in tenure patterns before the transition. Evident is the extreme state ownership of housing in Armenia, Estonia, and the Russian Federation compared with the countries of Eastern Europe. The extraordinarily high homeownership rates in Bulgaria, Hungary, and Slovenia are striking; all are above the 65 percent level of the United States, which is often viewed as the quintessential country of homeowners.³ Development of cooperatives became a very important element in the housing strategies of Czechoslovakia and Poland in the 1980s, and this is reflected in the comparatively large share of units in this legal form.⁴

The diversity in the importance of state housing versus owner-occupation and cooperative tenure resulted from conscious government policies. In all socialist countries the government had the responsibility under the constitution to provide citizens with adequate housing. By 1980 it was clear that they were failing. Those countries with lower shares of state housing are those that decided in the 1980s to maximize the resources of the population mobilized to address the persistent housing shortages. Subsidies and loans were provided to induce families to purchase housing (see below). The USSR retained the emphasis on state rentals and devoted more budget resources to housing production.

Table 1.1 *Tenure Distribution of the Housing Stock before Reform (percentage)*

| <i>Country</i> | <i>State Rental^a</i> | <i>Coops</i> | <i>Individually Owned</i> | <i>Other^b</i> | <i>Total</i> |
|---------------------------|---------------------------------|-----------------|---------------------------|--------------------------|--------------|
| Russian Federation (1990) | 67 | 4 | 26 | 3 | 100 |
| Armenia (1980) | 53 | 4 | 43 | — | 100 |
| Estonia (1990) | 60 | 12 ^e | 26 | 2 ^f | 100 |
| Bulgaria (1995) | 16 | ^c | 84 | — | 100 |
| Czech Republic (1988) | 38 | 18 | 41 | 3 | 100 |
| Hungary (1990) | 23 | 6 | 71 | — | 100 |
| Poland (1990) | 35 ^g | 25 | 40 | — | 100 |
| Slovak Republic (1990) | 25 | 20 | 53 | 2 | 100 |
| Slovenia | 33 ^d | — | 67 | — | 100 |

Source: Struyk (1996a), table 1.2.

a. Includes enterprise- and government agency-provided housing.

b. Includes units owned by farm cooperatives, unions, and other special categories.

c. Less than 1 percent.

d. Social housing; includes a small share of private rentals.

e. And other entities.

f. Foreign state-owned.

g. Includes 4 percentage points of private rentals.

A cardinal attribute of the Soviet housing system was the extraordinary occupancy rights enjoyed by tenants. Families lingered for years on waiting lists (8 to 10 years was common) before they were allocated a unit by a municipality or the enterprise where a family member worked, or, for those somewhat more affluent and working in the right sector (and country), before they were admitted to a group forming a cooperative. But once they occupied their unit, it was almost certainly theirs for life; indeed, it could be passed on to successive generations of occupants as long as the successors were registered as living there before the prior occupants died or moved away. This security of tenure was and is highly prized. And the people of the region are sensitive to the weakening of their occupancy rights by the reduction of the state housing stock through privatization, some weakening in the tenure security provisions in lease agreements for state units, stronger rights of banks to evict mortgagors-in-default, and the emergence of private rentals with dramatically reduced tenant protection in their leases that are now typically enforceable in the courts.

Privatization changed the ownership landscape in most countries. Under privatization, sitting tenants have the right to purchase their units from the local government or state enterprises, typically at a substantial discount or, in a number of cases, for free except for a nominal processing fee. When the new owner receives title to the property, he has full rights of disposition. He can sell or rent the unit on the open market, without restriction, if he wishes. Most of the housing involved is in multifamily apartment buildings, with privatization on a unit-by-unit basis. The new owners generally do not receive the right to take over maintenance and management of the building until a condominium is formed, is registered, and applies to take over management. So the rights given to new owners are very substantial, but usually not as comprehensive as those of a condominium owner in Western countries. Condominium formation is well under way by now, though.

It is beyond the scope of this chapter to delve into the motivations of governments for pursuing housing privatization, the details of the various programs, or the problems associated with privatization.⁵ What is important is that successful privatization is required as a condition of the restoration of property rights to unit owners. Under the Soviet system, property rights were sharply restricted. An owner could sell his unit only at a price set by a state appraiser and then often to someone named by the local government. Owners could rent their units, or renters sublease, only when the family was out of the country for an extended period. Hence, reinstating property rights was critical.

Housing privatization proceeded rapidly in some countries during the transition. Table 1.2 shows the extent of privatization by 1994 in five such countries. Indeed, thanks to the combination of privatization and the tradition of homeownership, in 1994 several countries in the region, including Hungary, already had homeownership rates of more than 80 percent.⁶ Indeed, one can argue effectively that countries with such high ownership rates should do nothing further to raise them because a significant rental sector is needed to house newly formed households, those who do not expect to live permanently in an area, and families in similar circumstances.

By 1998, privatization had proceeded further, and indeed several countries, such as Hungary, Estonia, Slovenia, and Armenia, had ended their programs. Table 1.3 shows the levels of homeownership in 1998 in the three countries that receive the most attention in this study—Hungary, Poland, and Russia. Privatization programs sharply raised own-

Table 1.2 “Fast Starters” in Housing Privatization: Percentage of All Units in State Ownership

| <i>Country</i> | <i>Before Transition</i> | <i>1994</i> |
|--------------------|--------------------------|-------------|
| Russian Federation | 67 | 43 |
| Armenia | 53 | 27 |
| Estonia | 60 | 10* |
| Hungary | 23 | 14 |
| Slovenia | 33 | 19 |

* Mid-1995.

ership rates in Hungary and Russia. In Poland, by contrast, there was only a small change in the overall rate. Most privatization has been changing the formal legal status of units in cooperatives. Only about 25 percent of privatizations involved tenants in municipal housing obtaining title to their units. Moreover, the ownership rate in urban areas is not much higher than 30 percent; in Warsaw it is below 10 percent.⁷

Today the situation in the region is fascinating. On the one hand, many countries have experienced a large increase in homeownership rates and in the property rights associated with ownership—developments that are deeply satisfying to the citizenry. In principle, the large home equity values created through the mass privatization programs provide the opportunity for these new owners to purchase a larger or better unit, using the equity and a low loan-to-value mortgage loan. On the other hand, there has been a decrease in tenure security for some households. Certainly families who are private renters and homeowners with mortgages are less secure than they would have been as

Table 1.3 *Percentage of All Units Owner-Occupied in the Study Countries*

| <i>Country</i> | <i>Percentage of Units</i> |
|----------------|----------------------------|
| Hungary | 90 |
| Poland | 67* |
| Russia | 55 |

Sources: Chapters in this volume and unpublished data for Hungary.

* Approximate.

renters of a state unit with the standard lifetime “social” rental contract.⁸ This fact is presumably one element explaining the reluctance of home purchasers in the region to borrow for home purchase or trading up or, when they borrow, to take loans up to the limit of their ability to pay.

Are Families Underhoused?

The perception of significant housing shortages has been a central argument used to promote government subsidies for new construction, including assistance for home purchase targeted at newly constructed homes. An example of this policy perspective is the statement of Poland’s former housing minister, Barbara Blida, that the broad goal of housing policy is to “create a cohesive economic and legal system capable of generating construction demand.”⁹

Objective evidence indicates adequate housing volumes, though, when these countries are compared with others that have similar income levels. Table 1.4 presents data on the square meters of housing per person for major cities in the countries of the Former Soviet Union, including the capitals of the three study countries, and for major cities in other middle-income countries. The pattern is clear: Inhabitants of major cities in the former Soviet bloc are not at a disadvantage compared with their counterparts in other regions.

Comparative analysis by Mayo (1997) comes to the same conclusion. He shows that in 1994 central and eastern European countries had an average of 19.6 square meters of floor space per capita, while in countries with similar incomes the average was 14.0. Similarly, the CEE countries enjoyed 366 dwelling units per 1,000 persons, while the comparator countries averaged 207.¹⁰

Of course, there is variation among countries in the region. Generally the former Soviet republics have less space per person. Among the other countries, Albania is in by far the worst position. Those in the next worst group, but already better than most Soviet republics, are Bulgaria, Poland, and Romania.¹¹

Other measures also suggest that housing production is at least adequate in the study countries. In Hungary, for example, the number of households per 100 units fell from 101 in 1991 to 97 in 1996; persons per room declined from 1.10 to 1.04 over the same period. Similarly in Poland’s urban areas, where growth is concentrated, units per 1,000 persons rose from 308 to 324 between 1990 and 1997; over the same period

Table 1.4 *Floor Space per Person in Selected Major Cities, 1990–1991*

| <i>Middle-Income Cities</i> | <i>Square Meters</i> | <i>Former Soviet Bloc Cities</i> | <i>Square Meters</i> |
|-----------------------------|----------------------|----------------------------------|----------------------|
| Amman | 10.0 | Budapest | 23.5 |
| Bogota | 8.8 | Bratislava | 23.2 |
| Bangkok | 16.5 | Warsaw | 17.4 |
| Istanbul | 17.0 | Moscow | 18.0 |
| Caracas | 16.0 | | |
| Rio de Janeiro | 19.4 | | |
| Seoul | 18.8 | | |
| Athens | 24.5 | | |

Source: Struyk (1996a), p. 11, based on United Nations and World Bank data.

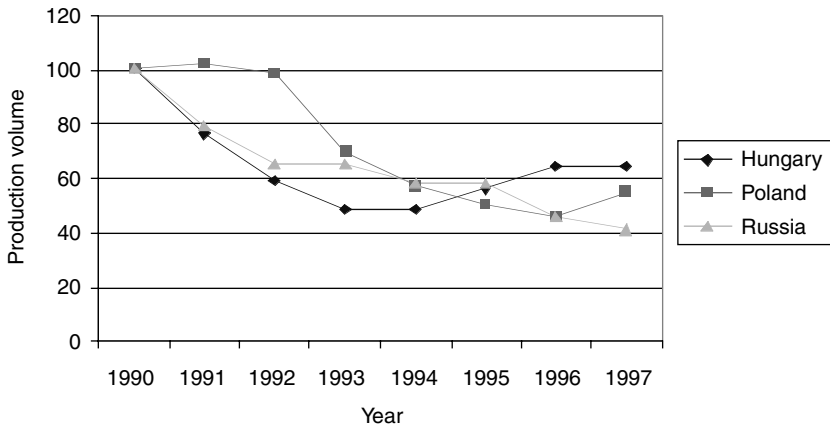
usable floor space per person rose by 7.4 percent to 18.7 square meters. Even in Russia there has been progress; with the population in urban areas actually declining over the period, space per person has increased.

A key factor improving housing conditions is the low to negative population growth, and in some cases even negative household growth. Data presented in the country chapters of this book show that Russian cities lost population in recent years and that the total number of Hungarian *households* declined by 23,000 between 1990 and 1996. Most new construction under these circumstances is replacement housing, typically larger units with better amenities than those leaving the housing stock.

New Housing Construction

The level of new housing construction fell for all of the countries in the region as they entered the transition period (Struyk 1996a). In most countries construction volumes fell to around half of their pre-transition levels. The study countries are no exception (figure 1.1).¹² A few countries, including Poland, sought to prop up construction levels with substantial subsidies, but this strategy was eventually abandoned as unsustainable. While production volumes have begun to recover in Poland and Hungary, they remain depressed in Russia and may fall even further. No one expects that production levels will soon reach their pre-transition levels, which were possible only with massive state subsidies.

Figure 1.1 *Housing Production in Study Countries (1990 = 100)*^a



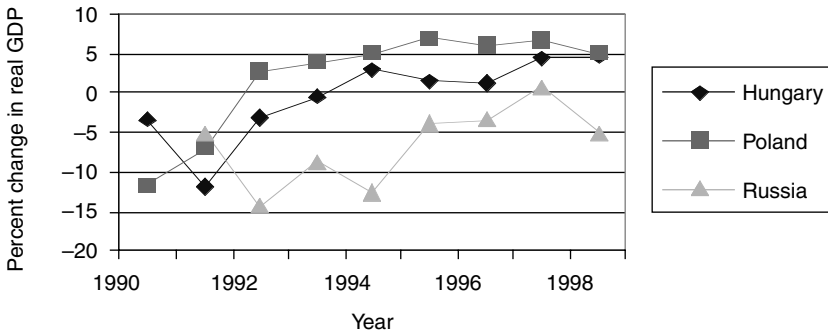
Source: Country chapters in this volume.

a. Figures for Poland in recent years are probably significantly understated.

An important indicator of the adequacy of the volume of new construction is the ratio of new units in urban areas to new households plus an allowance for fully depreciated units that should be retired from the stock and replaced. This type of calculation is limited because it reflects “housing needs” rather than effective demand. Another limitation stems from the methods used to compute replacement needs. Nevertheless, the figures provide one useful perspective. In Russia, despite the low volume of construction, new units have *exceeded* new households in urban areas for several years, mostly because the number of households in urban areas has been falling. Similar data are lacking for Poland and Hungary.

*Economic Environment*¹³

Another piece of contextual information concerns the performance during the 1990s of the economies of the three transition countries that are the focus of the analysis. With respect to *real GDP* growth, a stark contrast exists between Russia, which only experienced positive growth in 1999, and Poland and Hungary, which both had achieved positive growth rates by 1994 (figure 1.2). In 1997 and 1998 both countries had growth rates of more than 4 percent, with a dip in 1998 resulting from the contagion effects of the Russian economic crisis.

Figure 1.2 *Percent Change in Real GDP*

Source: EBRD, Transition Reports, 1997 and 1998, "Selected Economic Indicators for Countries in Transition."

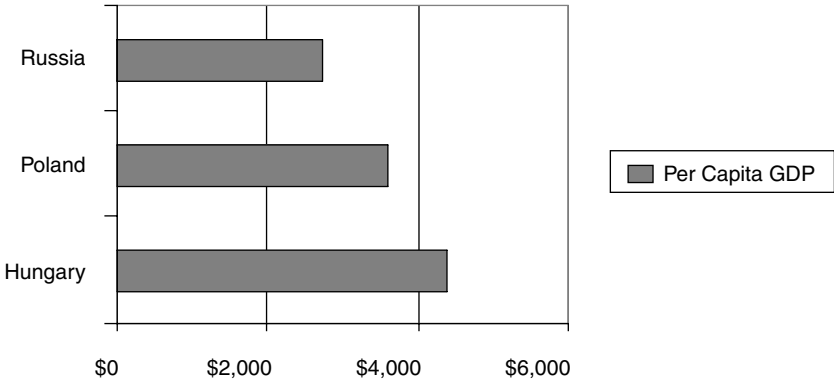
The positive GDP growth for Russia in 1999 of around 3 percent is attributed to the massive devaluation of the ruble that created heightened demand for domestic products, and to the return of normal-to-high prices for the all-important energy exports. Analysts expect sustained positive growth in 2000 but caution that continued growth depends on greater structural reforms.

Despite the near-term good news, Russia's prolonged negative growth is reflected in its lower *per capita income* and higher *share of population with incomes below the poverty level* compared with Hungary and Poland (figure 1.3). Russia's per capita income in 1997 was only 62 percent of Hungary's, and Poland's was 81 percent. Even allowing for greater underreporting in Russia, the difference is substantial. One probable implication of these data is that unit purchase and qualification for mortgage finance has been a possibility for a smaller share of Russian households than for households in Hungary and Poland.

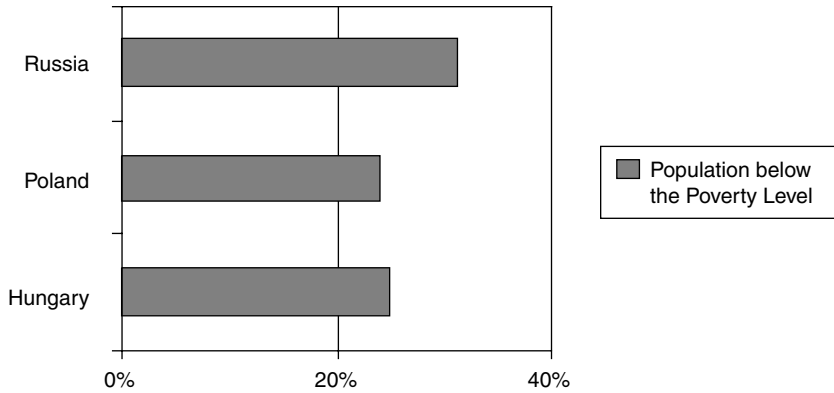
Inflation has been a continuing problem in all three countries. Again, Russia's problem is an order of magnitude worse than the other countries', particularly with the renewed spurt of inflation in 1998–99 resulting from the massive ruble devaluation. The 1998 Russian financial crisis cut both household income and housing prices sharply. So the overall affordability picture did not deteriorate as much as one might have imagined. But consumer confidence plummeted, and the demand for mortgage loans fell correspondingly.

Figure 1.3 Selected Income Data for 1997

Panel A: Per Capita GDP



Panel B: Population below the Poverty Level (%)

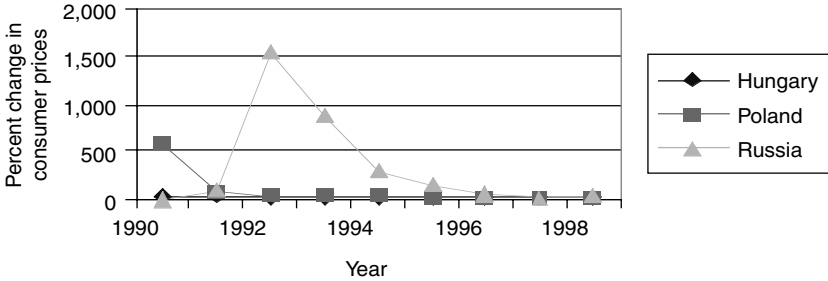


Source: World Bank 1999, tables 1 and 4.

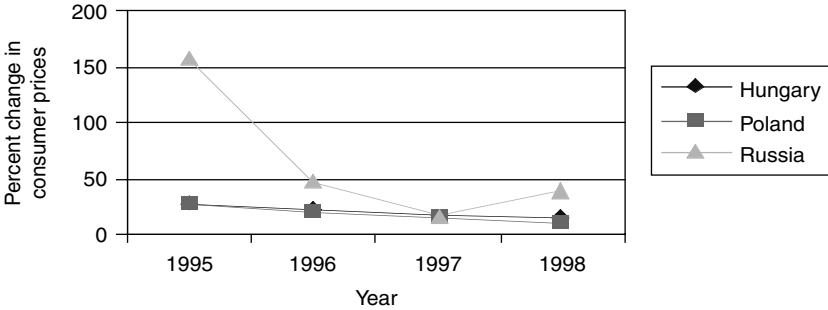
Inflation remained stubbornly at double-digit levels in both Hungary and Poland for the whole decade, although the level drifted steadily downward (figure 1.4). Finally, in 1999 annual inflation in both countries dipped below 10 percent. Still, high inflation implies high interest rates, which have certainly cut into the potential demand for mortgage finance. As later sections describe, it has also encouraged banks to experiment with alternatives to the standard fixed-interest-rate mortgage to expand the size of the loan a family could take.

Figure 1.4 *Percent Change in Consumer Prices*

Panel A: 1995–1999



Panel B: 1995–1999



Source: EBRD (1999), “Selected Economic Indicators for Countries in Transition.”

One must take special note of the implications that the adverse economic conditions in Russia had for mortgage lending. In 1994–95 Russian policymakers broadly agreed that the extreme inflation of the early transition years was the prime reason for the decline in production, the collapse of investment, and the growing poverty problem. Containing inflation became the primary objective. Money supply was severely restricted, with M2 (broad money) being only 20 percent of GDP compared with 60 percent in Western countries. But tight money was not matched by contained national budget deficits. These deficits were financed with short-term government debt and quasi-financing through late payments and similar mechanisms. For several years the strategy worked and inflation was contained. Ultimately, however, the debt burden became insupportable, and default and massive ruble devaluation followed in August 1998 (Sutela 1999). Of course, the economic crisis

was also catalyzed by the combination of falling oil prices, which drastically cut Russia's import earnings, and the general turbulence in developing countries' financial markets that began in Thailand and spread rapidly, unnerving investors.¹⁴

The high yields on government debt discouraged bankers from engaging in normal lending operations, and the tight money supply left them with persistent liquidity problems. With banks' liabilities extremely concentrated in short-term deposits, long-term mortgage lending was generally unattractive. The 1998 financial collapse caused a substantial shakeout in the banking system. But even as recently as early 2000, analysts saw little evidence of restructuring and suggested that more turbulence is ahead for banks (Thomas 2000a, 2000b).

Housing Expenditures and Unit Prices

Expenditures on housing as a percentage of income in Hungary are now in the same range as in major European countries. (Table 1.5

Table 1.5 *Average Percentage of Household Income Spent on Housing^a*

| <i>Country</i> | <i>Year</i> | <i>Percentage of Income</i> |
|----------------------|-------------|-----------------------------|
| Study countries | | |
| Hungary | 1996 | 24 |
| Poland ^b | 1994 | 13 |
| Russia ^c | 1998 | 5 |
| Comparator countries | | |
| Italy | 1992 | 16 |
| Spain | 1992 | 13 |
| Denmark | 1992 | 28 |
| Belgium | 1992 | 17 |
| France | 1992 | 20 |
| Austria | 1990 | 19 |
| Germany | 1992 | 21 |
| United Kingdom | 1992 | 19 |

Sources: Chapters in this book; Metropolitan Research Institute (1996), table D.1; and the UN-Habitat database.

- a. Includes, as applicable, contract rent, mortgage payments, and utilities.
- b. Rental units only.
- c. Percentage of expenditures.

shows average expenditure-to-income percentages for all households in a sample of countries.) Expenditures in Poland have also risen significantly, but a large share of the stock still enjoys subsidies. In both countries the percentages have increased during the transition, driven primarily by increased operating costs, particularly energy prices.¹⁵ Russia again stands out as an exception. Its low percentage results from a combination of continued price controls: rent controls on municipal and enterprise housing, which are gradually being removed, and energy prices far below world market levels. While energy prices are controlled by the national government, municipalities control rent levels and the rate of rent increases, subject to meeting a target in the year 2003.

More important than average expenditure burdens in assessing the potential demand for mortgages is the ratio of average unit prices (for both new and existing units) to average household incomes. In most European countries this ratio ranges from 6 to 8. In Russia, where the ratio was in the double digits in the early transition years, the average ratio was 4.6 in 1997, and it rose to 5.9 in 1998 as incomes fell faster than housing prices.¹⁶

In Hungary the ratio is estimated to have been around 4.9 in 1999. Significant hikes in dwelling prices have pushed the ratio up since 1997. In Poland the ratio for urban areas in 1998 was in the range of 5 to 6, although there was great variation among urban areas. The ratio is substantially higher in Warsaw, for example.

Home Purchase Finance

Although there were some common features, the countries of eastern Europe and the Former Soviet Union entered the transition with sharply different experiences in long-term housing lending. Among the shared attributes were the monopoly of such lending by each country's state savings bank, the targeting of loans on newly constructed units, and the use of long-term, fixed-interest-rate loans. With fixed prices and little or no official inflation, a fixed-rate loan certainly made sense. Interest rates were low, in the range of 2 to 3 percent a year, actually implying subsidies because deposit rates were about the same. Loan periods were long, at least 25 years.

Defaults were exceptional, in part because banks were able to put pressure on borrowers through their employers. When necessary, wages could be garnished. However, in the extraordinary case that a mortgagor did default on his loan, the law made eviction impossible, unless the lender could provide the borrower with alternative housing.

The principal differences among countries were in the volume of lending undertaken and the depth of the subsidies associated with home construction. As noted, these differences reflected housing strategies pursued beginning in the early 1980s. In those countries that had decided to make maximum use of household resources to address the housing problem, loan volumes were high. In the other countries, where state development of rental housing retained its primacy, loan volumes, tightly controlled by central planners, were low. The countries of the Former Soviet Union and, to a lesser extent, former Czechoslovakia are in the second group, and only Hungary, Poland, Bulgaria, and Yugoslavia are in the first. In all of these countries, high-volume long-term housing lending was stimulated by various forms of downpayment and interest rate subsidies.

At first blush, then, long-term housing lending in the former Soviet bloc looks similar to mortgage lending in the West. Unfortunately, the similarities are only on the surface. The state savings banks were not profit-motivated, but rather were simply another enterprise fulfilling tasks assigned to them by the system. Who received loans depended on who was nominated for them by other organizations that had the right to do so. There was no loan underwriting to speak of, and loan servicing was primitive. The annuity mortgage, standard in the West, was not employed. Instead, these countries used a simple instrument in which a uniform share of the original loan balance is paid off as part of each month's loan payment. In short, at the start of the transition, even in those countries with large-scale home purchase lending programs, there was no cadre of trained mortgage bankers. Moreover, the legal basis for such lending was very underdeveloped—loans were often signature loans, and there was no legal provision for collateral-based lending. Loan underwriting and servicing practices were truly rudimentary.

The economic transition, with its freeing of previously controlled prices, entailed a sharp surge of inflation in all countries in the region. GDP and real household incomes plummeted. High inflation produced

high interest rates, and the state savings banks had to raise interest rates on deposits and new loans. The combination of falling purchasing power and higher interest rates cut the demand for long-term housing loans. And the state savings banks were generally not anxious to extend new loans, even at higher interest rates. The clear result was sharply lower numbers of loans to families. The number of loans originated in 1993 in Hungary was 47 percent of the 1990 level. In Slovenia the comparable figure was about 10 percent. In Russia in 1994, Sberbank, the state savings bank, originated less than 5 percent of the number of loans it had in 1991 (Struyk 1996a, p. 36).

Coping with the "Old Loans"

The surge in the cost of funds to the state savings banks also caused large losses on their portfolios of existing long-term, low-interest housing loans. As shown in table 1.6, Poland and Hungary, both countries with very large volumes of outstanding loans, responded decisively to the large losses of their respective savings banks by raising interest rates on outstanding loans or making deals with borrowers to prepay loans, with the bank in Hungary forgiving some of the outstanding debt. The Hungarian loan buy-down was particularly successful; about three-quarters of the outstanding loan balances were paid off (Struyk 1996a, p. 37). Poland still devotes about 40 percent of its national housing budget to addressing this problem (see chapter 2). Hungary also has sizable but smaller continuing outlays. In both countries, outlays should fall sharply within five or six years.

Russia had a different experience. The hyperinflation of about 2,000 percent in 1992, the first year of reform, caught economic planners off guard, and the value of the outstanding loans was reduced to a pittance. No plan was ever formulated.

Legal Basis for Mortgage Lending

Since the start of the transition, all three study countries have enacted laws permitting normal mortgage lending and eliminating the traditional requirement that the bank must provide substitute housing (of a low standard) in case of eviction. They also took other actions to increase the rights of banks and facilitate foreclosure and eviction of

Table 1.6 *Treatment of Old, Low-Interest Loans*

| <i>Country</i> | <i>Treatment</i> |
|--------------------|---|
| Hungary | Borrowers given choice of paying off some or all of the loan, with half of the outstanding principal forgiven and the new interest rate on the balance set at the market rate (initially 36 percent), or shifting to a variable rate mortgage with a 15 percent initial interest rate. |
| Poland | In 1990 the original interest rate was raised to market level (115 percent then; by fall of 1992, 62 percent), with increased payment distributed as follows: The borrower would pay 8 percent of the total, government would pay 32 percent, and 60 percent would be capitalized into the loan balance. In 1991 the payment scheme was recast into a “dual index loan” format, under which the borrower’s payments are computed as a percentage of income. |
| Russian Federation | No change. |

borrowers-in-default, and to create or strengthen real property title and lien registration. Some of this legislation is quite recent—for example, Russia’s Law on Mortgage was finally enacted in July 1998 and its national property registration law only a year earlier.

Still, as detailed later, problems appear to remain in every country. In Hungary, despite several pieces of legislation to improve the certainty and speed of the process, foreclosure and eviction still normally take years.¹⁷ While to some degree the elapsed time can be attributed to slowness on the part of the state savings bank (OTP) with nearly all of its home purchase loans in default, in pursuing its claims, the perception among bankers is nevertheless that the process is cumbersome. And it is this perception that has checked the enthusiasm of other banks in undertaking mortgage lending for home purchase.

In Poland three problems persist (Merrill et al. 1997, pp. 65–67). First is the problem of the “statutory lien.” Existing law gives the state first right to proceeds from the sale of property securing a mortgage loan—that is, proceeds are directed first to satisfy unpaid taxes and other state claims. In addition, the state does not have to register its claim for it to be valid. Hence, the bank cannot know with certainty the validity of its

mortgage claim. Second, there are substantial delays in the processing of claims. Finally, registration of the mortgage lien is slow, sometimes taking more than a year because of the inefficiency of the registry, thus exposing the bank to the possibility that multiple loans may be taken on the same property without the existing claims of banks being discovered upon title search.

Because the Russian Law on Mortgage was so recently enacted, little experience has been recorded. But banks are worried that the courts will not enforce the law or will do so only with significant delays. One indication is that the cities of Moscow and St. Petersburg, to encourage mortgage lending, have enacted laws expediting court proceedings and creating a stock of units in which evicted borrowers can be housed. The stock of units addresses the problem that the court might issue an eviction order that could cause a family to be on the street.

The impact of these growing pains with foreclosure and eviction is greater the higher the incidence of mortgage default. Of course, banks will use more stringent underwriting standards if they expect the foreclosure process to be expensive. Nevertheless, default information is instructive. From the fragmentary data available, it appears that default rates on home purchase mortgages have been much lower than on loans to enterprises.¹⁸

In Poland and Hungary, the scattered information available suggests that default rates have been low. In Hungary, defaults are more common (but formal information is lacking), at least for loans originated by the state savings bank (OTP). But even this situation is hard to judge because OTP has been lax in its loan servicing and very reluctant to begin court proceedings against borrowers in defaults (Rabenhorst et al. 1998).

Industry Structure

The strong influence of German and Austrian Bausparkassen is reflected in the way mortgage lending is or will be executed in Hungary and Poland as the savings contracts already begun are fulfilled and the savers become eligible for loans. In these countries lending is now carried out by Bausparkassen organizations (Hungary), savings cooperatives (Hungary), mortgage banks, commercial banks, and, in Poland, through another form of contract savings scheme. The dominant lender in both countries remains the former state savings bank under the communist

regimes, now a commercial bank. But these are financial systems under development, and there are several possibilities for how industry structure will evolve in the next few years. In contrast, in Russia the system is very simple: Mortgage loans are only being made by private commercial banks. The principal institutional innovation has been the creation of a secondary market institution, the Agency for Housing Mortgage Lending, which is designed to purchase loans from the banks originating them, thereby relieving banks' liquidity problems.

Hungary and Poland

Both Hungary and Poland have instituted housing-linked contract savings programs. The presence of the specialized Bausparkassen banks is a distinguishing feature of the housing finance system in Hungary. Poland passed legislation for a Bausparkassen program in 1997, but in June 1999 the Council of Ministers decided to cancel the program because of its projected high costs and because it duplicated an alternative program that had been in existence since 1995 (discussed below). By the end of 1999, legislation implementing this decision had not been passed but was expected.¹⁹

The closed circuit Bausparkassen is described in box 1.1, and the specific features of the programs in three Visegrad countries are shown in table 1.7. For the Czech Republic and Hungary the information is for the actual programs; for Poland the information is for the program enacted but not implemented. Some prominent characteristics of the Visegrad schemes are as follows:²⁰

- Savers who fulfill their savings contract are eligible for a loan up to the same size as their savings. The upper limit of savings is in the \$12,000 to \$15,000 range.
- Savings contracts are for four to six years, if the bonus is to be paid to the saver. The bonus is generally around 30 percent of the amount saved during the year.
- The effect of the savings bonus has been to make the effective rate of return on savings very competitive with market rates.
- The interest rates on loans made through the system are 8 to 20 percentage points below those in the market, a much larger spread than in Germany and Austria.

Box 1.1 *Bausparkassen: The German Housing-Linked Contract Savings Scheme and Its Attributes in the Visegrad Countries*

Housing-linked contract savings schemes are designed to encourage families to save for home purchase by getting them to commit to a contractual savings plan and by promising a mortgage loan at the end of the contract savings period. The German system is a closed system in that the only funds available to be lent are the savings of future would-be borrowers, plus the repayment principal on outstanding loans.²¹ (Some systems are “open” in that they accept loanable funds from other sources.²²)

Because the system is closed, a Bausparkassen may not have the money to fund the saver-borrower’s loan when the savings contract is fulfilled. This eventuality has given rise to an elaborate allocation system in which preference is given to savers who have saved the most over the longest period. In the “new start” systems of the Visegrad countries, this has not been a problem because they are structured so that during the early years the funds simply accumulate savings.

Another result of the closed system is that it is possible for both the interest rate paid on deposits and the interest charged on mortgage loans to be substantially below market rates. In effect, each cohort of savers is subsidizing a cohort of borrowers. However, if the interest rate on savings is negative in real terms, the saver’s future downpayment is eroding in real terms. For this reason, and because of the apparent reluctance of families to participate in programs paying such low interest on savings, the German system features the national government providing “bonus payments” on the amount of each year’s new savings.²³ So in the end, it is the government that is subsidizing all cohorts of borrowers. With the interest rate on savings typically fixed in the contract, in case of increased inflation the government often must raise the bonus to maintain the attractiveness of the system.

A positive feature of all housing-linked contract savings schemes is their ability to expand the pool of potential borrowers. Although a family may not qualify for a mortgage loan from a

Box 1.1 (*Continued*)

commercial bank, it can qualify in a Bausparkassen program by saving regularly and fulfilling its savings contract.

In the German system, both in the original and as structured in the Visegrad countries, it is possible for a saver to receive a loan before he has completed his savings contract. This is a “bridge loan” to cover the period from the origination of this loan until the loan is paid off by the regular Bausparkassen loan after the savings contract is fulfilled. The loan term can be up to three years. Bridge loans carry market interest rates.

There is no attempt to target the savings bonuses to lower-income families other than through the limitations on the maximum amount of savings permitted. However, the schemes generally contain features to ensure that funds borrowed will be used for housing purchase.

The German system features specialized institutions to offer the housing-linked contract savings plans. This tradition has been followed in central and eastern Europe, although typically the new Bausparkassen are partially owned by local commercial banks and by German or Austrian Bausparkassen.

- The programs are popular: In the Czech Republic there were 2.2 million savings accounts as of 1998; in the two-year-old Hungarian program, there were 350,000 accounts in the same year.
- The program can also be expensive. In the Czech Republic government subsidies were about 1 percent of total national government spending in 1997; Hungary’s young program accounted for 0.3 percent of all government spending.

Three features of this program are worth emphasizing. First, the subsidies are not targeted, except by the limitation on the amount of savings applicable for the government bonus payment.

The second feature is that, as a stand-alone source of finance, the scheme does not provide a very large amount of money for home purchase. Upon initial inspection, one would think that the Bausparkassen’s

Table 1.7 *Characteristics of Contract Savings Schemes in Selected Countries, 1998*

| <i>Characteristic</i> | <i>Czech Republic</i> | <i>Hungary</i> | <i>Poland</i> |
|--|-------------------------------|-------------------------------|--|
| General | | | |
| Date of law | Feb 1993 | Nov 1996 | Jul 1997 |
| Date of first operations | Sep 1993 | May 1997 | |
| Inflation 1997 | 10% | 18% | 13% |
| 1998 | 12% | 14% | 11% |
| Number of specialized banks | 6 | 4 | — |
| — Number with equity from German or Austrian Bausparkassen | 6 | 3 | — |
| — Number of accounts | 2,200,000 | 350,000 ^b | — |
| Savings | | | |
| Yearly premium on savings | 25% | 40% | 30% |
| Yearly maximum premium ^a | 4,500 CK \$125 | 36,000 HUF \$152 | 1,300 PLN \$325 |
| Maximum premium as percentage of 1997 monthly wage | 53% | 75% | 100% |
| Effective interest rate | 13% tax-free | 16% tax-free | 15% taxable |
| Market interest rate | 10–12% | 14–16% | 15% |
| Yearly savings to maximize rate of return ^b | 18,000 CK \$278 | 120,000 HUF \$508 | 4,350 PLN \$1,078 |
| Minimum savings contract period | 5 years | 4 years | 2 years |
| Terms to keep premium without taking housing loan | 5 years + fulfill contract | 8 years + fulfill contract | n.a. |
| Loan terms | | | |
| Maximum multiplier/ (savings + premium) | 1 | 1 | 1 |
| Interest rate on loans and deductibility from personal income tax | 6% not deductible | 6% deductible | 3% not deductible above rate on savings |
| Market interest rate ^c and deductibility from personal income tax | 14% deductible | 27% not deductible | 25–26% not deductible |

Sources: Lea, Laszek, and Chiquier (1998), appendix B; Diamond (1998a).

a. Exchange rate as of May 1999.

b. Estimated.

c. For annuity mortgage, not dual index or deferred payment mortgage.

low interest rates should make it superior to market-rate mortgages in helping families purchase a housing unit. But two attributes of this mechanism undermine this seeming advantage. One is that the amount of savings on which the government makes bonus payments is limited. The other is that the loan size cannot be greater than the size of the savings balance at the end of the savings contract. To see the impact of these restrictions, take the case of a saver who fulfills a four-year contract, saving \$508 per year, which maximizes the return on savings in Hungary. Including the annual bonus on new savings,²⁴ the saver would have accumulated about \$5,250 at the end of his contract. With a loan of the same amount, the family has \$10,500 to use for its home purchase. This is not very much in Hungary, for example, where even now one is lucky to find apartments for \$400 to \$500 per square meter. Generally loan periods are for five or six years, although they can be substantially longer. Note that the monthly payment on a five-year loan at 6 percent interest is roughly equivalent to the monthly payment on the same loan amount at 25 percent for 15 years. In other words, the lower interest rate does not necessarily mean greater affordability compared with a market-rate loan.

The third notable feature of these systems in the Visegrad countries is that the evidence to date is they generate little additional savings. Rather, participants shift funds from another savings instrument into their Bausparkassen account (Diamond 1998b).²⁵

The number of Bausparkassen institutions in Hungary is small, only four. From the early 1990s the German and Austrian associations of Bausparkassen energetically promoted their system in the Visegrad countries. So it is not surprising that in Hungary, German or Austrian Bausparkassen have an equity interest in three of the four banks (table 1.7). A standard pattern is also for the Bausparkassen to be established as a subsidiary of an existing commercial bank.²⁶ Poland has a second type of contract savings institution, *kasy mieszkaniowe* (KM), which differs in important respects from the standard Bausparkassen. Interest rates on savings and mortgages are variable, being tied to the central bank discount rate. The program operates through commercial banks: Any bank can offer a program. Savings premiums are made as a 30 percent tax credit through the personal income tax, up to a maximum of PLN 15,000. Like the Bausparkassen plan, savers must fulfill a multiyear contract, and loans must be used for housing purposes. But unlike the Bausparkassen, the KM is run on a nonprofit basis, with banks permitted to charge a 1 percent fee to manage the accounts.²⁷

Mortgage banks—specialized mortgage lenders that raise funds for lending by selling mortgage-backed bonds in the capital market—are few in both countries. These banks are closely patterned on their German counterparts. They finance their lending by selling bonds (*Pfandbriefe*) in the capital market. A primary characteristic of the loan pools supporting the bond issues is the highly conservative property appraisal and underwriting of the loans. The procedures instill substantial confidence in investors.²⁸ Bonds issued by mortgage banks carry a favorable capital-risk weight for banks holding them as assets.

As of late 1999 Hungary had two mortgage banks. In Poland two had been registered and several more had applied for licenses. One Hungarian bank, established by the state with very limited private-sector participation in 1996,²⁹ has yet to develop into a high-volume operation, although its loan volume is increasing. In 1999 the bank made two successful bond issuances³⁰ and it shifted its attention from commercial real estate lending to residential mortgages. It believes it can be competitive with commercial banks because of its lower spreads and the competitive cost of funds that is possible from Hungary's inverted yield curve. The second mortgage bank was created in 1998 by the German HypoVereinsbank.

Poland's first mortgage bank was established with the participation of the same German bank. It was scheduled to begin operations in early 2000. The Polish mortgage banks were expected to concentrate on commercial lending rather than residential mortgages in their early operations.³¹

The Polish system has another actor. In 1993 Poland established the Mortgage Fund to act as a mortgage refinancing facility, initially using funds lent by the World Bank and USAID and the government's equity contribution. Lines of credit were extended to commercial banks for financing dual-index mortgages they originated (see below). However, primarily because of banks' high liquidity during this period, they were reluctant to draw on the fund's resources, and its future is in doubt.³²

In summary, the housing finance systems in Hungary and Poland are clearly under development, and those countries may eventually move from a commercial bank-dominated system to one in which contract savings plans and mortgage banks become major players, if not the main ones. But it appears the systems developing in Hungary and Poland will in any case be somewhat different from the German system, under

which the principal loan is made by the mortgage bank with supplemental financing from the Bausparkassen in a combined loan package. For the next year or two at least, the pattern in Poland and Hungary will be for the Bausparkassen and the KM to be larger loan originators than mortgage banks; and there will be few borrowers who take multiple loans. Because the Bausparkassen and KM savings contracts and associated loan amounts are modest, the impact on housing affordability will be correspondingly modest.

Russia

Before the transition in Russia the state savings bank, Sberbank, was *the* provider of long-term finance to households for unit construction. Aside from loans to urban housing cooperatives to finance the combination of construction and purchase of high-rise apartment units, loans were limited to construction of simple dwellings in small towns and the countryside. Overall loan volume was small: Lending for both cooperatives and single-family construction was equivalent to only 7 percent of the value of new construction in 1990 (Struyk 1996a).

Sberbank, like its counterparts in Eastern Europe, was caught at the beginning of the transition with a portfolio of very low fixed-interest-rate long-term housing loans and a sharply rising cost of funds. By mid-1993 it had decided to stop long-term housing lending.³³ This opened the door for private commercial banks to step in. While the economic and legal environment was daunting in the early years, several banks started creative lending programs. Loans were often structured as lease-purchase contracts to protect against credit risk, and loan terms were short (two to three years) as a partial guard against the Russian banking system's formidable liquidity problems.

The central point for this discussion, however, is that private commercial banks are virtually the only mortgage lenders in Russia. In 1995 the government began a process of constructing a secondary mortgage market institution from scratch in response to statements from bankers that a substantial volume of mortgage lending would occur only if they could avoid holding long-term loans—that is, they wanted a liquidity facility that would purchase their loans. By the fall of 1997, the necessary legal steps had been taken to create the Agency for Housing Mortgage Lending as an open joint stock company, initially fully owned by the

government. The Agency was to purchase loans using funds secured through issuing bonds that are loosely collateralized by mortgages. The Agency purchased its first loans using its capital in March 1999 under a pilot program in the city of St. Petersburg. Expansion of purchase volumes has been complicated by Russia's default on international debt, which precludes the Agency from borrowing from international markets for some time at least. So it is turning to the domestic market to raise funds. But the Agency's start-up has also been hampered by delays in receiving a license from the Central Bank of Russia.³⁴ Interestingly, other refinance facilities are being proposed or are operating at a low level. These include the operations of the U.S.-Russia Investment Fund and an aborted, highly subsidized scheme by the city of Moscow. (The Agency's structure is described in chapter 3.)

The Agency's mortgage contract and other documentation, as well as its guidelines on loan underwriting and origination, are being widely adopted, thereby achieving a degree of standardization lacking in the other countries in the region.

In short, the formal Russian housing finance system is simplicity itself: Commercial banks act as loan originators combined with a liquidity facility that purchases mortgages in much the way Fannie Mae operates in the United States. But because credit and liquidity risks have made banks reluctant to originate loans, a number of builder-financed operations have also emerged, along with some bank-operated contract savings schemes. These schemes are numerous and likely assist with the purchase of more units each year than formal mortgage lending does.³⁵ Moreover, a number of oblasts (regional governments) and municipalities have initiated deep-interest-rate buy-down subsidy schemes with their own budget funds. These schemes undermine the demand for market-rate mortgages from banks.³⁶

Summary: Accessing Capital Markets

Both the Russian and the Polish-Hungarian (German) housing finance systems are seeking to mobilize funds from broader capital markets for mortgage lending—Russia through its liquidity facility and Poland and Hungary through mortgage banks. The pressure for banks to gain access to capital markets to fund mortgages depends primarily on

two factors: (1) the cost of deposits versus the cost of funds in the capital markets and (2) the term structure of deposits, with banks with short-term deposits needing to find longer-term liabilities in capital markets to manage their liquidity risk when long-term loans constitute more than a small share of assets. There were clear differences among the study countries in mid-1999 in their need for capital market finance. Polish banks, for example, were highly liquid and their cost of deposits very competitive with those in the capital markets. This fact suggests that it would be difficult for mortgage banks to compete against commercial banks on price for retail home purchase loans. The Polish situation could change quickly, however, as its expanding economy generates increased demand for commercial loans, thereby reducing liquidity and raising interest rates on loans.

The Russian banking system represents a different case. In 1999 it was somewhat liquid, certainly more liquid than it had been for years. This was because there were no government bonds to invest in, although the government did borrow significant sums directly from commercial banks. In addition, there was a dearth of demand for commercial loans. Still, liabilities at commercial banks remained heavily concentrated in the very short-term category. For this reason the nascent liquidity facility remains a priority for the country. The role that capital market finance will play in any of these housing finance systems remains a very open issue.

Types and Volume of Loans

This section discusses the kinds of loan products being offered in the three study countries. All three have engaged in substantial innovation.

LOAN INSTRUMENTS. Before the transition none of the three study countries employed the equal-payment, self-amortizing annuity mortgage that is standard in Western countries. Similarly, loan underwriting and servicing systems were at best highly simplified. All three countries needed to strengthen their lending operations—including adopting new loan contracts in which the property being purchased explicitly served as collateral and instituting the self-amortizing loan.

As illustrated earlier, all three study countries experienced considerable inflation during the transition, continuing through 1998. In this environment the standard mortgage referred to above has the distinct limitation that nominal interest rates on the loan must be high enough so that banks can make a profit when their cost of funds for paying positive real interest rates on deposits is correspondingly high. These rates make mortgage finance unaffordable to most households. So banks had an incentive to search for loan products that would enhance affordability while continuing to ensure acceptable levels of risk and profitability.

In fact, a family of loan products have been developed since the 1970s in the West to address exactly this type of problem. Several of these are discussed and defined in box 1.2. Interestingly, banks in each of the three countries selected a different innovative loan product to offer most frequently to consumers, although there was significant small-scale experimentation with a variety of instrument designs and indexes. While the choice in each country reflects the advice of donor consultants to some extent, the choices are also consistent with the banks' views about the type of product that would be acceptable to consumers. In Russia, for example, banks rejected use of the deferred payment mortgage despite aggressive promotion by a donor technical assistance team. Table 1.8 lists for each country the type of loan instrument adopted and summarizes the experience of each in offering these loans.

In Russia the dollar-denominated loan with the annuity mortgage became the standard instrument. But in Hungary and Poland, governments and their advisers struggled to gain bank and consumer acceptance for the more exotic alternatives to the standard loan instrument. Banks objected to the negative loan amortization inherent in the dual index mortgage and the deferred payment mortgage; where banks have offered them, success has depended in part on rigorous training of loan officers dealing with clients. Consumers found the instruments hard to understand and were also concerned about rising loan balances.

Eventually the dual index mortgage was able to achieve a credible market share and broad bank acceptance in Poland; other indexed instruments also were offered by various banks and accepted by a modest share of borrowers. The largest lender, Bank PKO BP, offered only dual index and deferred payment mortgages in recent years. In Hungary the dominant lender originates about half of its loans as deferred payment mortgages, but it is the only commercial bank offering this product. In both countries in 1997 the main alternative to the standard

annuity mortgage still accounted for fewer than half of loan originations. As macroeconomic stability strengthens—and inflation is further contained—one can expect to see even less use of these instruments.

Box 1.2 *Mortgage Instruments for Inflationary Economies*³⁷

Why Special Instruments

The “standard” mortgage instrument used by many lenders for home purchase is the fully amortizing, constant payment mortgage. The loan uses a repayment pattern of constant, regular payments calculated from the original loan amount at a fixed rate of interest for a given term. This structure allows the original loan amount to be completely repaid at the end of the term, with the lender having a fixed rate of interest on the outstanding loan balance throughout the loan term.

Experience in inflationary economies has highlighted the problems this standard instrument can cause for both borrowers and lenders. With high inflation, lenders are forced to charge a high nominal interest rate on a loan in order to maintain a positive real rate of return on their investment. This high rate leads to high initial payments under a fixed-rate, fixed-term loan. However, as time passes the real value of the loan payment (constant in nominal terms) is eroded by the continuing inflation. This decline in the real value of the payment over the term of the loan is known as the “tilt” problem: The real repayment of the loan is “tilted” toward the early part of the loan term.

This tilting of the repayments has a modest positive effect for the lender (in that he receives higher real repayments in the early years of the loan term). The effects of the tilt on the borrower are much more substantial. The higher nominal interest rate required to overcome the expected impact of inflation raises the payment; this higher payment must be met out of the borrower’s current income. Over time, of course, as nominal household income rises with inflation, the required payment becomes more and more easily affordable. However, the high real value of the initial payment implies that households will have a harder time qualifying to bor-

(Continued)

Box 1.2 (*Continued*)

row. Given that the tilt effect increases as inflation increases, it is clear that higher levels of inflation make it increasingly difficult for households to borrow for home purchase.

A series of alternative mortgage instruments have been developed to address the tilt problem. They have in common deferring some of the payments due in the early years of the mortgage contract to later years when the borrower can better afford to make larger nominal payments. A significant impact on banks making such loans is that the loans experience negative amortization for some years before the loan principal begins to be paid off in sufficiently large amounts for the loan balance to decline in nominal terms.

The Dual Index Mortgage³⁸

The dual index mortgage (DIM) attempts to overcome the tilt problem in a way that distributes risk reasonably between both the lender and the borrower. Under the DIM, the loan's repayments and the outstanding balance are related to appropriate indexes to address the key concerns of each party. Payments are indexed to some measure of income of workers or households in order to maintain the affordability of the loan to the household. The nominal loan balance is indexed to a measure of inflation or cost of funds in order to protect the real value of the lender's asset.

In circumstances where real wages are falling, households would not be required to make the full payment of principal and interest due; the unpaid portion is capitalized into the outstanding balance. Note that repayments are indexed to a general wage series, not the wages of the individual borrower. So credit risk is reduced, not eliminated.

Because the real rate of repayments can vary, the loan term must also be variable to accommodate shortfalls in real repayments when real wages are falling and accelerated real repayments when real wages are rising. Thus, a key question in designing the DIM is establishing the initial loan maturity schedule so that sufficient maturity extension can be accommodated to deal with pos-

Box 1.2 (*Continued*)

sible shortfalls in real repayments. For example, the mortgage could be structured so that in the absence of any real wage changes the loan would fully amortize in 12 years, but the contracted term of the mortgage could allow for an additional five years to cover any losses stemming from shortfalls in real repayments.

If the index for adjusting the loan balance is well-chosen to move with the bank's cost of funds, the bank can largely insulate itself from interest rate risk under the DIM.

The Deferred Payment or Dual Rate Mortgage

The deferred payment mortgage (DPM), also called the dual rate mortgage, offers an alternative to the DIM that places more of the adjustment burden on the borrower. But where used it has permitted a lower initial interest rate in computing monthly repayments and thereby has increased the size of the loan for which the borrower can qualify.

The DPM uses two interest rates. The *payment interest rate* is used to compute the current payment due from the borrower. The *contract interest rate* is the rate charged on the loan and is used to compute the full payment due each month. Each month four actions occur: The bank computes the payment due using the contract interest rate; the borrower makes a payment based on the payment interest rate; the bank adds the difference between the two payments to the loan principal; and the bank reduces the amortization period by one month. By reducing the amortization period each month, the bank forces the loan to be paid off on the term stated in the mortgage contract.

In a typical case, the payment interest rate could be 10 percent and the contract rate 25 percent. Under such parameters, negative amortization is substantial in the early years of the mortgage contract but falls sharply at something over half of the stated loan maturity.

(*Continued*)

Box 1.2 (*Continued*)

If the contract interest rate is variable, then changes in interest rate are reflected in the borrower's payment through their impact on the size of the loan principal. So the bank shifts interest rate risk to the borrower. As a consequence the bank will usually use a comparatively low maximum ratio of mortgage payment to income, perhaps 20 percent, to provide a cushion for the borrower's ability to pay in case of interest rate increases. (The payment rate is fixed.) Simulations indicate that large interest rate increases lasting for two or three years do not result in correspondingly large percentage increases in loan repayments because of the muting effect of adjusting the loan balance rather than payments directly.

Dollar-Denominated Loans

In some countries banks have used loans whose mortgage principal and payments are denominated in U.S. dollars to address the tilt problem—that is, to increase the size of the loan the borrower can take with a given initial monthly payment, and to protect the bank against interest rate risk. The monthly repayment is computed in dollars, using the applicable interest rate and loan term, and then converted to local currency, using the exchange rate on the day on which the payment is made.

If the exchange rate moves with the inflation rate, then the dollar interest rate is effectively being set at the real interest rate plus premiums for several types of risk—for example, credit risk or liquidity risk. Because these risk premiums are charged regardless of whether the loan is dollar-denominated or local currency-denominated, the difference between the dollar rate and the local currency rate will be close to the rate of inflation, possibly a very large figure. In this loan type, like the DPM, interest rate risk (approximately by exchange rate risk) is borne largely by the borrower. A sudden devaluation, where payments increase much faster than incomes, can produce “payment shock” that dramatically

Box 1.2 (*Continued*)

raises the credit risks to the bank. So the bank pays some price in greater credit risk for shifting the interest rate risk to the borrower.

In fact, in countries of the former Soviet Union in particular, exchange rates and interest rates have not moved closely together. For this reason, some banks have extended dollar-denominated, *variable interest rate* loans to protect against interest rate risk.

Table 1.8 *Sample Countries' Experiences with Alternative Mortgage Instruments*

| <i>Country</i> | <i>Loan Product*</i> | <i>Frequency of Use</i> |
|----------------|---------------------------------|--|
| Hungary | Deferred payment mortgage (DPM) | Slight majority of loans originated by the state savings bank (OTP) are DPMs; other banks offer traditional loans. |
| Poland | Dual index mortgage (DIM) | <ol style="list-style-type: none"> 1. DIMs were adopted by the state savings bank (PKO BP) early in the transition to help borrowers make payments on the "old loans." 2. "Subsidized version" offered 1990–95 by PKO BP. 3. "Commercial version" encouraged by creation of a liquidity facility (mortgage fund); in 1998 five banks sold loans to the fund; most banks offer DIMs and traditional loans. |
| | Dollar-denominated mortgages | Offered as an alternative by several banks. |
| | Deferred payment mortgages | Major loan product of the largest lender, Bank PKO BP. |
| Russia | Dollar-denominated loans | Standard loan instrument during the whole transition period. |
| | Deferred payment mortgages | Very limited offerings of this product |

* See box 1.2 for a description of these loans.

LOAN TERMS. Terms on home purchase mortgages typical in 1998 are shown in table 1.9. The most striking feature is the high interest rates charged. The figures seem particularly high because interest rate risk (or in the Russian case exchange rate risk) is being borne by the borrower. In all countries the high interest rates are directly related to significant inflation in recent years. Nevertheless, real interest rates and spreads are high. In Hungary the real interest rate on mortgage loans in 1998 was around 12 percent; in Poland the parallel rate was 13 percent. Spreads over the cost of funds, too, appear to be large in both countries. In Russia the spread between deposit interest rates on dollars and interest rates on dollar-denominated loans was around 10 percentage points. As inflation is controlled, interest rates should decline in all three countries. But only in Poland is there realistic hope that competition will reduce spreads any-time soon.

By Western standards, loan terms tend to be short, particularly in Russia, although this should improve somewhat as the Agency for Hous-

Table 1.9 *Typical Commercial Bank Terms on Home Purchase Mortgages in 1998*

| <i>Condition</i> | <i>Hungary</i> | <i>Poland</i> | <i>Russia</i> |
|-----------------------------|--|--|---|
| Type of instrument | DPM; conventional | DIM; conventional ^c | Dollar-denominated; conventional ^d |
| Interest rate on loan | VRM ^a , 27 percent initial rate for conventional; ^b 25 percent for DPM | VRM, 25 percent for both loan products | 20 to 30 percent |
| Maximum loan-to-value ratio | 40 to 70 percent | 70 to 80 percent | 70 percent |
| Loan terms | 5 to 15 years | 7 to 15 years | 3 to 10 years |
| Collateral | Lien; sometimes additional assets | Lien | Lien; often additional assets |

Sources: Chapters in this volume and Hegedus and Varhegyi (1999).

a. Variable rate mortgage; typical rates adjusted at the discretion of the bank.

b. Rate is 1 to 2 percentage points lower if the borrower has had a savings contract with the bank.

c. Some dollar-denominated and DPM loans are also made.

d. A declining number of banks are using lease-purchase contracts.

ing Mortgage Lending purchases loans with 5- to 10-year terms. Lenders' concern about the efficacy of foreclosure laws and implementation is clear in Hungary and Russia, where banks sometimes require the pledge of assets beyond the home to secure the loan. These concerns translate into wider spreads.

LOAN VOLUME AND COMPETITION. Loan volumes are low to modest in all three study countries, however, as measured with the available data. (Measurement is difficult at best because of the general lack of official statistics.) Consider the commonly used measure of outstanding mortgage debt as a percentage of GDP. The figures in table 1.10 for the study countries and European Union nations with comparatively low ratios make the point emphatically that loan volumes must have been very low for at least several years for the stock of loans to be so small.

Another way to assess the volume of lending is with respect to the share of unit purchases made with the assistance of a mortgage loan. Diamond (1999) estimates that about 20 percent of dwelling purchases in Poland involve a mortgage loan. In Hungary, the upper limit is placed at 10 percent of existing units and 15 percent of newly constructed units; the real figures could be significantly lower. In Russia, the figures for

Table 1.10 *Outstanding Mortgage Debt Ratios in Study Countries and Comparable Countries*

| <i>Country</i> | <i>Home Purchase Mortgages as Percentage of GDP</i> |
|----------------|---|
| Hungary | 1.6 |
| Poland | 0.6 |
| Russia | * |
| Spain | 22.0 |
| Portugal | 26.3 |
| Ireland | 26.0 |
| Italy | 7.3 |
| France | 20.4 |

Source: Figures for study countries are for 1997 or 1998. Figures for the other countries are for 1997 and are from Lea (1999), table 1.

* Less than 0.5 percent.

mortgage loans are even lower, but total financing (including builder finance and other schemes) might be in the same range as Hungary's.

As for the trends in mortgage lending, Poland is the exception, with clear year-on-year increases in recent years; in 1998 about 43,500 loans were originated. Volume has been increasing rapidly, with annual percentage increases in outstanding loan volume running at close to 100 percent (Merrill et al. 1999a, tables 2 and 3). In Hungary, in contrast, the volume of lending actually declined in 1996 and 1997 and since has been essentially stagnant (Hegedus and Varhegyi 1999). Before August 1998, Russian banks were making perhaps 10,000 to 15,000 loans a year—a tiny figure for a country of its size. In 1999 and 2000, lending volume is much lower and banks are not likely to increase the number much until the Agency for Housing Mortgage Lending steps up its operations or there are sustained substantial improvements in macroeconomic conditions.

Meaningful competition may begin to take hold in Poland, and a weaker version may arise in Hungary. But the old state savings banks remain dominant in both nations. In Poland, PKO BP in mid-1999 still held 63 percent of total outstanding mortgage volume. But this share is being steadily eroded (Merrill et al. 1999a, p. 9). A half dozen Polish banks were major players in mid-1999. In Hungary, OTP originated 95 percent of housing loans by volume in 1997. But since then its share has fallen somewhat as other banks have become more price- and service-competitive. The state-supported Land Credit and Mortgage Bank (FHB) is developing into a strong competitor to OTP through its aggressive pricing of mortgage loans. In the first quarter of 2000 it is believed to have originated loans equivalent to 25 percent of OTP's volume.³⁹

In total, six commercial banks plus the state-supported mortgage bank in Hungary and 28 banks in Poland are reported to be active lenders. In Russia only a relative handful of banks made a significant number of loans, defined as at least 100 or more a year, before August 1998, and there was correspondingly little competition. On the other hand, many of the top 300 banks originate a low volume of loans (fewer than five per month). They have gained some experience with the product and are in position to expand operations when conditions improve.

Another indicator of the extent of competition among banks in making mortgage loans and the efficiency of mortgage lending generally is

the spread between the interest rate on a government bond and mortgage loans with similar maturities. The government bond is viewed as a riskless investment. The spread incorporates premiums charged by banks for taking certain risks, the cost of their operations, and their profits. Table 1.11 shows the spreads for several Western countries and for Poland and Hungary. The figure for Russia could not be computed because of lack of data. Note that the spreads for Poland and Hungary use the one-year government bill rate, and the loans are for longer periods.⁴⁰

The higher spreads in Poland and Hungary are clear. Note, however, that these higher spreads reflect not only competition but also possibly greater lending risks. Bank spreads for mortgage loan rates over their cost of funds are also much wider in the three study countries than in Western nations (see Poland chapter).

Framework for Thinking about Government Intervention

Before examining the ways the governments of Hungary, Poland, and the Russian Federation have intervened to support homeownership, it is useful to consider the various options governments generally have available, to define a set of criteria for judging them, and to rate the interventions in terms of the criteria.

Table 1.11 *Spread between Interest Rates on Government Bonds and Mortgage Loans*

| <i>Country</i> | <i>Spread^b</i> <i>(percentage points)</i> |
|-----------------------------|---|
| Poland ^a | 4.5 |
| Hungary ^a | 7.1 |
| United States | 2.2 |
| United Kingdom ^b | 1.5 |
| Germany ^c | 2.1 |
| Denmark | 1.3 |
| France ^c | 2.3 |

a. Compared with one-year government bonds.

b. Centralized lenders (not building societies).

c. Depositories.

Types of Intervention

Governments have a remarkably wide range of options available for supporting home purchase. Broadly, these fall into two groups—subsidies and regulations.

SUBSIDIES.

- Interest bonuses on savings when the savings are part of a housing purchase–related contract savings scheme, along the lines of the German–Austrian Bausparkassen system.
- Subsidies paid to banks on behalf of borrowers for interest payments on mortgage loans.
- Personal income tax benefits: deduction of some or all interest payments on home purchase mortgages from the income subject to tax, and partial or full sheltering of capital gains realized on sale of the unit from tax.
- Transaction subsidies, such as relief from registration fees.
- Government support for guarantees of mortgage loan repayment (mortgage default insurance for banks) and interest payments to investors on mortgage-backed securities.
- Construction subsidies, including exemption from VAT or other taxes, gift or discount on land for construction, subsidized construction period finance, direct construction subsidies, and infrastructure subsidies.
- Downpayment subsidies, which can range from modest to large enough to cover the majority of the purchase price of the unit.
- Government support for secondary mortgage facilities.

REGULATION OF FINANCIAL INSTITUTIONS.

- Interest rate controls on mortgage loans.
- Mandated share of assets to be held in mortgage loans.
- Lower reserve requirements for deposits supporting mortgage loans.
- Mandated purchases of mortgages or mortgage-backed debt instruments by government pension and other funds.
- Creation of a new form of institution required to carry out housing-linked contract savings schemes or to be a “mortgage bank.”

Governments in the region—directly or working through their central banks—have tended to shy away from most forms of promoting homeownership through regulatory actions in the banking sector. Mandated lending or purchases of mortgages can be especially dangerous, leading to poor underwriting by banks originating loans and substantially distorted investment patterns, as experienced in many developing countries where sectoral lending priorities have been established. In part at least, avoidance of the use of regulatory powers to foster mortgage lending can be attributed to the independence of the central banks and the strong desire to bring the banking sector up to Western standards as quickly as possible. One motivation for the latter has often been the desire of the government to capture badly needed revenues by selling controlling shares in former state banks to international investors.

The clear exception to this rule, however, has been the willingness of parliaments to authorize the creation of new banks to administer contract savings schemes—the Bausparkassen—and specialized mortgage banks. Because only this type of regulatory action has been important, the balance of this discussion is focused on subsidies, and the impact of regulations for contract savings schemes is covered with the savings bonuses.

Banks are active participants in several of the subsidy programs. Most obvious is the program of subsidies on savings in mortgage-related contract savings schemes, where these specialty financial institutions exist in this form only because of the subsidy's presence. But banks can also be active participants in several other subsidies: government payments to the bank on behalf of the borrower of interest due on qualifying mortgage loans, government-assisted mortgage default insurance, interest rate or other subsidies on loans to finance housing construction, and, in some cases, the administration of downpayment subsidies.⁴¹ Similarly, when a mortgage liquidity facility is assisted by the government, banks selling loans to the facility benefit through lower liquidity risk and, in some systems, lower credit risk. In short, there is an intimate relationship between homeownership subsidies and financial institutions.

Rating Interventions

Economists generally accept a half-dozen criteria for judging the efficacy of the kinds of intervention under consideration here. These are listed and described in table 1.12.

Table 1.12 *Criteria for Judging Subsidies*

| <i>Criterion</i> | <i>Explanation</i> |
|-------------------------|---|
| Open and transparent | The presence of the subsidy is easily identified; its costs are clear to the government and parliament; beneficiaries can accurately and easily value the benefit. |
| Well-targeted | Subsidies are received by beneficiaries who would not otherwise be able to become homeowners. |
| Improved access | Permits some households, not otherwise able to borrow, access to loans from banks (e.g., Bausparkassen with its guarantee of a loan to those who fulfill the savings contract, or a downpayment subsidy). |
| Cost-effective | Incremental increase in homeownership achieved at a low cost per incremental owner. |
| Administratively simple | Cost of running program is modest relative to benefits and in absolute terms. |
| Cost control | Government commitments are clear, are not long-run in nature, and can be reduced in a timely way. |
| Development impact | Subsidy is neutral or positive in its impact on the efficiency of the broader financial system. |

Table 1.13 rates each of the subsidy types listed above in terms of these criteria.⁴² The ratings range from “--,” meaning the subsidy does very badly when judged against a criterion, to “++,” which indicates a very strong rating. The specifics of the subsidy design in a few cases are so important that a general rating is not possible; this is indicated by “*” in addition to a rating on the subsidy’s general tendency. Finally, some subsidies are essentially neutral with respect to a criterion, and this is indicated by “n.”

These ratings assume that government’s primary objective is to increase homeownership. As discussed above, a strong secondary objective for many governments is to increase the volume of new construction. Where the rating for the new construction objective differs from that for the homeownership objective, the rating for the construction objective appears after a slash (/) behind the primary rating. In fact, only one type of subsidy—construction subsidies—has a different rating depending on the objective. Other programs *could* foster new construc-

Table 1.13 *Rating of Government Interventions*

| <i>Intervention</i> | <i>Transparent</i> | <i>Well-Targeted</i> | <i>Access to Finance</i> | <i>Effective</i> | <i>Admin. Simple</i> | <i>Cost Control</i> | <i>Neutral for Fin. System</i> |
|-------------------------------------|--------------------|----------------------|--------------------------|------------------|----------------------|---------------------|--------------------------------|
| D: savings bonus in contract scheme | -- | -- | --/-- | ++ | - | -- | - |
| D: subsidy on mortgage interest | + | * | + | + | - | -- | n |
| D: income tax deductions | - | -/* | + | + | + | -- | n |
| D: transactions subsidies | + | - | n | + | - | + | n |
| D: housing allowances | + /+++ | ++ | n.a. | n.a. | + | -- | n.a. |
| S: construction subsidies | -- | -/* | n | - | -- | -- | n |
| D: downpayment subsidies | ++ | ++/* | + /n | +/* | + | ++ | + |
| S: Support of secondary facilities | -- | -/* | + | * | + | * | + |

Legend:

- Intervention has very low rating on this criterion
- ++ Intervention has strong, positive rating on this criterion
- * Rating depends substantially on the specific design of the program
- n Intervention is neutral with respect to this impact
- n.a. Not applicable
- D Demand-side subsidy
- S Supply-side subsidy

tion by restricting benefits only to families purchasing a new unit. And some programs in the study countries have such restrictions, as described below.

For the homeownership objective, two forms of subsidy received consistently low marks: savings bonuses in contract savings schemes and construction subsidies. Both subsidies are very hard for the beneficiary

to value accurately. Recall that the savings bonus is paid once each year, on the incremental savings in the contract savings account during the previous contract year. Its ultimate value depends on how many years the savings continue to sit in the account (without further bonuses). The composite interest rate received on savings at the end of the contract requires the saver to compute the rate of return over the life of the savings contract, possibly needing to adjust it for being tax-free while other forms of financial savings are taxed. Similarly, a family purchasing a new unit that benefited from construction subsidies can value the subsidy only by comparing the price of this unit with others in the market. And in fact this is the only effective way of making the valuation because generally the developer does not pass much of the construction subsidies on to the purchaser.

In general, savings bonus programs also are not well-targeted toward lower-income families, or families just at the margin of being able to afford a home purchase. Anyone can sign a contract. The only control is on the amount of savings on which the bonus is paid—hence, low ratings on the “well-targeted” and “effective” criteria. Similar problems are present for construction subsidies.

Further low marks accrue to the savings bonus because of its administrative complexity, including the need to ensure that savers who take a loan use the funds for an allowed housing purpose. Likewise, ensuring that the subsidies for construction really get used for this purpose and are passed on to unit purchasers is a challenge met only with labor-intensive effort and a great deal of paperwork.

The savings bonus suffers from a further major deficiency: The government is committed to long-term subsidy payments (four to six years typically), which are hard to impossible to control during this period. Generally, once these specialty institutions have been created it is extremely difficult for a government to withdraw its support completely. Three other forms of subsidy carry defined or implicit long-term spending commitments: subsidies paid to banks on interest payments for mortgage loans, income tax deductions for mortgage interest payments, and mortgage default insurance.⁴³ In the case of default insurance, experience has shown that the extent of the government’s risk is often underestimated.⁴⁴

Finally, the savings bonus intervention is unique among the subsidy schemes in having a direct impact on the form of the banking system by its creation of new specialty lending institutions. The proliferation of

specialty financial institutions is generally viewed as increasing the cost of financial transactions. The one rigorous analysis of the efficiency of the price (interest rate) on loans made by the Bausparkassen in Germany found, after adjusting for various factors, that these loans were priced about 13 percent higher than those originated by mortgage banks (Diamond and Lea 1992a, table 7.2).

Two other subsidies—mortgage default insurance and support of a liquidity facility—have incentive effects on commercial banks and will influence the composition of banks' lending in the direction of increasing the share of home mortgage loans in total assets. In the context of development of commercial banking systems in the former Soviet bloc, these incentives are viewed as moderately positive because they encourage banks to enter this form of retail banking—something they have otherwise been reluctant to do because of a combination of often tough competition from the state savings bank, the established housing lender (except in Russia), and the costs of beginning a new line of lending.

The program with the most consistent set of “+s” is downpayment subsidies. Note that these can go beyond a modest share of the purchase price. In Russia's scheme, geared to the middle class, a lower-income family who had been on the waiting list for housing could receive up to 70 percent of the purchase price as a grant paid directly to the seller at the time of the closing. Grants are larger the lower the family's income and the longer it has been on the waiting list to receive a state unit. Transparency is total for both legislators and beneficiaries: The subsidy is the amount handed over at the loan closing. A structure like the one in Russia applicable to households on the waiting list for housing has good targeting. But other versions, like the version in Hungary and the one in Russia used for retired military officers, do less well on this criterion. Downpayment subsidies also get very high marks for cost control: The number of beneficiaries depends on the funds parliament appropriates each year.⁴⁵ Additionally, these subsidies have a modest impact on the ability of the beneficiary to obtain a mortgage loan by driving down the loan-to-value ratio to a level giving the bank ample assurance of no net loss if there is a default on the loan. Econometric evidence for an Australian downpayment program for younger households indicates that this type of program can have a substantial impact on the home purchase decision of young households (Bourassa et al. 1994).

Finally, the downpayment program is administratively simple. All administrative action takes place over a period of several months. The

file is closed once the disbursement is made and the beneficiary's occupancy of the purchased home is confirmed. There are exactly two payments by the relevant government agency to the bank. One is the subsidy to be paid out, and the other is the bank's administrative fee. Contrast this with the records kept by the bank monthly for 5 to 10 years on interest payment subsidies or the annual calculations for each member in a Bausparkassen program for four to six years. These records are the basis for vouchers sent to the administering government agency, which must check them, then forward them to the treasury for disbursement and further checking.

Government Intervention in Practice

What kinds of subsidy policies have the governments of the three study countries implemented to support homeownership? Table 1.14 summarizes the situation in 1998 in terms of national government subsidy programs. It is worth noting that policymaking for the housing sector continues to be dynamic, and the country chapters outline proposals for new policies that were under discussion in the fall of 1999.

A striking feature of the table is the large number of subsidies that exist. Hungary has the most programs in operation and Russia the fewest; Poland is closer to Hungary. A second clear point is that the policies are designed to promote new construction. In Hungary and Poland, benefits through the tax system are available only for purchase of newly constructed dwellings. Similarly, Hungary's downpayment subsidy and interest rate buy-down program are only for new units.⁴⁶ In Russia, the deductions from the personal income tax are larger for new units, but purchasers of an existing dwelling still get some benefits.

Also striking, in contrast to the support for new construction, is how little attention is being given to new rental housing. Only Poland has a substantial program, and this supports nonprofit housing, with limited rents, rather than development of municipal housing. Interestingly, in Russia, where state-owned rental housing was *the* program during the Soviet era, there is no national government support for constructing more such projects.⁴⁷

Many of the programs now implemented in these three countries are not among those that received higher scores in table 1.11. With respect to *targeting*, those getting low marks include the bonus payments on hous-

Table 1.14 Summary of Principal National Government Subsidies: 1998*

| | Hungary | Poland | Russia |
|---|--|---|---|
| Direct subsidies | | | |
| 1. Interest rate buy-downs | Yes, for new construction. 4-3-1 percentage point reductions, reducing each five years; up to maximum of HUF 2.8 million for family with 2+ children. Loans also guaranteed by government against default, up to 80 percent. | No | Yes, very limited. |
| 2. Downpayment or direct grants for home purchase | Yes, for new construction; for families with children. | No | Yes, main approach; categories of households are eligible, e.g., retired military officers. |
| 3. Interest bonuses on contract savings | Yes | Yes. See #4 under tax expenditures. Also the government bank, BGK, has a contingent liability as the system's liquidity facility. | No |

(Continued)

Table 1.14 Summary of Principal National Government Subsidies: 1998* (Continued)

| | Hungary | Poland | Russia |
|--|--|---|---|
| 4. Construction subsidies | Yes, interest rate subsidy to developers for construction period finance; 75 percent subsidy of interest payment for one-year loan; 50 percent subsidy for up to three-year loans. | Yes, only for nonprofit rental housing. | Yes, small program for well-defined groups. |
| 5. Support of mortgage liquidity facilities | No | Yes, the mortgage fund; limited activity. | Yes, very small to date. |
| 6. Support for mortgage banks | Yes. Capital for a government-owned bank; beginning in 2000 the bank receives subsidy for payments on new bond issues. No support for private mortgage banks. | No | No |
| 7. Subsidies on "old loans," i.e., those originated before the transition. | Yes, significant budget outlays. | Yes, still very large budget outlays. | No |

Tax expenditures

| | | | |
|---|--|--|--|
| 1. Deduction of home purchase costs, including mortgage interest payments, from taxable income. | Yes, 20 percent of loan repayment, up to maximum of HUF 35,000, for loans taken from January 1, 1994; only for loans for unit purchase. | Yes, for new construction only; main programs; now in form of tax credit; limit applies. | Yes, substantial; new construction favored; maximum defined as 5,000 minimum monthly wages or about 417,000 rubles. If a new unit is purchased or purchase involves a mortgage loan, deductions can be taken for three years, cumulatively up to the maximum. Deductions for other unit purchases must be taken in the year of the purchase. |
| 2. VAT exemption on construction materials for new units. | Yes, up to HUF 400,000 per unit. | Yes | Yes, restricted. |
| 3. Exemption of capital gains on sale of unit from income tax. | Yes, if property was purchased before 1982, appreciation is exempt. | No | Yes, same limit as tax deduction. |
| 4. Tax benefit on savings for housing. | Yes, 20 percent of sum deposited with financial institution in special account; maximum amount deducted is HUF 60,000, minimum deposit term is one year. | Yes, tax credit on contract savings scheme for housing. | No |

* Excludes rehabilitation and weatherization subsidies for condominiums and other owner-occupied properties and, in Hungary, tax subsidies to employers who provide grants to employees for home modernization.

ing-linked savings plans (Hungary and Poland), deductions of mortgage interest payments or purchase price from the personal income tax (all three countries), downpayment programs (Hungary and the version for military officers and other select groups in Russia), and interest rate buy-downs for developers and home purchasers (Hungary). In short there is little assistance that is well-targeted. With one exception, where targeting is undertaken, it is through restrictions on unit size, sales price, or size of deduction permitted, or through restricting eligibility to families with young children (Hungary). Among these, the targeting to families with children may succeed best in helping those most likely to become homeowners to do so earlier in their housing careers. Only one program is explicitly income-tested, the Russian downpayment program enacted by the federal government but funded locally.

Additionally, many of the programs involve *long-term subsidy commitments* to beneficiaries, for periods of three years or more and in some cases much longer. In addition to the continuing subsidies on “old loans,” these include Hungary’s interest rate buy-down, bonuses on contract savings (Hungary and Poland), and deductions of mortgage interest or construction expenditures for new housing from the personal income tax (all countries).

Downpayment subsidies are employed in both Hungary and Russia. Both tightly *control the government’s future commitments*. Hungary’s program attempts to target benefits to needy households by limited eligibility to families with young children. Russia’s national program is targeted to certain categories of citizens—those to whom the state has made a commitment to provide housing or those who are judged to be especially deserving. Included are such groups as retired military officers and migrants from the Far North, where economic activity is no longer viable;⁴⁸ it is cheaper to subsidize housing elsewhere than to subsidize these families’ continued presence in the Far North.

Hungary and Russia are encouraging home purchasers to take mortgage loans and thus are *promoting the development of mortgage lending* generally. Both permit borrowers to deduct interest payments from their income tax liability up to some limit. In addition, Hungary has an interest rate buy-down program for families with young children.

Hungary and Poland have also promoted the creation of specialty housing finance institutions. Both have authorized the creation of mortgage banks, and Hungary has instituted the Bausparkassen system. These new institutions—and especially the subsidies for the contract

savings scheme—raise a question about the possible cost of these initiatives in terms of the efficiency of mortgage lending in the middle term.

Finally, all three countries have taken some action, beyond passing legislation, to promote accessing capital markets for funds for mortgage lending. The Polish government supports the Mortgage Fund, a liquidity facility with a limited mandate, through a capital contribution and certain guarantees. Similarly, the Russian government provided its start-up liquidity facility with a small amount of capital. The Hungarian government is directly supporting one of the country's two mortgage banks.

Overall the interventions in place in these three countries in 1998 do not correspond well to the attributes of well-designed programs reviewed in the last section. They are notably inefficient, in the sense that they are benefiting many households besides the marginal home purchaser. Moreover, it is unclear if the beneficiary can correctly estimate the value of benefits coming from some programs, such as bonuses on contract savings schemes. Income targeting is very poor in all three countries. The Polish and Hungarian governments have tied themselves to a series of long-term budget commitments that will substantially limit their scope of action in the future.

How Much Does All This Cost?

How much these programs cost involves two highly relevant questions. The first, and more important, is how much are these countries spending to make one more household a homeowner? The second is how much money is being spent on these programs in the aggregate? Because the potential number of beneficiaries for many of these programs is very large indeed, the response to the second question really concerns the priority each government has assigned homeownership and housing improvement in its overall program. Cost estimates are not available for Hungary.

Spending per Beneficiary

To address this issue, the authors of the Poland and Russia chapters have computed the present value of individual subsidy programs (both direct expenditures and tax expenditures) for each program and for groups of programs for which typical households becoming homeowners could

qualify.⁴⁹ Because the benefits often depend on the value of the dwelling the household purchases, and sometimes on the income of the household, the calculations generally have been done by income group and for the average value of housing that someone with that income would purchase. Differences in programs among countries argue for presenting the results for Russia and Poland separately first; after this, some general conclusions are drawn. Note that there are some differences in the calculations among countries, and these are noted in each part.

RUSSIA. The primary subsidies in terms of expenditures and coverage are (1) downpayment subsidies to certain groups of households—for example, those on the waiting list for improved housing and retired military officers; and (2) the deduction of the price of a unit purchased from the income taxable under the personal income tax. The downpayment subsidies by the federal government cover from 80 to 100 percent of the value of the unit. Those paid by municipalities following federal guidelines range from 5 to 70 percent of the purchase price of the unit (limited in size to a norm that varies by household size); the percentage of the grant depends on the household's income and the number of years it has been on the waiting list for housing.

The value of the entitlement income tax deductions, taken over a maximum of three years, is generally limited by the household's income rather than the value of the unit. The calculations assume that the household purchases a new unit, which allows it a larger tax deduction than would purchase of an existing unit.

Table 1.15 shows the present value of the municipal downpayment and the income tax deduction subsidies as a percentage of the purchase price of a unit.

The striking point in the table is the depth of the combined subsidies. The downpayment subsidy is much more important than the tax deductions, as illustrated in chapter 3. The large downpayment benefits result in part from the particular conditions assumed—notably that the family had been on the waiting list for housing for a decade. In this case, households in the lower 80 percent of the income distribution would receive benefits equivalent to about 40 percent of the purchase price of a standard unit, in terms of size and basic amenities (hot water, elevator, etc.). Even beneficiaries in the highest income quintile obtain subsidies equal to more than a quarter of the unit price.

Table 1.15 *Present Value of Homeownership Subsidies per Beneficiary by Income Quintile: Russia, 1998^a*

| <i>Income Quintile</i> | <i>Present Value of Benefits as Percentage of Unit Value^b</i> |
|------------------------|--|
| 1 | 40 |
| 2 | 41 |
| 3 | 42 |
| 4 | 43 |
| 5 | 25 |

Source: Chapter 3.

a. Includes downpayment subsidy and tax benefits of purchase of a new unit. The downpayment subsidy would be paid by the municipality following the federal guidelines. The household is assumed to have been on the waiting list for 10 years, which gives a high government contribution rate.

b. Calculations use average price of units purchased for all income groups.

POLAND. The main benefits flow via the entitlement tax advantages to households purchasing a new dwelling—both through the personal income tax and VAT exemptions on construction materials. These purchasers can also take advantage of subsidized interest rates in the currently operating contract savings scheme. The present value of these subsidies is shown in table 1.16 for households in the higher-income deciles.

So higher-income Polish families have about a quarter of their new housing unit paid for by the government under the existing program. Because higher-income households purchase larger units, the subsidy scheme is highly regressive. Among the three subsidies, the tax deduction for unit cost is by far the most valuable.

SUMMARY. The homeownership subsidy programs in both Russia and Poland confer deep subsidies on those who purchase new units. In Russia those purchasing an existing unit receive a lower but still large subsidy through the downpayment scheme and lower tax benefits; in Poland they receive nothing. So the subsidies in Poland are strongly pro-construction, even though the evidence is that a bias in favor of new construction is unnecessary—that widespread housing improvements have occurred during the transition that are only slightly related to these

Table 1.16 *Present Value of Homeownership Subsidies per Beneficiary by Selected Income Decile: Poland, 1998^a*

| <i>Income Decile</i> | <i>Present Value of Benefits as Percentage of Unit Value^b</i> |
|----------------------|--|
| 7 | 24 |
| 8 | 24 |
| 9 | 24 |
| 10 | 25 |

Source: Chapter 2.

a. Includes tax benefits of purchase of a new unit and value of subsidies on savings in a housing-linked contract savings scheme.

b. Calculations use average price of units purchased by households in each income group.

subsidies. Indeed, 600,000 units that have benefited from the subsidies remain officially uncompleted so that the owners can maximize the subsidies available. Thus, many of the improvements associated with the subsidies are not included in the official statistics.

In both countries the existing subsidies are regressive. They are more regressive in Poland because they are so heavily administered through the income tax system and are only for new housing. Moderate-income households are not likely to be able to purchase a new unit even with the tax write-offs, making subsidies more regressive than is suggested by the figures in table 1.14. In contrast, in Russia it is more feasible for moderate-income families—those in the fifth to seventh income deciles—to use the downpayment subsidy. And, holding the number of years on the waiting list constant, they will receive deeper subsidies than their higher-income counterparts. Still, the tax benefits available to home purchasers in Russia are highly regressive and they are received by many more households than in Poland.

Aggregate Spending

Total spending depends on the number of households assisted by each program as well as the depth of the assistance to each beneficiary. Table 1.17 displays summary information on national government support for homeownership in 1998, both direct spending and tax expenditures.

Table 1.17 *Total Spending on Homeownership Programs by National Governments, 1998**

| <i>Country</i> | <i>Poland</i> | <i>Russia</i> |
|---|---------------|---------------|
| Budget outlays | 2,992 | 620 |
| Tax expenditures | 1,905 | 400 |
| Total | 4,897 | 1,020 |
| Tax expenditures as percentage of total | 39 | 40 |
| Total as percentage of GDP | 1.30 | 0.27 |

Source: Chapters in this book.

* In millions of dollars; average 1998 exchange rate used to convert local currency into dollars.

Greater detail can be found in the country chapters. The larger role of municipal governments in housing assistance in the Russian Federation should be kept in mind in reviewing these data.⁵⁰

The smaller role of the Russian national government in supporting homeownership compared with Poland is clear, and Poland's allocation of resources is fairly typical for the Visegrad countries. As a percentage of GDP, Russia's spending is only about one-fourth of 1 percent; Poland's spending is six times this level.

But how is one to interpret the spending on housing subsidies in a broader context? One way is to contrast spending on homeownership with other social expenditures. Table 1.18 shows the percentage of GDP that public spending (not just spending by national governments) on education and health in these countries constituted around 1995.⁵¹ The figures show that relative to these areas homeownership spending was quite modest, suggesting that Russia and Poland are keeping their general priorities well-ordered.

Table 1.18 *Public Spending on Education and Health as Percentage of GDP*

| <i>Country</i> | <i>Public Spending on Education as Percentage of GDP</i> | <i>Public Spending on Health as Percentage of GDP</i> |
|----------------|--|---|
| Hungary | 6.0 | 6.8 |
| Poland | 4.6 | 4.8 |
| Russia | 4.1 | 4.1 |

Another interesting pattern in Table 1.18 concerns the relative importance of tax expenditures in total spending on homeownership. In both Poland and Russia, two-fifths of all spending on homeownership programs is through the tax system. The share for Poland would rise to 100 percent if the country were not saddled with commitments on old loans. The large role of tax expenditures in Russia and their total dominance among active policies in Poland point to systems that in general are poorly targeting benefits to the marginal home purchaser. Again, Russia's municipal version of its downpayment is the counter-example of a program that does better.

Why Some Subsidies Are So Popular

In light of the record just reviewed, why is it that the subsidies for homeownership and housing construction for purchase remain in place in the region? The short answer is because they are popular with voters. Through this set of programs, governments are seen to respond to citizens' demands that something be done to address several problems: the putative chronic housing shortage, insecure tenure under market leases and under mortgages for home purchase requiring a large share of the purchaser's income for monthly payments, and the excessive expense of homeownership (in terms of the share of monthly income required for home purchase, for either savings or mortgage payments).

Diamond (1998a, p. 13), in discussing the political attractiveness of the contract savings schemes, notes the "something for everyone" nature of the program:

- All savers feel they are getting a gift of extra interest for being virtuous in saving.
- Most homeowners feel they are getting some help with the burden of buying or renovating their homes.
- The public feels the housing sector is being helped.
- Banks that set up Bausparkassen programs are being given an opportunity to make extra profits and also increase their ability to compete with the state savings bank for retail lending.

In this context it is not surprising to note that the Bausparkassen programs in all of the Visegrad countries were a parliamentary initiative.

They were assiduously promoted by banking interests from Germany and Austria and typically opposed by the government.

Some of the more questionable features of these programs are probably quite deliberate, making it possible to accomplish certain goals without creating undue attention. The nontransparency of some programs—because it is hard for beneficiaries or parliamentarians to value benefits—serves the objective of making it possible for substantial benefits to flow to voters for whom the assistance is not critical to their becoming a homeowner, although the programs likely permit them to purchase bigger homes. Entitlement programs—like the savings bonuses on housing-linked contract savings schemes and deduction of home purchase or construction costs from taxable income—have the advantage of insulating these programs from the rough and tumble of the annual budget process.

It is doubtful that many officials in these countries understand the full cost of these programs, or at least that they understood them when they were enacted. It may be that the basic thinking is that the relevant standard of comparison is the cost of constructing *and* operating state rental units—the horribly inefficient staple of the old regime. (At the beginning of the transition, the housing sector was rated as the least efficient sector in the USSR.⁵²) As long as all the program costs for the ownership assistance programs are below this level, the country is financially ahead. A fatal flaw with this reasoning, of course, is that well-run social housing can be dramatically more efficient than state housing in the former Soviet bloc. In other words, officials in eastern Europe may be using a badly inflated cost-of-services figure for state-assisted rental housing as their implicit test for the efficiency of homeownership subsidy programs.⁵³ In any case, the expense of the programs now in place is extremely high: These countries are spending large amounts of public funds per beneficiary to achieve or maintain the housing standards of wealthier countries.

The only opposition to these programs seems to come from the Ministry of Finance, because it is responsible for preparing each year's budget. But to date they have not been successful in holding back these populist policies.

What Accounts for the Low Loan Volumes?

Much of the information provided thus far illustrates that the governments in Hungary, Poland, and Russia have pursued policies to foster the

development of mortgage lending and to encourage homeownership, both of which should lead to an expanding volume of mortgage lending. But thus far loan volumes remain low, and in Russia they are extremely low. Only in Poland is sustained growth clearly evident, but still at a low volume. How does one account for the lack of response of households and banks to the stimulative acts taken by these governments?

A substantial list of reasons can be constructed, which when taken together constitute a formidable list of impediments to the growth of mortgage lending. It is useful to consider the disincentives separately from the perspective of lenders and consumers.

Banks' Interests

One can cite at least five factors that discourage banks from entering this market.

- Home purchase mortgage loans entail high information and management costs. It is expensive to set up a mortgage lending operation from scratch: Staff must be rigorously trained to minimize credit risk, and special loan-servicing software must be acquired. Loan origination is expensive because of the effort that must be devoted to verifying the borrower's income, appraising the property, and performing due diligence on the title.
- There are the remaining uncertainties about the outcome of the foreclosure process. At best, the process will be expensive; at worst, a judge could prevent eviction for an extended period of time.
- The structure of liabilities of banks in the region is decidedly short-term in nature—that is, heavily weighted to terms of a year or less. Many banks worry about the intermediation and liquidity risks associated with long-term mortgage lending. When they do lend, the price of credit reflects these concerns.
- Because interest rates have been high, only high-income families can afford to take a significant loan. But these are often the households who can arrange nonbank financing. So the banks may see only small loans as their market, and this is unattractive because of the high cost per dollar of interest revenue earned. The idea that small loans would dominate is consistent with demand being driven by the trade-up market. So families who received a two-room unit through a privatization program, for example, would

need only a small loan in addition to their equity to purchase a three-room unit. This explanation has plausibility in Hungary and Russia, where privatization programs were very large, but not in Poland, where comparatively few units were privatized.

- Other investments have offered attractive returns. The most common alternative has been government debt. This was dramatically the case in Russia in 1997 and 1998 (until the crash), with government bonds paying extraordinarily high interest rates. But the same pattern has been present in the other countries. The risk-adjusted rate of return on home purchase mortgages, though, seems to have been much better than that for loans to enterprises with their high default rates.

Consumers' Interests

Numerous factors—some inherited from the old regimes and some developments during the transition—have arguably worked together to discourage households from wanting to consume more housing. With demand for housing blunted, the derived demand for mortgage finance has fallen as well. These are the important factors involved:

- The high interest rates on mortgage loans common in the region certainly discourage borrowing. Moreover, these rates appear extraordinarily high to those who were used to the interest rates of 2 and 3 percent that were standard during the Soviet period.
- Similarly, there may well be a limit to the share of incomes households are prepared to devote to housing. While the share of income devoted to housing varied somewhat from country to country under the Soviet system, it was seldom more than 10 percent of income, even for lower-income families. With price decontrol, operating costs accelerated sharply; this, combined with real income *reductions* in the early years of the transition period, meant that the share of income devoted to housing operating costs rose significantly. In Hungary, the share rose on average from 10 to 18 percent of household income between 1989 and 1996.
- Consumption opportunities multiplied with the change in regime. Scattered data suggest high levels of spending on cars and other consumer durables during the transition. Data in annex 1.A, for example, show that automobile ownership surged 29 percent in Russia

during 1990–95. In Poland in the same period, 14.6 million TVs were purchased—practically enough for one for every family. Consumers may have decided to postpone additions to their housing consumption for the time being in favor of other goods and travel.

- Housing privatization endowed many families with explicit ownership rights and significant equity. These households may feel that they have sufficient housing assets in their portfolio and are not ready to use their equity to trade up, possibly with the assistance of a mortgage loan.
- Many younger families have access to housing wealth. Because of the low birth rates sustained in the region for many years, most young people have a good chance of inheriting a unit from a relative. At a minimum, this could provide most of the funds needed to purchase a dwelling in a preferred location. But the small number of children also means that many families collectively have the ability to advance to young adults substantial funds for their housing purchase—something they may be more willing to do when interest rates are very high.
- The return on housing investment has not been very good. The standard pattern in the region was for a sharp increase in unit prices to occur at the beginning of the transition when the market opened up and those with purchasing power and unsatisfied demand entered the market—in part to protect their savings from depreciating where bank deposit rates were lower than the inflation rate. But in the next phase, thanks to privatization, more housing units were offered on the market and prices declined. In Hungary the value of housing real estate in 1997 was only about 45 percent of the 1989 level, after it had risen in the first two years of the transition (see chapter 2). But in the major cities of Hungary and Poland, prices have accelerated since 1998.
- Families who live in state rental housing or who own a privatized unit enjoy great occupancy security. Moving to another unit and taking a mortgage to purchase it exposes the family to some risk of losing the unit. For many families, this risk—although very low in reality—is unacceptable.
- Rent controls apply to substantial shares of the housing stock in Poland and Russia. These controls work to make the cost of renting low compared with the cost of owning and discourage families from considering home purchase.

- A surge in unemployment has been a fact of life in all countries in the region during the transition. Uncertainty about employment and a steady income may persuade many households not to take on long-term loans to finance their home purchase.

While some of these factors can be addressed directly by public policy, most notably rent controls, most involve changes in consumer attitudes that take another generation to be realized. One can interpret some of the government programs discussed earlier as bribes to the population to overcome their various inhibitions.

This dilemma raises two questions: If consumer demand for mortgage finance is expected to be modest in the years just ahead, has it made sense for banks and donors to invest resources to develop mortgage lending operations? Should other countries in the region follow the same path? The answer to both questions is yes. Retail banking generally and mortgage lending specifically are important components in the lending operations of banks in industrialized countries.⁵⁴ These products complement lending to commercial clients through lines of credit and longer-term loans for expanding operations. Mortgage lending is important for cross-selling other financial services such as life insurance. Commercial banks in the region, except for the former state savings banks, began life with little to no retail banking experience. In this light, the deliberate pace of development of mortgage lending and early limited demand may be seen as helpful, rather than the opposite. There was adequate time to develop and test systems, particularly loan underwriting. A number of banks are now ready to deal with increased volumes as lower interest rates encourage more demand.

Conclusions

What conclusions can be drawn about the justification for policies of government assistance to encourage homeownership in the region and the efficacy of the programs adopted to encourage increased homeownership directly and to strengthen the housing finance system as a vehicle for promoting this goal?

THE HOUSING CRISIS. There is scant evidence of a “housing crisis.” When the housing conditions in the three study countries (and many

others in the region) are compared with conditions in other nations that have similar income levels, the study countries are found to have housing conditions at least as good. While homeownership is viewed as a tool for unlocking the savings of households to address the “housing problem,” the already high ownership rates in most countries, often thanks to mass privatization, argue for concentrating on reform of the rental sector. Removal of rent controls and excessive tenant protections, where they still exist, are at the top of the list of actions needed to encourage private investment. Government funds would be better channeled to supporting rehabilitation of the multifamily housing stock (both owner and rental) than to the construction of new housing units.

Prominent analysts in these countries are aware of these facts and understand the need for policy changes.

GOVERNMENT’S ROLE. Several conclusions are possible about government’s role in promoting homeownership. One must begin with the importance of macroeconomic stability. As illustrated starkly by the Russian case, and to a lesser degree by conditions in Poland and Hungary in the mid-1990s, even with a good legal and institutional framework in place for housing finance, little borrowing for home purchase will occur when the economy is characterized by substantial turbulence. High interest rates and uncertain future incomes discourage borrowers from taking long-term loans, and instability increases banks’ exposure to the credit, interest rate, and liquidity risks inherent in mortgage lending. Economic stability strongly promotes housing investment by making mortgage loans attractive to both sides of the market. A good portion of the subsidies expended in the region to support homeownership have gone to offset the impacts of inflation—the large outlays for savings subsidies in the housing-linked contract savings schemes are a prime example.

One can expect that stability will further increase in Central Europe as these countries prepare for accession to the European Union (EU). A profound impact of the European Monetary Union was the convergence in interest rates at a lower level among its would-be members in preparation for the introduction of the Euro. EU candidates will be proving their worthiness for membership in part with strong macroeconomic stability.

Another conclusion about the role of government concerns subsidy policies. The policies followed by Poland and Russia (and probably Hun-

gary) are very expensive per household assisted to become a housing unit owner, and they are poorly targeted with respect to income. The municipal version of Russia's downpayment program and Hungary's downpayment program are exceptions with respect to targeting, but they too are costly.

It may be the case that policymakers are assuming a responsibility to provide a unit to every family—the Holy Grail of socialist housing policy—and have determined that homeownership subsidies are cheaper than the subsidies required to construct and operate municipal rental units in the old rent-controlled environment. Clearly this mentality must change: Provision of state rentals is the wrong counterfactual. Rather the choice must be among market-oriented programs with the choice being made on efficiency grounds. Again, it may well be the case that the state can assist many households more effectively with housing allowances in private rental units rather than paying the deep subsidies necessary for homeownership.

MORTGAGE DEMAND. Increasing the demand for mortgage finance may take some years of economic stability (lower interest rates) and a reordering of consumer priorities. The low demand for mortgage finance across the region seems only partially driven by the high cost of money. Equally important seems to be consumers giving priority to other purchases, such as cars, other durables, and travel. Being able to spend more on other things is closely related to the resistance to spending what is by regional standards a very high share of income on housing—25 to 30 percent of gross incomes—commonly required to make mortgage repayments. This factor is coupled with the substantial housing wealth and small family size in the region, which make other sources of funds for home purchase available to many young families. Finally, local trends in unit value appreciation will be important. In Hungary, declines in real property values appear to have discouraged home purchase and borrowing in the mid-1990s. All these factors argue that mortgage demand is likely to expand slowly over the next few years.

DEVELOPMENT OF HOUSING FINANCE SYSTEMS. Three conclusions can be drawn in this area. The first concerns the Bausparkassen that have proved so popular in the Visegrad countries with the exception of Poland. The judgment of Douglas Diamond is apt. After studying these programs in the region, he concluded:

Evidence is overwhelming that Bausparkassen schemes are very inefficient uses of public resources. The outstanding question is not whether the benefits are worth the cost but whether there are any benefits at all (1999, p. 27).

The Bausparkassen are expensive forms of government subsidies: They target the subsidies poorly; they result in limited home purchasing power for participants; and they seem to result in little if any net household savings. It should also be clear that the Bausparkassen are not the foundation of the German system in these countries. Unlike German borrowers, eastern Europeans can only afford to take a single loan. With Bausparkassen in the dominant position, these will be low loan-to-value, highly subsidized transactions.

The second conclusion in this category is that true competition is some years away. While competition is most advanced in Poland, meaningful competition will not only require transparency and easy comparability of the offers made by different lenders. There must also be a change in the attitude of would-be borrowers to an ethic of comparative shopping, away from simply being grateful that a bank offered to make them a loan.

The final conclusion on housing finance systems is that they are likely to develop differently in each of the three study countries. Given the institutional dynamics of the sector, one cannot forecast more than a few years ahead.

In Poland, universal banks will remain the dominant lender. Poland's home-designed contract savings scheme is a modest factor and is likely to remain so, assuming the government follows through with its plan not to subsidize Bausparkassen. Several mortgage banks will become operational but concentrate on the commercial real estate market rather than home purchase mortgages.

In Hungary (and probably the Czech Republic and the Slovak Republic) Bausparkassen will become the primary lenders as the contracts are fulfilled and savers decide to use the low-interest loans available to them. OTP, Hungary's state savings bank, will remain the dominant lender among universal banks and be the largest lender in the group. Mortgage banks will be on the scene and are likely to be stronger players than in Poland in lending for home purchase.

Russia's lending architecture will continue to develop along the lines already set. Economic stability, however, is critical to future progress. Universal banks will be the dominant, if not the sole, loan originators. A

liquidity facility will become a key element in the housing finance system—either the Agency for Housing Mortgage Lending or another entity. The need for such a facility is widely agreed upon within the banking community and government circles. As traditional mortgage lending expands, developer finance and other schemes will wither.

In short, there will be no standard housing finance model for the region.

Lessons for Other Transition Countries

The following seven lessons from the experience of eastern European nations and the Russian Federation are directed to the countries of southeastern Europe and the Commonwealth of Independent States, other than Russia, which are now embarking on the development of their housing finance systems, often in the context of promoting homeownership. Most of these countries have very high rates of homeownership, resulting usually, but certainly not always, from mass housing privatization programs. At the same time, these nations exhibit substantial diversity in their population and household growth rates, the volume of housing per household, and income levels. The lessons stated here are cast broadly and seem to be generally applicable.

MACROECONOMIC STABILITY. It is hard to overestimate the importance of economic stability in making mortgage lending a reality. The reasons were outlined in the previous section. But even beyond the benefits for mortgage lending, in the face of high inflation and interest rates, government subsidies for homeownership are likely to be more expensive and more complex in design than otherwise. A good example comes from the Russian home purchase certificate program for retired military officers. A great deal of attention was devoted to devising a system under which the purchasing power of the certificate would be maintained while the officer looked for and purchased his unit.

It is true that the new mortgage instruments—for example, deferred payment mortgages and dual index mortgages—can help maintain housing affordability under inflationary conditions. But the general experience (with the notable exception of Poland) is that neither banks nor borrowers are comfortable with them. So loan volumes will be low. These instruments are not a substitute for stability.

GOVERNMENT FOCUS ON ASSISTING ACTIONS. More important than subsidies in inducing banks to make mortgage loans with at least a five-year term is a strong mortgage law that minimizes the credit risk associated with lending. While this sounds obvious, there are countries in the CIS that still prohibit eviction in case of foreclosure of a home purchase mortgage loan in default. Beyond this, judges need training in the new law and senior judges need to review early rulings to be certain that they are in line with the law and that judges are not still invoking Soviet legal principles. Reliable, accurate, and prompt title registration systems are also a necessity. Finally, the government, working with local bankers associations, must develop training programs to ensure proper loan underwriting and servicing that will minimize credit risk.

SPECIAL INSTRUMENTS, NOT SPECIAL INSTITUTIONS. The development of housing finance in the Visegrad countries has been dominated by the creation of institutions to execute special tasks: Bausparkassen for housing-linked contract savings schemes, and mortgage banks to attract funds to housing lending from capital markets. The disadvantages of this approach are clear: New institutions are costly to develop, they take time to become operational, and they make the whole housing finance system inflexible. Specialization, of course, has its advantages as well. But countries initiating the development of their housing finance systems would be well-advised to rely first and foremost on universal banks.

There are numerous examples of universal banks performing the same roles as specialized institutions. In Poland they administer a government-supported contract savings scheme. In France and other countries, universal banks are selling mortgage-backed bonds in capital markets, very similar to the operations of mortgage banks (Lea 1999).

BEST HOMEOWNERSHIP SUBSIDIES. If government determines that assisting with home purchase is a priority for the nation, then experience shows three attributes that are most desirable. First, make them demand-side subsidies. The best among these are downpayment subsidies. Second, target them to lower- and moderate-income households, with larger grants going to lower-income families. Again, the structure of the Russian program is instructive. Third, avoid long-term commitments from the budget, such as multiyear subsidies to lower interest rates on mortgage loans. Such commitments limit the ability of a gov-

ernment to shift programs in response to changing conditions in the country. Incremental funding also often causes legislators to underestimate the total cost of the commitments they are making.

WORST HOMEOWNERSHIP SUBSIDIES. The list of subsidy mechanisms with undesirable features is long. Prominent entries include the following:

- Deductions of costs of home purchase or homeownership from taxable income under the personal income tax.
- Forcing banks by law or regulation to devote a certain share of their assets to mortgage lending or to cross-subsidize mortgage loans to make them affordable.
- The Bausparkassen system, for reasons outlined in the previous section.
- Interest-rate write-downs, or the deduction of mortgage interest payments or the cost of the unit purchase from taxable income.

These programs all tend to be expensive, to be badly targeted to households who need the assistance to become homeowners, and to involve multiyear commitments.

ACCESSING CAPITAL MARKETS. Obtaining funds from capital markets is a way of getting funds for financing mortgages, particularly in countries where the banking system is characterized by low liquidity and banks' liabilities are concentrated in short-term instruments. Despite its putative attractiveness, no country in the region has yet succeeded in systematically channeling funds from general capital markets into housing loans. Neither mortgage banks nor a liquidity facility has proven itself. Hence, countries developing their housing finance systems should proceed cautiously in embracing one of these vehicles as a principal component of its system.

RENTAL SECTOR: THE ESSENTIAL COMPLEMENT. Some governments in the region used mass privatization as a way of trying to wash their hands of the enormous rental housing responsibilities they formerly held. In other countries either the national government or local governments have used the municipal (former state) housing stock as an economic shock absorber, keeping rents low to cushion the impact of

adverse economic developments. A few, such as Poland, have continued this policy long after strong economic growth kicked in.

Government policy for the rental sector has a twofold role. Obviously, the longer rents are controlled and kept far below market levels and tenant rights are kept strong, the weaker is the incentive to renters to spend more of their own money to become homeowners. At the same time, a functioning rental housing market is needed to provide housing to those who cannot afford or do not want to become homeowners. Controlled rents also discourage private investment in the sector. Hence, continuing reform of the rental sector is the handmaiden of successful and efficient homeownership policies.

NOTES

1. The World Bank classifies countries into three groups based on GNP per capita. The cutoff levels are: low-income, \$725 or less in 1994 (51 economies); middle-income, \$8,955 (57 economies); and high-income, more than \$8,955 (World Bank 1999, p. 181).

2. Enterprise housing was especially important in the constituent republics of the Soviet Union. In the Russian Federation, for example, in 1991 it accounted for 42 percent of all housing units, compared with 25 percent for municipal housing. Yugoslavia was a unique case in this regard because enterprises were assigned a broader housing role. In effect, they were made the primary provider of social (not strictly state) housing. Of the total housing stock in Slovenia, for example, state enterprises accounted for 68 percent in 1990, and the balance was divided between municipal housing (30 percent) and state housing (2 percent).

3. The source of the U.S. data is U.S. Department of Housing and Urban Development and U.S. Bureau of the Census (1995, table 1A-2). Figure is for 1993.

4. For a discussion of the different policies among the countries listed in the table that produced such varied tenure distributions, see the essays in Struyk (1996b).

5. See Struyk (1996a and 1996b); the essays in Clapham et al. (1996); Buckley, Hendershott, and Villani (1995); and Katsura and Struyk (1991). Information on who actually privatized can be found in Hegedus et al. (1993) and Romanik and Struyk (1997).

6. The other countries are Albania, Bulgaria, Croatia, Lithuania, Romania, and Slovenia. Source is Metropolitan Research Institute (1996).

7. Data presented in chapter 2.

8. Home purchase loans under the old regime are discussed below. In general, however, eviction of a borrower in default was nearly impossible.

9. Quoted in Merrill et al. (1997), p. 4.

10. The comparator countries used by Mayo were Algeria, Brazil, Chile, Colombia, Greece, Jamaica, Jordan, Korea, Malaysia, Mexico, South Africa, Thailand, Tunisia, Turkey, and Venezuela.

11. Data are country averages from Metropolitan Research Institute (1996), table C.9.
12. The decline in Poland is very likely overstated because those building single-family units can avoid paying the property tax until the unit is officially registered as occupied. The number of completed and occupied, but unregistered, units runs to several hundred thousand (Merrill et al. 1999a, p. II-3).
13. For a concise summary of the economic conditions in these countries, see European Bank for Reconstruction and Development (1999), chapters 2–4, and the individual country assessments. Data for the figures are from this report, except for the 1999 GDP growth rate for Russia. Russia's growth caught forecasters by surprise, but by mid-2000 it was widely agreed to be at around the 3 percent level.
14. For a complete description of these developments, see Shleifer and Treisman (2000).
15. More detailed data are available for Hungary for 1993, when the mean ratio was 26 percent. In that year households in the lowest income quintile spent 42 percent of their income on average on housing; the corresponding figure for households in the highest income quintile was 15 percent. Figures provided by J. Hegedus, based on data in the Hungarian Household Panel Survey, 1993.
16. Data from the Russian Guild of Realtors and the Institute for Urban Economics.
17. The current legal situation and the procedures followed by banks are detailed in Rabenhorst et al. (1998).
18. For a general description of the banking systems in these countries, see Bernstam and Rabushka (1998); Borish, Ding, and Noel (1996); and Roe, Siegelbaum, and King (1998).
19. The decision has been challenged by the banks that had invested heavily in preparing to open Bausparkassen. Some were threatening to sue the government for damages if the law passed.
20. Based primarily on material presented in Diamond (1998a).
21. In reality the system is not fully closed. As described later, savers are permitted to take "bridge loans," which carry market interest rates. Funding for these loans can come from outside of the system.
22. Both systems are discussed in Lea and Renaud (1995).
23. The bonus is a one-time payment computed as a percentage of the new savings in the past 12 months. The effective rate of return on savings depends on the base savings interest rate, the bonus rate, and the number of years funds stay in the account after the bonus has been paid. Clearly, the shorter the time funds remain in the account after having attracted the bonus, the higher the rate of return.
24. The bonus is usually paid at the end of the year on additions to savings made that year. So the effective rate of return on savings is higher the shorter the savings period.
25. Boersch-Supan and Stahl (1991) find a positive saving impact for the system in Germany.
26. This pattern is repeated in Germany, where 18 of 21 Bausparkassen were owned by commercial banks in 1990 (Diamond and Lea 1992a, p. 87).
27. For details see Lea, Laszek, and Chiquier (1998). By late 1999 KM had attracted about 65,000 savers—a small number compared with the Bausparkassen programs in other Visegrad countries—leading some Polish bankers and policymakers to view it as a failure. At the time the government announced plans to cancel the Bausparkassen program, it also announced that it intends to introduce changes to the KM.
28. For a description of mortgage banks, see Lea (1999) and Arndt (1999).

29. Erste Bank of Austria originally held 4 percent of the equity. At this writing, the Hungarian government is in the process of purchasing these shares.
30. In Hungary the Land Credit and Mortgage Bank made its first private placement of \$3.6 million in bonds in December 1998. The bonds carry a five-year term and were priced at 70 basis points above government securities of the same term. The bank placed a third bond offering in February 2000. The government subsidizes this issue by reimbursing the bank for 3 percentage points of the 9.7 percent coupon rate paid to investors—that is, there is no subsidy to investors in the bonds. The bank subsidy is to apply to future bond issues as well.
31. Under the law governing mortgage banks in Poland, it is possible for them to acquire qualifying mortgage loans from other originators for inclusion in their mortgage pools. Polish bankers see this only as a long-term development.
32. Only four banks are reported to have used the facility. For greater detail, see Merrill et al. (1997), section 3.3.
33. While this was the general policy of Sberbank of Russia, a few of the regional Sberbanks, most notably in Moscow, decided to continue low lending volumes.
34. As a joint stock company the Agency could carry out its functions without the banking license. In this case it would be under the supervision of the Securities Commission. As of the first quarter of 2000, the Agency was seeking additional legislation that would clarify its rights to a banking license and would facilitate the issuance of mortgage-backed bonds.
35. See chapter 3 for a discussion. “Buyers’ clubs” and similar nonbank, often informal financing arrangements have also emerged in Hungary. But they appear to be significantly less important than in Russia. The Hungarian situation is described in Hegedus and Varhegyi (1999).
36. Kazan, Nizhni Novgorod, Orenburg, Samara, Sarov, and Kharbarosk Krai are among those conducting such programs. Information on these programs is from an unpublished document prepared by the Institute for Urban Economics in Moscow in 2000.
37. Early sections of box 1.2 are drawn from Telgarsky and Mark (1991). An interesting comparison of the performance of the dual index mortgage (DIM) and the price-level adjusted mortgage (PLAM)—very similar to a dollar-denominated loan—under highly volatile economic conditions in Mexico is presented in Lipscomb and Hunt (1999). This is an especially useful analysis because Mexico has probably had more experience with the DIM than any other country.
38. For more on these instruments, see Chiquier (1998).
39. In December 1999 OTP was charging 23.5 percent for a mortgage loan; FHB was charging 14.5 percent. The lower FHB rate results from a combination of its free capital and the very high spreads on mortgage lending at commercial banks (see statements in the text). Both OTP and FHB originate loans under various government programs to promote new construction and home purchase that are described later in the book. (Information on FHB operations was obtained in interviews with senior management.)
40. At the end of 1999, both Hungary and Poland had inverted yield curves for bonds, with the interest rate on five-year government bonds at least 100 basis points below that on one-year bonds. The volume of longer-term bonds, however, is much less than the volume of short-term bonds, and the short-term rate is generally viewed as a more stable and reliable benchmark.
41. In Russia the government has contracted with banks to administer this scheme, including checking that all legal aspects of the sales transactions were in order and making the payment of the subsidy at the time of sale. This is described somewhat further in this chapter and in the separate chapter on Russia. A program similar to the downpayment scheme in Russia, one to finance home

purchase by demobilized USSR officers returning to Russia from the Baltics, is described in Romanik and Struyk (1995).

42. Broadly, the effects in the table are based on first-round impacts. Unless supply and demand are perfectly elastic to price variations, some capitalization of subsidies in housing prices will occur (Haffner and Oxley 1999).

43. Construction subsidies get a marginally low score here because the incidence of cost overruns on government-supported projects tends to be substantial, leading to additional appropriations to complete projects several years after the initial appropriation.

44. This occurs even in countries with long histories of mortgage lending. In the United Kingdom default rates jumped at the end of the 1980s and resulted in massive losses. Similarly, the Federal Housing Administration in the United States had to increase its insurance fees in the 1980s to cope with unexpectedly high default rates. On the U.K. experience, see Stephens (1996); Douetil (1994).

45. Unless the country decides this should be an entitlement program, which is highly unlikely.

46. In Hungary an additional, deeper interest rate buy-down program became operational in early 2000 through two banks in which the government holds large interests. Interestingly, in mid-2000 the Czech Republic was also considering reinstating this type of subsidy program on top of its large Bausparkassen program to stimulate construction (Johnson 2000).

47. Some municipalities, notably Moscow, are continuing to construct municipal social housing with their own funds.

48. Federal law defines an income-targeted program that has been adopted by a number of municipalities, as described in chapter 3.

49. In the present value calculations, the inflation rate is used as the discount rate. So the discount rate in Russia's calculations is much higher than those for Poland or Hungary. See the country chapters for details.

50. The majority of public housing sector spending is at the subfederal level. This spending is heavily concentrated on operating subsidies for municipal housing and, to a lesser degree, cooperatives. There are also some subsidies for new construction of municipal housing and home purchase subsidies—including downpayment subsidies and a few mortgage support programs. Fienkman, Treisman, and Titov (1999, p. 23) report that in 1994 these subsidies constituted 4 percent of GDP. While other countries also devolved housing responsibilities from the national to local governments early in the transition period, most localities cut spending sharply in contrast to Russia. Again, Fienkman et al. (p. 26) report that in Poland local spending devoted to housing fell from 10.1 percent of total local spending in 1991 to 1.6 percent in 1993.

51. Data from World Bank (1999), tables 6 and 7. Figures for education are for 1995; those for health for 1990–95.

52. Struyk (1996a), p. 2.

53. In Sweden, for example, the municipal housing program is comparatively well-run. Berger, Jonsson, and Turner (1994) analyzed the correspondence between rents for privately owned and municipal housing in Sweden and found them generally to be well-aligned.

54. For example, in the United States at the end of 1999, for 8,580 commercial banks insured by the Federal Deposit Insurance Corporation, retail banking assets comprised 23 percent of total assets. Of the 23 percent, 10 percentage points were for loans to individuals other than mortgagors and 13 percentage points were mortgage loans for one- to four-family residential units (Federal Deposit Insurance Corporation 2000).

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Annex 1.A

Selected Data on Consumer Expenditures on Durable Goods

Table 1.A.1 *Passenger Car Ownership in Hungary and Russia: 1990–1995**

| | 1990 <i>Number (000)</i> | 1995 <i>Number (000)</i> | <i>Percent Change 1990–95</i> |
|---------|-----------------------------|-----------------------------|-----------------------------------|
| Hungary | 1,944 | 2,180 | 12 |
| Russia | 12,000 | 15,450 | 29 |

Table 1.A.2 *Sales of Video Appliances: 1990–1995 (sales per 1,000 persons)*

| | <i>Hungary</i> | <i>Poland</i> | <i>Russia</i> |
|---------------------------|----------------|---------------|---------------|
| Televisions | 76.7 | 378.2 | 121.1 |
| Video recorders | 94.8 | 2.4 | n.a. |
| Portable cassette players | 42.0 | n.a. | 105.7 |

Source: Various tables from the Internet site of Consumer Eastern Europe, reporting data from Euromonitor.

* Net of cars retired from the stock.

Home Purchase in the Visegrad Countries: The Case of Poland

The housing finance sector in Poland has reached an enviable position in the transition from decades of state monopoly and control to operation in a market-driven and competitive environment. Since it ended subsidized lending in 1996, Poland has moved steadily toward an institutional and legal framework supportive of the continued development of housing finance. Recent policy initiatives by the government of Poland (GOP) are designed to consolidate progress toward a housing subsidy system that is better targeted and consistent with market-based housing finance. Furthermore, Poland has largely conquered serious inflation; the rate of increase in the consumer price index moved into the single digits in 1998, although it has begun to creep up again in 2000. Also, Poland has maintained the highest average rate of economic growth in central and eastern Europe (CEE) since GDP reversed a downward spiral in 1993.

Continued reform of the banking sector, the entry of major foreign banks and capital, and implementation of improved regulation and supervision have all contributed to the environment for housing finance now operating in Poland. The sector receives support from professional organizations, most especially the Polish Banks Association, but also associations of appraisers, builders, and realtors. Finally, peripheral institutions and services—such as the newly formed Credit Bureau and initiation of mortgage-related insurance products to address specific gaps

in the current system—will help reduce risk, an important effort because real interest rates remain much too high.

The millennium finds Poland's universal banks with a steadily increasing portfolio in mortgage finance. Poland is on the cusp of another transition in the institutional architecture of the housing finance system, as licenses for European-type mortgage banks continue to be granted during 2000 and several mortgage banks are expected to begin operations. Meanwhile, the universal banks have been able to gather sufficient market momentum that the future institutional structure is likely to include both universal banks and mortgage banks. Finally, unlike many of its CEE neighbors, Poland is developing a contract savings system according to internal specifications, and the *Bausparkassen* may not be established in Poland.

Government policies toward housing may also undergo a reform in approach. Subsidy policies have been designed to be consistent with the GOP's tax reform proposals, to target middle- and lower-income households, and to address lingering problems such as rent control. The GOP program proposed in 1999 offered support to both homeownership and the rental sector and sought better targeting and transparency in subsidy policy. However, the fate of the revised housing program put forth by the coalition government, although approved by the cabinet in mid-1999, is now uncertain. Poland's president rejected those portions of the tax reform proposals that were integral to implementation of several portions of the new program. The Ministry of Finance, however, announced in July 2000 that the tax deduction for new construction, the major component of the old program, would be eliminated in 2001. This would represent a major step forward. Thus, at a minimum, the reform proposals certainly made public the types of changes that could improve the efficiency of the subsidy system; possibly some major changes will take place.

Other questions and problems remain. New construction has not yet regained pre-transition levels. The banking system is still inefficient, as indicated by its large spreads. Furthermore, it would appear that Poland is "overbanked," so that further mergers and takeovers will be likely. Real interest rates seem especially high, as noted. Use of mortgage loans for purchase of a home is relatively low, covering about 20 percent of purchases, although this rate is higher than in Hungary and the Czech Republic. It is difficult, however, to label these indicators as "high" and

“low” because very little in the development of housing and housing finance systems in other emerging markets has necessarily prepared a blueprint for development of housing finance in a transition setting. In addition, because the institutional structure of the housing finance system is not yet finalized in Poland, there are questions of whether a level playing field will predominate and whether long-term funds for housing finance will be secured from the capital markets through mortgage bonds or whether additional systems for liquidity, refinancing, or securitization will come into play. Finally, the development of administrative systems and legal supports to homeownership and housing finance are still incomplete. This has two major impacts: Risks remain high and the banks bear too much of the risk burden, and banks have had to develop short-term insurance products to deal with shortfalls in the legal framework (which of course increases rates still further). The housing finance sector also lacks both the databases and the analyses necessary for a better understanding, and therefore control, of the various risks.

Government Policy toward the Housing Sector and Homeownership

Poland is now in the midst of an important transition period with regard to many government policies, including housing. During 1998 and 1999 the coalition in power in Poland made considerable efforts to rationalize and improve its housing sector strategy. The framework for the proposed housing policy was a broad one, consistent with other reform themes of this government, which include the following:

- Major tax reform proposals, designed to simplify the tax system but, more important, to lower both corporate and personal tax rates.
- Debureaucratization, involving efforts to reduce unnecessary procedural detail while providing rational legal and administrative supports consistent with the requirements of a market-driven economy.
- Increased attention to the needs of middle- and lower-income households, which include education and health as well as better targeting of housing assistance.

- Macroeconomic stability, a consistent theme that is now paying off in Poland, although there is a difficult balancing act to perform with regard to inflation, the current accounts deficit, exchange rate policy, and numerous demands on the state budget.

Major portions of the program pertaining to subsidies for homeownership were linked to the tax reforms being proposed by the Ministry of Finance. Homeownership, which is currently supported by a very large tax break for new construction, was to receive support instead from subsidies targeted to moderate-income households in the proposed “own home” program. However, in December 1999, Poland’s president signed two portions of the tax bill—those pertaining to reduced corporate tax rates and reduced rates on a variety of other taxes—but declined to sign the proposal for reductions in personal income tax. Also, the governing coalition has recently collapsed. As noted above, however, the Ministry of Finance just announced that the tax deduction for both construction and renovation of dwellings will be eliminated in 2001 and a VAT rate of 22 percent will be established for material and labor used in building and renovation (which is higher than the current preferential rate). The changes were said to be necessary to conform to European Union (EU) standards. It is not clear whether or how this will impact other portions of the housing reform program. The elements of the current housing subsidies, and the proposed changes, are briefly noted below.

The Current Housing Subsidy Program

- **Support for Homeownership.** A large tax break for new construction is the centerpiece of the homeownership subsidies. Smaller tax breaks are also provided for rehabilitation and Poland’s contract savings program. The VAT rate is lower on building materials. The government also supports the Mortgage Fund, which provides refinancing of eligible mortgage loans.
- **Support for the Rental Sector.** The housing allowance program supports low-income renter households, although the system is inadequate to support affordability if rents were increased toward market levels (a badly needed reform in Poland). Subsidized con-

struction of rental units for moderate-income households is designed to increase the supply of affordable housing (the TBS program).

- **Rehabilitation and Thermal Renovation.** Although Poland has sought to develop comprehensive rehabilitation programs, this major problem is supported only by very modest programs not directed at the main need—major capital repair.
- **Infrastructure.** Subsidies for infrastructure are provided to gminas (local governments or jurisdictions) for infrastructure to support new housing construction.
- **Support to Previous Subsidy Programs.** A major portion of the housing budget must be used to carry out support to past subsidy policies; this primarily benefits the cooperatives and holders of old passbook savings accounts related to home purchase.

Proposed Changes in the Subsidy Program

- **Support for Homeownership.** The tax break for new construction was to be replaced by a new “own home” program that would target moderate-income households (who have not already taken advantage of the current tax-relief program). The parameters of the contract savings system are also being revised.
- **Support for the Rental Sector.** The housing allowance program was to be expanded and linked to rent decontrol. The TBS program would also receive increased support.
- **Rehabilitation and Thermal Renovation.** A residential capital repair program, especially important for communal (public) housing, was to be added, and funds for thermal renovation were to gradually increase.
- **Infrastructure.** Housing-related infrastructure was to receive increased funding in order to reduce supply-side bottlenecks to new construction.
- **Social Housing.** Funding for special housing for the homeless and indigent was to begin in 2000.

These reforms would have produced a more targeted and efficient subsidy system that was more responsive to major problems and more supportive of a move to a fully market-based housing sector. As noted,

while their immediate passage is unlikely, they have provided an important and educational dialogue.

Major Themes for Poland

The Housing Finance System:

- **Poland's system of home purchase finance has made considerable progress in the past three years toward a competitive, market-driven system.** The accomplishments are many: The former state savings bank (PKO BP) ceased subsidized lending in 1996 and, while still dominant in the market, has lost considerable market share and now accounts for only about 65 percent of the loan volume. At least five universal banks are its major competitors, and numerous others have begun mortgage lending. Mortgage lending has risen from only PLN 200,000 in 1995 to PLN 663 million in 1996, PLN 2.9 billion in 1998, and PLN 7.5 billion in December 1999.
- **The structure of Poland's housing finance system, although it shares common elements with those of its neighbors in CEE, differs in several important ways.** Mortgage banking in Poland, modeled after the German-Austrian mortgage banking system, is far behind the development of this system in the Czech Republic, in particular, and also in Hungary. Universal banks have had nearly four years in which to develop their mortgage lending business and, as noted, are quickly gaining momentum. However, numerous mortgage banks are being formed and are applying for licenses (two have been granted to date), and it is likely that more mortgage banks will open their doors during 2000. Finally, the legislation supporting the Bausparkassen approach to contract savings in Poland may be rejected in favor of reform of Poland's own contract savings system, the *kasy mieszkaniowe*.
- **The institutional structure of Poland's mortgage lending system may be about to undergo a second major transition.** As of mid-2000, the situation is as follows: Two mortgage bank licenses have been issued and others are imminent; the dominant role of the universal banks in mortgage finance will be challenged in the medium term; and the future of the now little-utilized Mortgage Fund—a

refinancing facility funded by Poland and international donors—is very uncertain. Thus, for the future, questions remain about competition, a level playing field, and the types of capital market funding. Poland probably is also considerably overbanked. Thus, further consolidation can be expected, as well as further foreign investment and mergers and, in the near future, the privatization of PKO BP, the last state bank to be privatized.

- **Only about one in five households purchase their new homes with mortgage loans.** In Poland, it is estimated that about 20 percent of households purchase new homes with mortgage loans (the rate for purchase of existing units is not known). It is difficult to discern the reasons for this lack of demand for mortgage credit in Poland, because real income is rising and real rates are falling slightly. However, while this rate seems low by U.S. standards, and in comparison with usage in numerous European countries, the proportion is even lower in Hungary and the Czech Republic, where perhaps as few as 1 in 10 new owners use mortgage loans. Clearly, patterns in the transition countries may not conform to developments elsewhere for some time.
- **Spreads and real mortgage lending rates are too high.** Numerous factors are no doubt contributing to higher than desirable interest rate spreads (the gap between lending rates and deposit rates) and real lending rates (the gap between nominal lending rates and inflation). Banks in Poland must work on reducing not only operating costs but also the various risks inherent in a housing finance system. For example, much more information must be collected and analyzed by the banks themselves and the inspection department of the Central Bank. And a central analytical role should be undertaken by the Polish Banks Association (PBA). Also, resolution of legal issues such as foreclosure and the statutory lien (which places banks' access to the collateral in the property behind that of government claimants) and improvement of serious administrative delays in functions like titling are still outstanding. As noted, some banks have devised short-term insurance products to deal with legal and administrative problems and delays concerning obtaining the dwelling as collateral.
- **Numerous problems of fine-tuning the housing finance system remain before it can become efficient.** In short, Poland must deal with a number of institutional and legal issues, as well as structural

issues defining the future shape of competition. Nevertheless, the system has developed to the point where it can move forward while the improvements are being undertaken.

The Housing Market and Government Policy toward Homeownership:

- **Poland's urban homeownership rate is low.** Even in comparison with former Soviet bloc countries, Poland's urban homeownership rate is low. Only about 30 percent of urban dwellers live in condominiums or private buildings, but the data do not clearly indicate how many of these are owners.
- **The major current subsidy policy for homeownership is a tax-break approach, which is not well-targeted.** Poland's current homeownership subsidy program has proved to be extremely expensive in terms of tax revenues forgone. Also, it has benefited primarily high-income households who would be most likely to purchase a home without benefit of this subsidy.
- **The proposed homeownership subsidy policy would have provided targeted subsidies.** The Ministry of Finance recognized that many young households, in particular, are desirous of becoming homeowners but face affordability barriers. Thus, the proposed subsidy policies would have been better targeted to new, middle-class owners. If this new program had been adopted, the current tax break subsidy would have been phased out gradually over approximately the next five years.

Housing Construction and Affordability:

- **New construction has not yet recovered to pre-transition levels.** Like those of its neighbors, the rate of new construction in Poland fell after transition, but in the initial years the fall was less precipitous. Construction is now showing signs of recovery; furthermore, housing is increasingly built by private developers and private individuals, with the role of co-ops and government greatly reduced.
- **Housing affordability is a problem, but not one that can be quickly fixed, nor one that depends on the government alone.** However, it would seem that would-be owners do not yet recognize

fully the potential of mortgage finance. Furthermore, because households are accustomed to a very low housing expenditure-to-income ratio, there are both real and “perceived” affordability problems in terms of the housing expenditure-to-income ratios common in the West.

- **Housing shortage?** Finally, it is commonly believed that Poland has a serious housing shortage. The method of analysis, however, simply computes the gap between the number of households and the number of acceptable housing units. If factors underlying effective demand were considered, it is probably the case that the housing shortage is small or localized in growing cities.

The Housing Market in Poland

Describing Poland’s housing sector is not as straightforward as might be expected. First, the data on housing supply, household income, rent burden, privatization rates, and so forth are not adequate to answer many of the obvious questions.¹ Second, as discussed below, debate continues on whether Poland has a housing shortage and, if so, how this deficit should be measured. It is not clear whether the post-transition improvement in the level of housing construction is low by comparison with the more dramatic success Poland has experienced in macroeconomic growth and fall in inflation. For one thing, the number of units under construction is nearly eight times larger than completions in any given year. The new construction subsidy program appears to reward a lengthy construction period. Also, although few data exist, it appears that developers use their own funds, and particularly funds provided by the prospective purchasers, rather than construction finance. These facts raise issues that should be kept in mind as Poland’s economy and housing sector are described below. Relevant questions include the following:

- Does Poland have a housing shortage?
- Has the housing sector been (relatively) left behind in Poland’s growth surge? If so, what factors—for example, supply constraints, cost of credit, rent control disincentives—might be responsible?

- Is the use of mortgage credit unusually low, or is this what might be expected in a transition economy?

Macroeconomic Backdrop

Considering the transition period overall, Poland has achieved a higher average rate of economic growth than any of its CEE neighbors. Relative to 1990, GDP fell in real terms by 7 percent in 1991, and it had not quite returned to its 1990 level even by 1993. Thereafter, however, Poland's growth has been impressive, averaging nearly 6 percent annually between 1994 and 1998 (table 2.1). Similarly, inflation has fallen steadily year after year, and finally reached single-digit rates in 1998 and 1999. As of May 2000, the annual rate was hovering around 10 percent, as Poland faces both fiscal and balance-of-payments pressures. GDP growth was 4.4 percent in 1999, but it is forecast to accelerate again and reach 5.3 percent by 2001.

GDP per capita (in constant prices) has also grown steadily. Similarly, salaries in various sectors have risen faster than inflation, resulting in a tremendous surge in consumption fueled by personal income in the household sector. This surge is of some interest because, as discussed below, housing may not have benefited as much as other consumer goods from the increase in demand. Similarly, the growth in consumer/retail credit has far outpaced that of mortgage credit.

Despite the impressive growth in GDP and real income, it should be kept in mind that Poland's GDP per capita (in U.S. \$) was \$4,075 in

Table 2.1 *Macroeconomic Indicators for Poland*

| <i>Indicator</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>1999</i> |
|-------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| GDP (constant prices; 1990 = 100) | 99.0 | 104.1 | 111.4 | 118.1 | 126.1 | 132.2 | n.a. |
| GDP growth rate (annual percentage) | 3.8 | 5.2 | 7.0 | 6.0 | 6.8 | 4.8 | 4.4 |
| GDP per capita (1990 = 100) | 98.1 | 103.0 | 110.1 | 116.7 | 124.6 | 130.5 | n.a. |
| Inflation (percentage) | 35.3 | 29.5 | 21.6 | 18.5 | 14.9 | 8.6 | 9.8 |

Source: *Statistical Yearbook of Poland*, 1998, State Statistics Office, Warsaw.

Table 2.2 *Poland's Housing Stock (number of units in thousands, 1997)*

| | |
|------------------------------------|--------|
| Total Housing Stock | 11,613 |
| Urban | 7,763 |
| Rural | 3,850 |
| Total Private Stock | 7,822 |
| Cooperative Owners | 1,923 |
| Other Private Owners | 5,472 |
| Communal Housing (with a mortgage) | 427 |
| Total Public Stock | 3,791 |
| Cooperative Tenants | 1,340 |
| Communal (public housing) | 1,630 |
| Enterprise Housing | 821 |

Source: *Statistical Yearbook of Poland*, 1998, State Statistics Office, Warsaw.

1998, compared with \$5,350 in the Czech Republic, \$4,676 in Hungary, \$9,899 in Slovenia, and \$4,291 in Croatia. Failure to appreciate the impact of these differences in income probably has an important bearing on the perception of Poland as having a housing shortage relative to Hungary and the Czech Republic, for example. Also, Poland tends to compare itself not only with its more wealthy neighbors but also with Western Europe.²

HOMEOWNERSHIP: URBAN AND RURAL. Although more than two-thirds of Poland's households live in urban areas, Poland's homeownership rates reflect a common legacy of the Soviet era: The majority of urban dwellers reside in public housing, mainly communal and enterprise housing and cooperatives (table 2.2). It is not clear how many of the urban dwellers are homeowners. In any event, only 30.8 percent of urban dwellers reside in condominiums or private buildings. The homeownership rate in Warsaw, for example, was only 6.2 percent in 1996. In contrast, the vast majority of rural housing is private, generally single-family dwellings.

New Construction

New construction, as table 2.3 shows, has only just begun an upward trend in 1997, having abruptly fallen to less than half its 1989 rate during the mid-1990s. It might be noted, however, that Poland's housing

Table 2.3 *Housing Construction: Completed Units (in thousands)*

| <i>Year</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Completed total | 137.0 | 133.0 | 94.0 | 76.1 | 67.1 | 62.1 | 73.7 | 80.6 |
| Urban | 107.8 | 106.7 | 71.9 | 53.2 | 48.2 | 45.3 | 55.2 | 61.6 |
| Rural | 29.0 | 26.3 | 22.5 | 22.9 | 18.9 | 16.8 | 18.5 | 19.0 |
| Cooperative | 83.5 | 84.3 | 50.0 | 31.7 | 26.8 | 24.6 | 28.1 | 26.8 |
| Communal | 2.6 | 3.6 | 4.6 | 3.6 | 3.3 | 3.0 | 3.7 | 3.2 |
| Enterprise | 10.7 | 8.2 | 6.4 | 3.8 | 2.5 | 1.6 | 1.4 | 1.0 |
| Developers (for sale or lease) | — | — | — | 1.5 | 2.8 | 2.7 | 5.1 | 8.1 |
| Housing associations | — | — | — | — | — | 0.1 | 0.3 | 1.5 |
| Individual | 40.0 | 36.9 | 33.4 | 35.5 | 31.7 | 30.1 | 35.1 | 40.0 |
| Individuals | 40.0 | 36.9 | 33.4 | 35.5 | 31.7 | 30.1 | 35.1 | 40.0 |

Source: *Statistical Yearbook of Poland*, 1998, State Statistics Office, Warsaw.

production fell off less rapidly and less dramatically than that in Hungary and the Czech Republic in the early years of the transition. PKO BP, the state savings bank and monopoly lender, only announced its intentions to stop subsidized lending to cooperatives in 1992; subsidized lending to individuals ended only in 1996. A dramatic change has taken place in the means of housing construction, however, with private individuals (and, gradually, developers) replacing the construction role traditionally undertaken by the cooperatives, and to a lesser extent by enterprises and gminas. Individuals and private developers account for well over half of new construction, while the public-sector role continues to decline. The preponderance of new construction is now also single-family houses. In 1996, of 110,500 permits issued, 71,000 were for single-family dwellings; in 1997, 64,400 permits out of 111,800 were again for single-family homes.

Finally, it should be noted that the data for housing completions in Poland may be somewhat misleading. The number of units under construction appears to be quite high in comparison with completions (e.g., in 1996, 576,500 were under construction; in 1997 the number was 602,900; and the number has risen to an annual rate of 637,100 in 1999) (table 2.4). The pace of construction is likely influenced by several factors. Many of these dwellings are presumed to be occupied, but for tax reasons they may not be declared complete. The new construction tax break subsidy is granted annually as long as the process lasts, up to a new ceiling on expenditures each year; this too would tend to stretch

Table 2.4 *Dwellings under Construction, End of Year (in thousands)*

| <i>Year</i> | <i>1990</i> | <i>1991</i> | <i>1992</i> | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>January– June 1999</i> |
|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------------------------|
| Total | 514.2 | 466.9 | 449.8 | 473.8 | 509.8 | 538.1 | 576.5 | 602.9 | 620.8 | 637.1 |
| Organized | 175.7 | 132.5 | 76.6 | 57.5 | 46.2 | 41.9 | 42.1 | 39.6 | 35.8 | 36.9 |
| Individual | 338.5 | 334.4 | 373.2 | 416.3 | 463.6 | 496.2 | 534.4 | 566.5 | 585.0 | 600.2 |

Source: *Statistical Yearbook of Poland*, 1998, State Statistics Office, Warsaw.

out the construction period to take maximum advantage of the subsidy. Also, because only 20 percent of households use a mortgage loan, financing the construction process may be gradual.

Finally, both the pace and the scale of privatization of the housing stock in Poland have been more modest than that of many of its neighbors. As indicated in table 2.5, about 42 percent of Poland's public stock was privatized as of 1997. Most of this was a transfer of ownership in cooperatives, where nearly 60 percent of the units are now in private hands. In contrast, only about 25 percent of the communal stock has been privatized. As discussed below, the rent control still endemic to this stock is of serious concern, because it both subsidizes some households who do not require assistance and retards the development of a private rental market.

DOES POLAND HAVE A HOUSING SHORTAGE? While the answer is a conditional yes, the assumptions behind much of the analysis in Poland are erroneous. Housing “need” is defined simply as the gap between the number of households (either at present or in the future, depending on the study) and the number of housing units that are deemed to be adequate. Using this approach, various studies estimate the current need for new units to be as large as 1.5 to 2.0 million, or the equivalent of about 14 to 18 percent of the current stock. The estimates are developed, however, without reference to “effective” demand, affordability, or supply constraints—that is, what is feasible given realistic assumptions about income, the cost of construction per square meter, the cost of mortgage finance, government subsidies, and other economic factors such as land delivery, production capacity, and so forth.³

Table 2.5 *Housing Privatization*

| <i>Privatized Public Housing</i> | | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|----------------------------------|-------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Communal | Sold | | 18,300 | 28,200 | 48,300 | 108,700 | 92,000 | 75,000 |
| | Cumulative | 170,500 | 188,800 | 217,000 | 265,300 | 374,000 | 466,000 | 541,000 |
| | Reprivatized | 10,066 | 5,693 | 3,496 | 2,705 | 2,825 | 1,804 | 2,306 |
| Enterprises | Sold | 988 | 10,052 | 22,636 | 35,231 | 30,529 | 46,008 | 46,093 |
| | Cumulative | 26,000 | 33,800 | 92,300 | 120,300 | 151,131 | 197,555 | 243,999 |
| | Reprivatized | 509 | 1,217 | 568 | 917 | 302 | 416 | 351 |
| Cooperative | Owners (yearly) | | 133,400 | 121,100 | 162,600 | 85,100 | 97,917 | 119,838 |
| | Cumulative | 1,207,800 | 1,341,200 | 1,462,300 | 1,624,900 | 1,710,000 | 1,788,030 | 1,923,237 |
| Total | Privatized Yearly | | 159,500 | 207,800 | 238,900 | 73,500 | 170,030 | 210,207 |
| | Cumulative Total | 1,404,300 | 1,563,800 | 1,771,600 | 2,010,500 | 2,235,131 | 2,451,585 | 2,708,236 |

Source: Crakow Real Estate Institute, based on *Statistical Yearbook of the Republic of Poland*.

Compared with the other advanced CEE countries, Poland does appear to have a relative shortage. Whereas Poland has 303 housing units per 1,000 persons, Hungary has 379 and the Czech Republic 360.⁴

As noted above, however, it is also the case that Poland's per capita income is considerably less than that for these neighbors. However, admittedly, Poland's housing is also in relatively poor condition; one estimate developed by the Housing Research Institute in Warsaw suggests that by 2010 fully 10 percent of the stock should be decommissioned because of deterioration.

Finally, it is undoubtedly the case that there is a relative shortage of single-family homes, or other popular alternatives for homeownership, especially in Warsaw and other large cities that are experiencing booms in economic activity. The homeownership rate in Warsaw—at 6.2 percent—is unusually small even for cities in the former Soviet bloc.

THE URBAN AND RURAL STOCK. Finally, a growing proportion of the housing stock is urban. The share of urban dwellings in new construction, which has been growing—and reached 76.4 percent of new construction in 1998—will gradually shift the proportion of total stock that is urban, now standing at 66.9 percent. The urban and rural stock must also confront different types of problems, as seen in table 2.6. Rural units are larger, but so are households in rural areas, so the effective area per person is about the same in both situations. Rural units, however, have a markedly lower proportion of modern facilities, including piped water, bathrooms, and central heat. In both areas, however, facilities have improved since the beginning of the transition.

Home Purchase Finance

Overview of the Current Situation

In less than four years, Poland has developed a competitive, effective, market-driven system of housing finance. Many factors assisted in this process, including banking sector reform, increasing macroeconomic stability, and a large infusion of both foreign capital and donor assistance. The banking system overall has been greatly transformed: only two banks remain under state ownership, and one of these—the state savings bank, PKO BP—is expected to be privatized in 2000. Foreign

Table 2.6 *Housing Indicators for Urban and Rural Housing*

| <i>Housing Indicators</i> | <i>1990</i> | <i>1995</i> | <i>1997</i> |
|---------------------------|-------------|-------------|-------------|
| Units per 1,000 persons: | 288.7 | 297.6 | 300.4 |
| Urban | 308.5 | 320.9 | 324.4 |
| Rural | 256.5 | 259.9 | 261.3 |
| Persons per 1 unit: | 3.4 | 3.29 | 3.26 |
| Urban | 3.15 | 3.03 | 3.0 |
| Rural | 3.87 | 3.82 | 3.8 |
| Useful area per 1 unit: | 59.6 | 60.5 | 60.9 |
| Urban | 54.3 | 55.2 | 55.6 |
| Rural | 69.9 | 71.0 | 71.5 |
| Useful area per 1 person: | 17.5 | 18.4 | 18.7 |
| Urban | 17.2 | 18.2 | 18.5 |
| Rural | 18.1 | 18.6 | 18.8 |
| Percentage of units in: | | | |
| Urban | | | |
| Pipe water | 95.3 | 96.7 | 97.1 |
| Water closet | 86.0 | 88.3 | 89.1 |
| Bathroom | 83.5 | 86.0 | 86.9 |
| Gas (network) | 71.8 | 74.9 | 75.9 |
| Central heating | 74.4 | 77.8 | 79.0 |
| Rural | | | |
| Pipe water | 67.6 | 76.2 | 79.4 |
| Water closet | 49.4 | 57.0 | 59.8 |
| Bathroom | 54.2 | 61.5 | 64.2 |
| Gas (network) | 6.3 | 12.1 | 13.8 |
| Central heating | 42.9 | 49.7 | 52.2 |

Source: *Statistical Yearbook of Poland*, 1998, State Statistics Office, Warsaw.

banks, mainly European, have made extensive entry into the market, either through establishing Polish branches or through purchasing shares in Polish banks being privatized, which has helped modernize the banking system. As has been discussed, inflation has fallen steadily and is likely to be well into the single digits in 2000; more must be done, however, to help lending rates fall apace. Market interest rates prevail in mortgage lending, because Poland's limited contract savings program has barely entered the lending phase.

Donor assistance and government transfers capitalized the so-called Mortgage Fund beginning in 1993. Although the fund was greatly

underused compared with expectations, it nevertheless offered liquidity to the banks now competing with the PKO BP. Dual index mortgages (DIMs) have provided an excellent mortgage product for Poland's circumstances, and the Mortgage Fund was instrumental in helping their design.

More than 30 universal banks now offer mortgage finance, although no more than five or six yet hold major portfolios. While PKO BP remains dominant, in three years its position in the market has dropped from that of a monopolist to that of a bank facing intense competition. Other banks now hold 35 percent of the total portfolio in value and about 23 percent of the loans. The volume of mortgage lending remains fairly small. But even though there are considerable barriers to overcome before use of mortgage finance grows toward the level seen in much of Europe and the United States, it is not clear what should have been expected at this stage in the transition process.

The housing finance sector now appears to be entering its "third phase" of transition—first having shed the legacy of the Soviet period, and next having developed a competitive market-based system based on the universal banks. The primary factor in this third phase is the development of European-type mortgage banks. Still, it is anticipated that at least in the short term the mortgage banks will face difficulties in funding and that the cost of wholesale funds may remain uncompetitive for some time. Moreover, rules allowing a level playing field for the universal banks must be put in play. Finally, unlike systems of its neighbors in CEE, Poland's system of contract savings has not been a dominant feature of its housing finance system and it may remain entirely Polish-based. Legislation authorizing the establishment of Bausparkassen may be repealed in the near future, and Poland's own contract savings system, the *kasy mieszkaniowe*, is now being redesigned.

The Legacy of Housing Finance from the Soviet Period

Decades of state housing production and control of all its financing have made it difficult for Poland, as for other countries in the former Soviet bloc, to quickly develop a market-based housing sector or system of housing finance. The deficiencies of direct state systems, which have been described in detail elsewhere, included an absence of private means of production, market-oriented financial institutions, and the many

legal or administrative structures necessary to housing ownership and transfer.⁵

One of the worst aspects of the legacy that Poland has had to face has been the immense burden of subsidized housing debt. As a percentage of the entire state budget—1.5 percent—Poland's debt burden during the mid-transition period (1994–96) exceeded that of Hungary (1.4 percent), the Czech Republic (0.8 percent), and Slovakia (0.7 percent). Furthermore, PKO BP persisted in a high level of subsidized lending even while several of Poland's banks were attempting to make market rate loans, delaying the moment when fair competition could come into play.⁶ The burden of these previous obligations—the “old portfolio” and the passbook savings accounts—has imposed two major problems. Their repayment has captured one-half to one-third of the housing budget in recent years, and the problems over the disposition of these obligations have delayed the privatization of PKO BP by distorting an otherwise reasonable balance sheet. As discussed later in the section titled Government Support of Homeownership, only by 2003 will the burden of old loans finally fall to a more tolerable proportion of the housing budget.

In addition, and not least important, the Soviet era left attitudes about rights and responsibilities toward housing, and about information, data analysis, and risk-sharing, that have also made it difficult to instill the behavior needed by market-based institutions. One legacy, for example, is a populace (including some of the housing “experts” themselves) accustomed to receiving housing at a fraction of its true cost and having little concept of the meaning of demand and supply. Households are unwilling to share data on income and debt with would-be creditors, and banks were initially reluctant to ask—or to share information with one another. Thus, it has taken some time for adequate underwriting concepts to emerge. Similarly, a credit bureau is only now getting under way in Poland; it will continue to face hurdles until banks realize it is in their interest to share data on indebtedness in the underwriting process. The central bank did not, until recently, view mortgage lending as requiring a tailor-made approach to regulation and supervision; aggregate data are therefore not yet assembled on mortgage portfolios.

These attitudes about information-sharing extend to relations between the Polish Banks Association and its member banks; thus, PBA has no database on housing finance either. No data on delinquencies or defaults in mortgage lending are yet available. Foreclosure has not really

been tested in Poland, and it remains an alien concept even to a few bankers. Until more information is systematically collected and analyzed on the relationship among borrower features, mortgage terms, and outcomes such as prepayments, delinquencies, and defaults, mortgage lending will continue to be conducted on very conservative terms. Furthermore, because many of these information and analysis factors contribute to high real interest rates (there is no way to adequately assess the risk/return relationship), the volume of lending will remain depressed. As will be evident from the data presented below, one result is a quite conservative profile—in terms of loan-to-value ratio and payment-to-income ratio—offered by Polish lenders.

Poland was fortunate in having a period of reform-minded governments early in the transition period, when reforms were initiated with regard to macroeconomic stabilization and financial sector restructuring. But the approach to the housing sector was inconsistent. In fact, it has been theorized that the housing sector subsidies were left in place to placate an otherwise suffering population. The result was an odd checkerboard of old-style subsidy programs coexisting until 1996 with a series of new-style reforms, which lent the housing system an oddly schizophrenic look. For example, PAMBank, supported by U.S. capital and assistance from USAID, made dollar-denominated, market-rate mortgage loans as early as 1993; similarly, PBK, a Polish bank, introduced mortgage lending in 1995, while the Mortgage Fund, described below, made its first loan in support of mortgage lending in 1994. Simultaneously, however, PKO BP was still offering subsidized loans as late as 1996, which certainly had a dampening impact on the development of competition in market-based lending.⁷

Key Developments in Housing Finance during the Transition

A number of important developments in the housing finance system during the transition period have contributed to the successful development of Poland's housing finance system. The success of the transition owes a great deal to the larger economic, social, and institutional transitions being undertaken in Poland at the same time. Among the notable factors that assisted housing finance to mature were these:

- Reform of the banking sector propelled the overall system toward a modern, market-based, competitive financial sector.

- Macroeconomic stability, especially falling inflation, proceeded on a steady course and made zloty-based consumer lending relatively affordable.
- The former state savings bank—PKO BP—ended subsidized lending in 1996, allowing competition from private and foreign-based banks to emerge.
- Four of the universal banks (BISE, PBG, PBK, and PAMBank) fairly quickly seized this opportunity and introduced genuine competition into mortgage lending.
- DIMs—dual index mortgages—proved to be very successful mortgage products in Poland’s environment of falling rates, and they enhanced the affordability of mortgage loans.
- The Mortgage Fund, a refinancing institution supported by international donors as well as the GOP, boosted liquidity by refinancing eligible DIM loans, but perhaps more important, it enhanced the understanding of both construction and residential mortgage finance.
- Other assistance from the donor community in both housing finance and public housing finance policies helped shape the housing finance system.

BANKING SECTOR REFORM. At present, Poland’s banking system is well on its way to becoming a privately owned, forward-looking (especially to the European Union) system. A successful reform program, coupled with privatization and an extensive infusion of private capital—mostly from large European banks—has left only two banks in state hands: PKO BP, as noted, and BGK, which operates as Poland’s housing development bank.⁸

Under the EBRP (the Enterprise and Bank Restructuring Program) the structure and condition of Poland’s banks have greatly improved since the beginning of the reform process in 1993. The EBRP is considered by some to be a model of bank reform for transition countries, because it forced banks to confront their debt problems and improve institutional capacity. Four private-sector institutions were established at that time from existing institutions;⁹ numerous licenses have been granted to foreign banks; the privatization program is still under way; and small private Polish banks have arisen, often to be consolidated with larger institutions.

THE MORTGAGE FUND. The Mortgage Fund, an institution unique to Poland in the CEE region, was created in 1993 to help catalyze the development of market-driven housing finance by offering long-term zloty loans to banks to support lending in construction and mortgage finance. It was financed by funds from USAID (a \$25 million housing guarantee loan), the World Bank (\$200 million), the European Bank for Reconstruction and Development (\$67 million), and the government of Poland (\$133 million). At present, the Mortgage Fund's future is in doubt, and it is no longer an important aspect of Poland's housing finance system. Poland's banks lending for housing finance generally had sufficient liquidity without the need to borrow from the Fund. Disbursements of the loans were disappointing, and as a result the World Bank and EBRD have both withdrawn their funds. The Mortgage Fund's contributions, however, during the 1993–97 period were extremely valuable, perhaps less in financial terms than in education, training, and systems development associated with the technical assistance that accompanied the funding. In sum, the fund played an important role in demonstrating the approach to unsubsidized lending; depending on the future institutional structure of Poland's housing finance system, this fund or a similar vehicle could once again be called upon to provide liquidity and access to the capital market, especially to smaller universal or mortgage banks.

DIMs. Dual index mortgages, or DIMs, have proved remarkably successful and highly utilized in Poland. In inflationary economic conditions, DIMs can be an effective mortgage instrument. The main advantage of a DIM approach is that borrowers can achieve greater affordability, while lenders can achieve variable market-based rates. The major flaw of conventional loan products in inflationary situations is the so-called “tilt” effect. For a loan that would in fact be affordable to a borrower over the long term, at the early stages of the loan, the initial payment ratios are very large relative (in real terms) to the later payment ratios—that is, in the later years as real income.

DIMs amortize according to two independent indexes—an index reflecting the changing income of borrowers and a financial index that determines the interest rate. DIMs thus separate the flow of payments and the amortization rate; their ability to “self-adjust” provides opportunities for both borrowers and lenders to combine features of affordability and a profitable, market-driven mortgage product.¹⁰

At present, about 40 percent of PKO BP's portfolio consists of DIMs, as do about 80 percent of BISE's portfolio and about 20 percent of PBG's; all are major players in the mortgage market. Indeed, this is one of few success stories (if not the only long-term success story) for DIMs in the world. DIMs have been heralded as an important answer to affordability in a number of countries, notably Mexico and France. In neither case have DIMs been as successful as in Poland, nor have they made up such a large proportion of the outstanding portfolio. Mexico has had more experience of DIMs than any other country, having introduced them during the 1980s. However, many of Mexico's DIMs did not survive the devaluation shock of 1995.

Several factors have combined to produce Poland's unique situation. First and foremost, Poland's economy, unlike Mexico's, for example, has not experienced any serious volatility since DIMs were introduced in 1993. Although inflation was relatively high at that time, it has followed a fairly steady downward course ever since. Second, extensive research into DIMs was carried out by the Mortgage Fund, and those DIMs eligible for Mortgage Fund refinancing were conservatively designed. Third, Poland's major lender, PKO BP, has relied heavily on DIMs and has undertaken its own major efforts in design, marketing, and education of would-be borrowers. In sum, the advantages and disadvantages of DIMs include the following:

Advantages:

- DIMs are designed to accommodate economies where inflation, and thus interest rates, are moderately high—for example, a macroeconomic scenario in which inflation is roughly 15 to 35 percent.
- The tilt effect dominates fixed rate—and variable rate—amortization schedules in inflationary environments. Initial high payment ratios cause loans to appear more unaffordable than they actually are in the long run. The main benefit of the DIM loan is to avoid the tilt effect and thus allow participation by a much broader range of the income distribution in formal lending for housing finance.

Disadvantages and Concerns:

- DIMs are highly technical and complex loan products to design, underwrite, and service. DIMs cannot be easily implemented without considerable technical development.

- There can be limited instability in the inflation rate, but not an excessive amount, for DIMs to operate with some margin of safety. Similarly, there must be reasonable concordance between the indexes for the interest rate and the wage rate. If these conditions are not met, especially soon after issuance of a DIM, there is risk that the term of the loans will be excessively extended and will not amortize in practice.

The Current System of Mortgage Finance

Poland is now in the third stage of its transition to a market-driven housing finance system. Equally important, Poland is making progress in building a variety of housing finance–related institutions and organizations. Although some serious problems still remain, Poland has continued to address the deficiencies in the legal and administrative framework for lending; to streamline existing mortgage products and introduce new ones; to develop a regulatory and supervisory system; and to develop peripheral institutions and organizations necessary to an effective real estate market, including a strong bankers association with a specialized committee on housing finance, a credit bureau, and associations of homebuilders, realtors, and appraisers.

A COMPETITIVE INSTITUTIONAL STRUCTURE. Although PKO BP remains the dominant lending institution, in three years its position in the market has dropped from being a monopolist to facing real competition. Other banks now hold about 23 percent of the loans and 35 percent of the total portfolio value.¹¹ The rate of increase in the volume of lending by the other universal banks is growing quickly. Of the competitors, two banks each hold about 7 percent of the total portfolio (in PLN); the share of the next five banks combined is about 14 percent (with shares ranging from 2 to 4 percent); and the share of all the other lenders together is about 8 percent.

In addition to becoming more competitive, Poland's housing finance portfolio has grown quite rapidly since 1996. The holdings of those lenders with the majority of the portfolio now represent a reasonably substantial share of their total assets. Considered across the entire banking system, however, housing finance still represents only a very small portion of total assets. Table 2.7 shows the growth in total assets and

Table 2.7 *Selected Data on Assets: Aggregated Balance for Poland's Banking Sector**

| <i>Month and Year</i> | <i>Total Assets (PLN millions)</i> | <i>Due from the Nonfinancial Sector (percentage)</i> | <i>Due from Consumers (percentage)</i> | <i>Total Mortgage Portfolio (percentage)</i> |
|-----------------------|------------------------------------|--|--|--|
| 12/96 | 207,111.7 | 38.62 | 5.62 | 0.32 |
| 12/97 | 259,636.0 | 40.88 | 7.07 | 0.58 |
| 12/98 | 334,296.8 | 39.91 | 7.14 | 0.87 |
| 6/99 | 364,538.5 | 40.90 | 7.76 | 1.08 |

* Source: Calculations made by Crakow Real Estate Institute based on data from National Bank of Poland and the CREI/Polish Banks Association survey.

asset components between the end of 1996 and mid-1999. Consumer lending and mortgage lending have both grown as shares of total assets, but the mortgage portfolio has grown more rapidly, now accounting for just over 1 percent of the total. If demand and stability conditions remain favorable, this percentage is likely to increase fairly rapidly, perhaps even reaching 10 percent of total assets, and a higher proportion of consumer lending, in the near future.¹²

MORTGAGE LENDING BY THE UNIVERSAL BANKS. Table 2.8 provides estimates of the total mortgage portfolio of all banks responding to the CREI/PBA Survey.¹³ These estimates include mortgage lending (loans for purchase of a dwelling) and developer credits for residential housing and for commercial construction.¹⁴ Total portfolio growth from the end

Table 2.8 *Total Mortgage Finance Credits Outstanding*

| <i>Month and Year</i> | <i>Total (PLN millions)</i> | <i>Number of Loans (thousands)</i> | <i>Average Loan (thousands)</i> |
|-----------------------|-----------------------------|------------------------------------|---------------------------------|
| 12/96 | 663.0 | 21.5 | 30.9 |
| 12/97 | 1,502.2 | 42.5 | 35.3 |
| 12/98 | 2,903.6 | 73.5 | 39.5 |
| 6/99 | 3,952.6 | 96.0 | 41.2 |
| 12/99 | 7,520.4 | n.a. | n.a. |

Source: Urban Institute Consortium Polish Banks Association bank survey and Crakow Real Estate Institute estimates.

of 1996 through 1997 was 125 percent, followed by increases of 93 percent during 1998 and more than double in 1999. Comparing these rates with the rate of inflation during comparable time periods makes clear that substantial real gains have been made (inflation was 19.9 percent in 1996, 14.9 percent during 1997, 11.8 percent in 1998, and 9.8 percent in 1999). Factors cited for the increase in the volume of lending include a decrease in interest rates and also, before the collapse of the subsidy reform program, the expected elimination of the personal income tax deduction for home construction.¹⁵

Table 2.9 and figure 2.1 divide the housing portfolio by type of credit. Mortgage credit dominates, accounting for more than 81 percent of housing lending; credits to housing developers stand at 15.2 percent and credits for commercial property development at 3.5 percent of the total. Different types of credit have grown at considerably different rates. Mortgage credits have increased nearly two and a half times in the 18 months between the end of 1997 and June of 1999; developer credits have increased just over four and a half times; commercial credits have increased somewhat less than twice. Reportedly, the commercial market is somewhat overbuilt, especially in Warsaw, and some rents have actually fallen. (Warsaw now has considerably more office space per capita than either Prague or Budapest.¹⁶)

In addition, beginning at the end of 1999, households with contract savings accounts were able to begin to take out low-interest loans. Bank Pekao (the former state savings bank) announced in late 1999 that 14,000 contract holders would be eligible to take out a loan; it expects 60 percent of these households to do so. Thus, growth in mortgage credits will receive a new boost from 2000 onward.

With no precedents for development of market-based housing finance in transition countries, it is difficult to assess whether the

Table 2.9 *Total Mortgage Finance Portfolio by Type of Credit*

| <i>Month and Year</i> | <i>Developer Housing Credits (PLN millions)</i> | <i>Mortgage Credits: Home Purchase (PLN millions)</i> | <i>Commercial Development Credits (PLN millions)</i> |
|-----------------------|---|---|--|
| 12/97 | 130.1 | 1,298.7 | 73.4 |
| 12/98 | 417.7 | 2,346.1 | 121.8 |
| 6/99 | 600.8 | 3,213.2 | 138.6 |

Source: Crakow Real Estate Institute/Polish Banks Association bank survey and CREI estimates.

Figure 2.1 Total Mortgage Lending

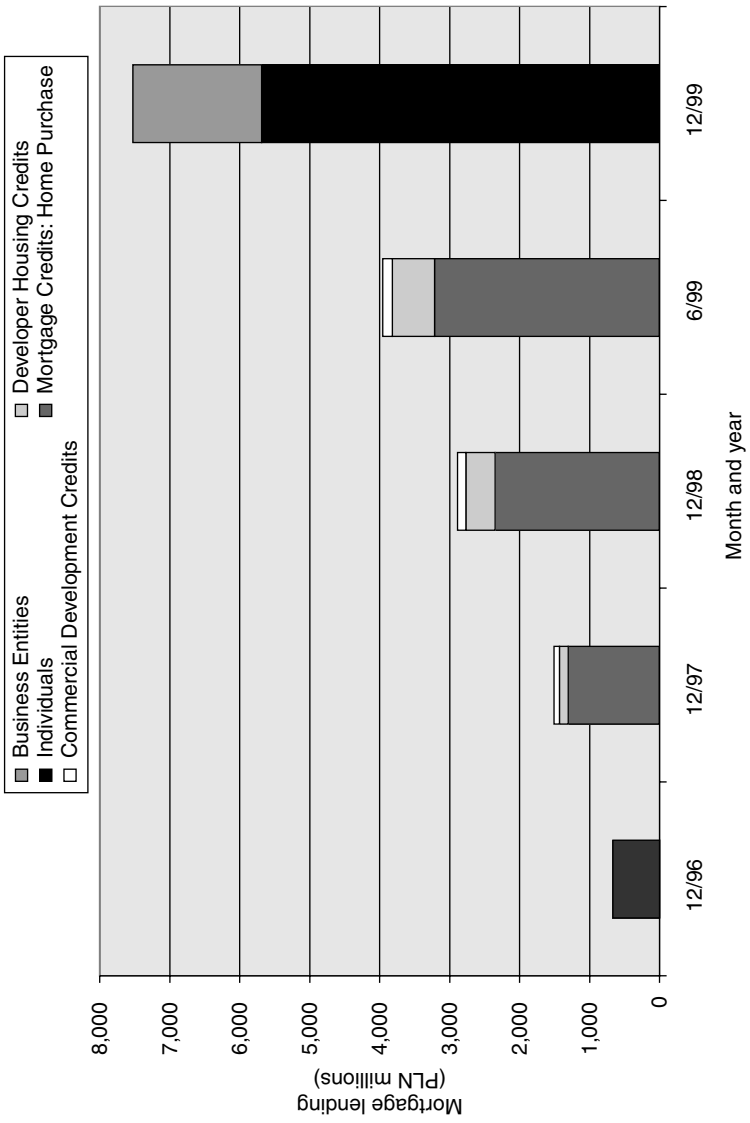


Table 2.10 *Increases in Total Consumer Credit and Mortgage Lending*

| <i>Period</i> | <i>Increase in Total Due to Consumers</i> | <i>Increase in Mortgage Portfolio</i> |
|---------------|---|---------------------------------------|
| 12/97–12/98 | 30% | 82% |
| 12/97–06/99 | 54% | 147% |

Source: Crakow Real Estate Institute/Polish Banks Association bank survey and CREI estimates.

increase in mortgage lending (from a very small base, of course) has been rapid or not, especially for mortgage credits for home purchase. One relevant comparison is the increase in mortgage lending compared with the increase in total lending to private persons—a broad measure of total consumer lending. Table 2.10 makes this comparison. Increases in mortgage lending for home purchase have outpaced those of consumer credit overall by a considerable margin. Mortgage finance as a share of total consumer lending, which was only 5.7 percent at the end of 1996, had risen to nearly 14 percent by June 1999.

In addition, mortgage lending use in Poland, while still fairly small in comparison with the United States and most of Europe, is higher than that in either Hungary or the Czech Republic. Estimates indicate that about 20 percent of purchases of new homes are made with mortgage loans (estimates of loan usage for purchases of existing homes are not possible because there are not adequate estimates of the number of transactions). Although it is not clear what level of utilization should have been expected at this stage in the transition process, Poland's banks are leading the region.¹⁷

A major shift in the institutional structure of lending in Poland may occur in the third stage of the sector's evolution, as Poland's new mortgage banks begin operation. How many of the universal banks will continue to compete, or whether those universal banks wishing to remain serious players in housing finance will establish mortgage banks, is not clear. What is clear is that the millennium will witness one of the most important steps in the institutional evolution of housing finance.¹⁸

LOAN PRODUCTS AND TERMS. Key features of the residential mortgage portfolio for the major lenders (table 2.11) include:

Table 2.11 Characteristics of Residential Mortgage Lending

| Descriptor | GE Bank Mieszkaniowy (PAMBank) | | | | | |
|-----------------------------|--------------------------------------|------------------------------------|------------------------------------|-----------------|-----------------------------------|---------------|
| | PKO BP | Pekao S.A. (PBG) | | PBK | | BISE |
| Mortgage Type | DIM, DPM | | DIM, Conventional | | DIM, Conventional | |
| Currency | PLN | PLN | PLN | PLN, \$U.S. | PLN | PLN, FRF |
| Maximum loan-to-value | 80% | 75% | 75% | 70% | 75% | 70% |
| Typical loan-to-value ratio | 40%–50% | 40%–50% | 40%–50% | 60%–65% | 40%–50% | 60% |
| Maximum amount of loan | 20 × gross monthly income | 20 × monthly income or 75% of cost | 27 × monthly income or 75% of cost | 70% of cost | 25 × monthly income or negotiable | 70% of cost |
| Minimum downpayment | 20% | 20% | 25% | 30% | 25% | 30% |
| Term | Up to 20 years | Up to 20 years | Up to 15 years | 7 to 15 years | Up to 15 years | 5 to 15 years |
| Interest rates | Variable | Variable | Variable | Variable, fixed | Variable | Variable |
| 1/97 | 25.50% | 25.50% | 25.90% | 25.01% | 25.37% | 25.90% |
| 12/97 | 25.50% | 25.50% | 24.10% | 26.00% | 24.96% | 24.92% |
| 6/98 | 25.50% | 25.50% | 24.10% | 26.00% | 24.96% | 24.92% |
| 10/98 | 24.20% | 19.54% | 19.54% | 26.00% | 19.63% | 21.69% |
| 5/99 | 16.40% | 18.40% | 18.40% | 18.71% | 16.01% | 16.97% |
| 7/99 | 16.40% | 17.25% | 17.25% | 17.35% | 15.20% | 16.90% |

Source: Crakow Real Estate Institute/Polish Banks Association 1999 Survey of Banks and Rzeszpospolita.

- **Type of Loan Product.** DIMs dominate the overall portfolio. Roughly 40 percent of PKO BP's portfolio is represented by DIMs, which also make up about 80 percent of BISE's and 25 percent of Pekao S.A./PBG's portfolios. The remainder of PKO BP's residential loans are DPMs (deferred payment mortgages, also an indexed product). Most of the balance is made up of variable interest rate products. Among the major lenders, only PAMBank offers fixed rate loans (\$ denominated).
- **Currency.** The vast majority of loans are zloty-denominated. However, PAMBank's loans include U.S. \$ and BISE offers French franc as well as zloty loan products. Smaller mortgage lenders offer Deutsche marks, or Austrian shillings (such as Bank Creditanstalt), or U.S. \$ (BPH, Creditanstalt, Investbank, and LG Petro Bank) loans.
- **Interest Rates.** Two features of the interest rates on variable loans are particularly noteworthy. First, rates have steadily declined, especially during 1999. Second, depending on the time period, the rates offered across the major competitors have varied fairly widely. (See also the analysis of lending rates relative to other market parameters, below.)
- **Maturity.** Loan maturities range from 5 to 20 years. "Typical" maturity is 10 to 15 years. Although prepayments were fairly common two or three years ago (perhaps as much as 10 percent of the portfolio as cited by one bank), the rate has now fallen. Two reasons are that some banks charge a prepayment penalty and interest rates are lower.
- **Maximum and Typical LTVs.** Table 2.11 shows both maximum and typical loan-to-value ratios (LTVs). Clearly, the typical LTVs, about 40 to 60 percent, are much less than the maximum stated in the banks' policies, reflecting the conservatism of both Polish lenders and borrowers. (In comparison, typical LTVs in the United States are 75 to 80 percent; many special affordability programs provide LTVs of 90 to 97 percent. In some cases, a portion of the LTV, the highest 15 or 20 percentage points, carries default insurance.)
- **Ratio of Monthly Payment to Income.** The ratio of the loan payment to a borrower's monthly income—the so-called effort ratio—varies widely, generally ranging between 17 and 40 percent.

Poland's Rate Structure: Efficiency and Affordability

This section compares time trends in lending rates, deposit rates, inflation, and interest rates on one-year government paper in order to assess the efficiency and affordability of Poland's rate structure.¹⁹ As discussed further below, high real lending rates and exceptionally large spreads are problems that Polish banks will need to continue to address in the next few years. Relevant questions include:

- How have the changes in mortgage lending rates corresponded with inflation?
- How do lending rates compare with those for government debt?
- How do lending rates compare with the cost of funds for Poland's banks?
- How do Poland's interest rate spreads compare with those of European nations?

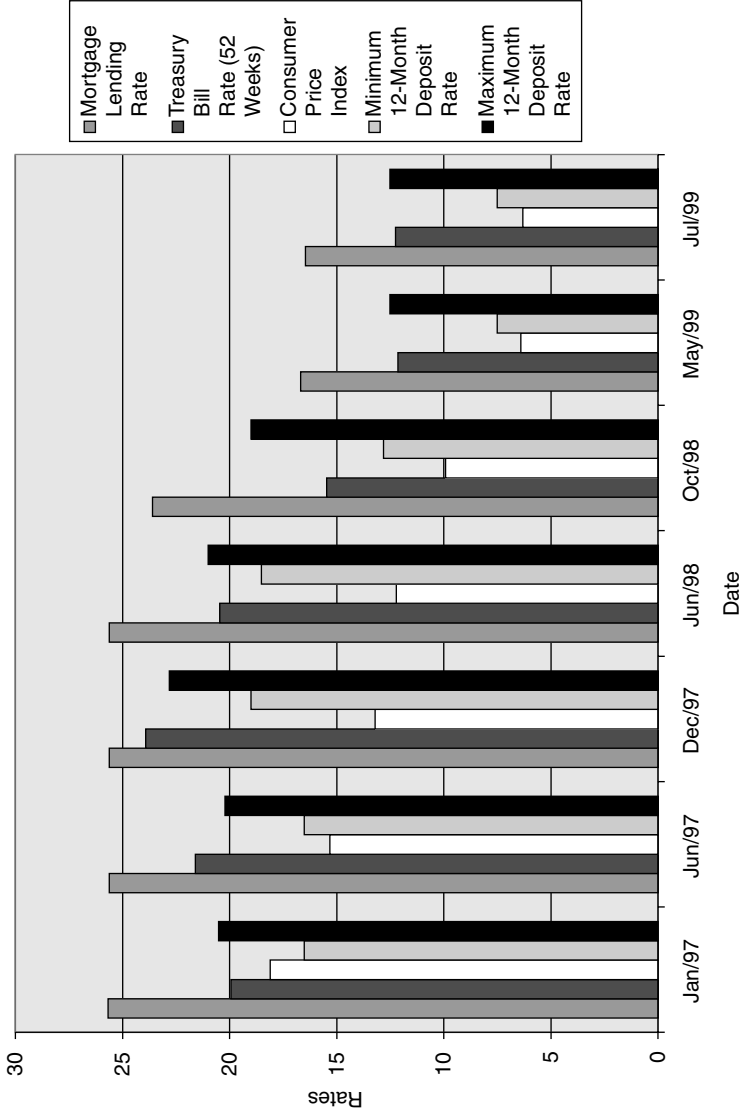
Figure 2.2 provides basic data on interest rates and inflation. To simplify, "gap" analysis is presented here. The mortgage lending rate shown in the table is the weighted average lending rate on variable rate mortgages for the five major lenders.²⁰ Other rates could be used as desired.

It is, of course, crucial to housing finance affordability that rates continue to fall. The steady fall in inflation since 1996 is impressive and appears to be continuing. Indeed, a breakthrough appears to have been achieved during 1999, as inflation fell to the single digits. The issue is whether interest rates have fallen accordingly. In particular:

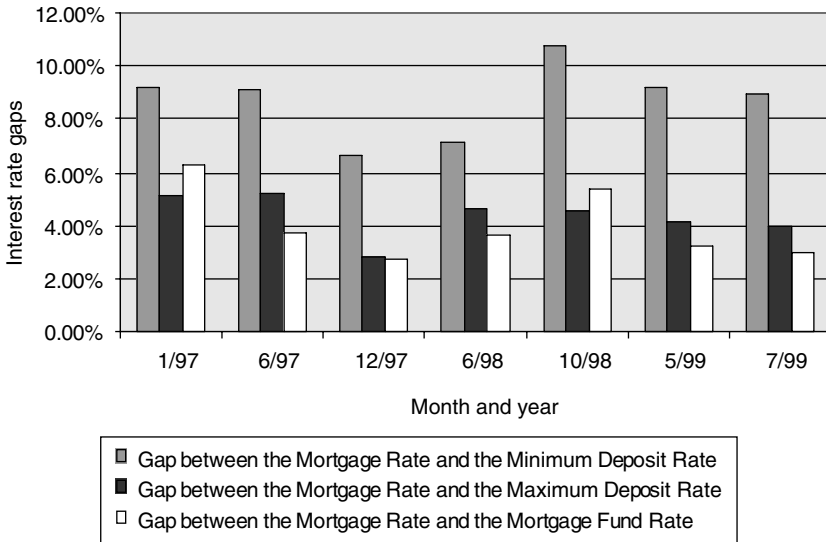
- Have lending rates, Treasury bill rates, and WIBOR (Warsaw Interbank Lending Rate) all followed the decline in inflation in comparable magnitude?
- Has the margin between deposit rates and lending rates begun to fall to acceptable levels, relative to international standards of operation?

The answer to whether the various interest rates are falling in rough correspondence with inflation (and with each other) is: not quite. Between January 1997 and July 1999, inflation fell by 11.8 percentage points (a 65 percent drop). In the same period, the weighted average interest rate fell by 9 percentage points (a 35.3 percent drop), and the Treasury bill rate—which fluctuated more than other rates during this

Figure 2.2 Comparison of Interest Rates in Poland²¹



Source: National Bank of Poland, GUS, and Reuters.

Figure 2.3 *Interest Rate Spreads in Housing Finance in Poland*

period—saw a net drop of 7.68 percentage points (a 38.6 percent drop). To keep strict correspondence with the drop in inflation, the mortgage lending rate would have had to fall at a somewhat higher rate. It did, however, follow the drop in T-bill rates in relative magnitude.

INTEREST RATE SPREADS IN THE BANKING SECTOR OVERALL. The efficiency of the banking sector can be usefully addressed by an assessment of the gap between lending rates and deposit rates. Figure 2.3 (and table 2.A.1 in annex 2.A) presents this gap analysis for mortgage finance, following a comment on spreads in the banking sector overall.

A recent assessment by Goldman Sachs of margins and costs in the Polish banking sector has documented the very large spreads—relative to Europe—between average rates paid to deposit holders and the average return from lending.²² The average interest margin of Polish banks was 6.2 percentage points in 1998, for example, compared with 0.7 to 0.9 in Switzerland, 1.0 to 1.2 percent in Germany, 1.1 to 1.8 percent in France, and 2.3 to 4.7 percent in Greece. This assessment indicates that the exceptionally high spread in Poland is a function of both high operating costs and high reserve requirements. Banks within Poland vary considerably in their spreads, with the larger, internationally oriented

banks having the lowest spreads. The largest spreads occur in small banks, which operate in local or niche markets (e.g., Bank Komunalny with a spread of 12.8 percent, Bank Czestochowa with 8.0 percent, and LG Petro Bank with 7.3 percent, all for the first six months of 1999). The lower spreads of the larger banks during this period are still not considered competitive, however. For example, WBK was at 5.4 percent during the first six months of 1999, Kredyt Bank at 5.3 percent, BIG Bank Gdanski at 5.0 percent, and Pekao S.A. at 4.6 percent. But BRE is reported to have had a spread of 3.6 percent, and Bank Handlowy a spread of 2.5 percent, during this period. Goldman Sachs suggests that if spreads were to fall by a reasonable amount from a market perspective—2.9 percentage points on average, according to their calculations—most Polish banks would start to suffer losses. To survive in that case, they would have to reduce operating costs and significantly increase returns.

The Efficiency of Mortgage Lending and the Cost of Funds. What does this analysis reveal about mortgage lending in Poland? The gaps between the mortgage lending rate and three measures of the cost of funds to banks (the minimum and maximum deposit rates and the Mortgage Fund rate²³) are rough proxies for the efficiency of mortgage bank lending as practiced by the major lenders (table 2.A.1).

The findings shown in figure 2.3 are revealing in that the gap between the mortgage lending rate and the minimum and maximum deposit rates varied greatly during this period, both within each series and in comparison with one another. In the long run, one might expect greater convergence between the deposit rates as the sector becomes increasingly competitive. Just as for the banking sector as a whole, greater efficiency in the long run should reduce the spread between deposit and lending rates. However, as long as banks can maintain the large gap between returns from lending and the cost of funds from depositors, wholesale funds such as those from mortgage bonds or the Mortgage Fund clearly will not be competitive.

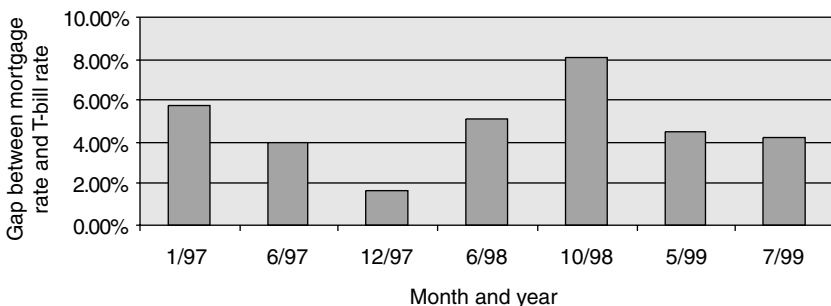
EFFICIENCY AND SPREADS IN COMPARISON WITH GOVERNMENT DEBT. Recall from the discussion in the Overview of the Current Situation section that the measure of intermediation efficiency is the difference between the mortgage lending rate and the rate on government paper of comparable duration. In the efficiency study of Europe and the United States cited above, adjustments were made to the simple differ-

ential between rates for a variety of point structures and special features (e.g., downpayments and fees or special discounts affecting the interest rate) to make the comparisons relevant across the markets included in the study. Government paper (sovereign debt) is assumed (in developed countries) to be risk-free. Thus, the gap between the rate of government paper and the mortgage rate is an approximation of the level of risk inherent in housing finance.

This analysis cannot be replicated exactly for Poland for a variety of reasons. Most important, government paper of comparable duration to mortgage lending does not yet exist in the market. The vast majority of Treasury bills are of 52 weeks' duration. Although a 10-year bond has recently been floated, little information is available and no freely quoted rate exists. Despite these shortcomings, the gap between the mortgage lending rate and the Treasury bill rate is still a useful measure of the relative risk inherent in mortgage lending in Poland (on the assumption that Treasury bills in Poland are reasonably risk-free). Evidence of a falling gap would signify that Poland's housing finance system is becoming more efficient and is perceived by the banks as becoming less risky. As before, the weighted average lending rate for variable rate mortgages (generally for 15 years or less) is used for comparison with the 52-week Treasury bill to provide a rough measure of efficiency.

Since January 1997, the gap between the lending rate and T-bills in Poland has fallen by about 30 percent (from 5.74 percent to 4.21 percent), as shown in figure 2.4 and table 2.A.2. There has been considerable fluctuation, however, so the trend line cannot yet be said to be steady. The efficiency findings from the intermediation study cited above found the gap between the mortgage rate and government paper for the United

Figure 2.4 *Intermediation Efficiency*

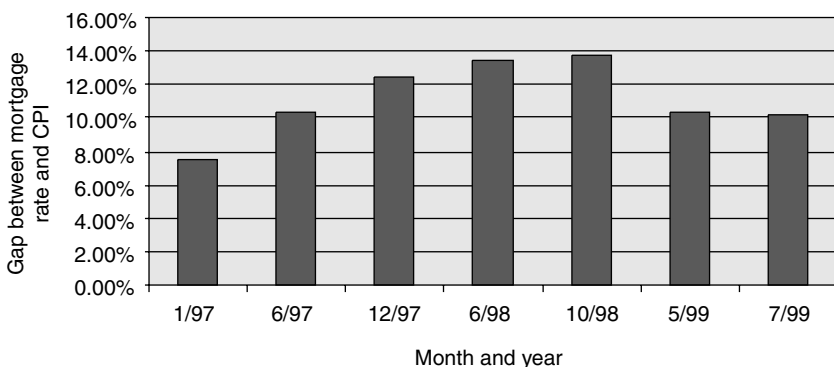


Kingdom, the United States, Germany, Denmark, and France to range between 100 and 230 basis points. These provide a long-term benchmark goal for Poland, although Poland cannot be expected to approach such numbers in the near term. What is of more concern in the short run is that there has been no consistent fall in the gap over the past two and a half years. It is somewhat encouraging that the trend has been uniformly downward since October 1998. Furthermore, the mortgage lending system handled a recent spike in short-term interest rates in a stable manner. Between early September and early November 1999, WIBOR rose sharply—from 13.6 percent to 18.66 percent on November 5, 1999. Despite this rise, mortgage lending rates held steady, ranging between 16 and 20 percent.²⁴

A second comparison useful for assessing efficiency is between the mortgage lending rate and the rate of inflation as a proxy for the “real” lending rate. The real lending rate is not a simple concept, and the rate of inflation as measured by the consumer price index may not be an ideal point of comparison. It is, however, the only readily available monthly price index. Figure 2.5 provides an estimate of this gap. Again, considerable fluctuation has occurred, which is not at all surprising. There has been a small downward trend in the gap—and thus in the proxy for the trend in real rates—since October 1998. But no overall real improvement was seen over the two years between June 1, 1997, and July 1999.²⁵

As Poland’s housing finance system matures, continues to be subject to the pressures of competition, and begins to reflect reductions in operating costs (no doubt helped by consolidation, privatization, and foreign

Figure 2.5 *Gap between the Mortgage Lending Rate and Inflation*



partners), efficiency should be enhanced and both of these gaps should shrink more rapidly. Recent declines in both mortgage lending rates and the various spreads indicate that competitive pressures have created a responsive financial environment in housing finance. However, the gaps remain too large for effective housing finance in Poland, especially in a long-term environment that will be increasingly subject to EU and other outside competition.

AFFORDABILITY OF HOUSING. Housing affordability is a complicated function of the interrelationships among income, construction costs, swings in market prices, mortgage rates, deposit rates, and so forth. Is housing becoming more affordable in Poland? In other words, compared with several years ago, can consumers (assuming the same level of real income and facing the same effort ratio²⁶) afford a larger loan because rates have fallen? Will this larger loan buy more housing than previously? Or alternatively, has real income increased faster than real interest rates and real construction and purchase costs?

The tentative answer is that housing affordability is slowly improving for consumers:

- Income, on average, is increasing faster than prices. Real average monthly wages increased by 5.5 percent in 1996, 5.9 percent in 1997, and 3.7 percent in 1998.
- Construction prices are increasing at roughly the same rate as inflation. The increase for 1998, for example, was 12.9 percent, compared with 11.8 percent for the consumer price index. In 1997, however, the construction cost index increased by 14.2 percent, while inflation stood at 14.9 percent. Thus, increases in real wages compared with increases in (real) construction costs have shown a gain.
- Real lending rates have shown a small downward trend since mid-1998 (although the gap remains large). So affordability, as assessed using a constant monthly payment, should be increasing slightly.
- The maximum deposit rate available to consumers appears to be gaining on the rate at which they must borrow for a mortgage.

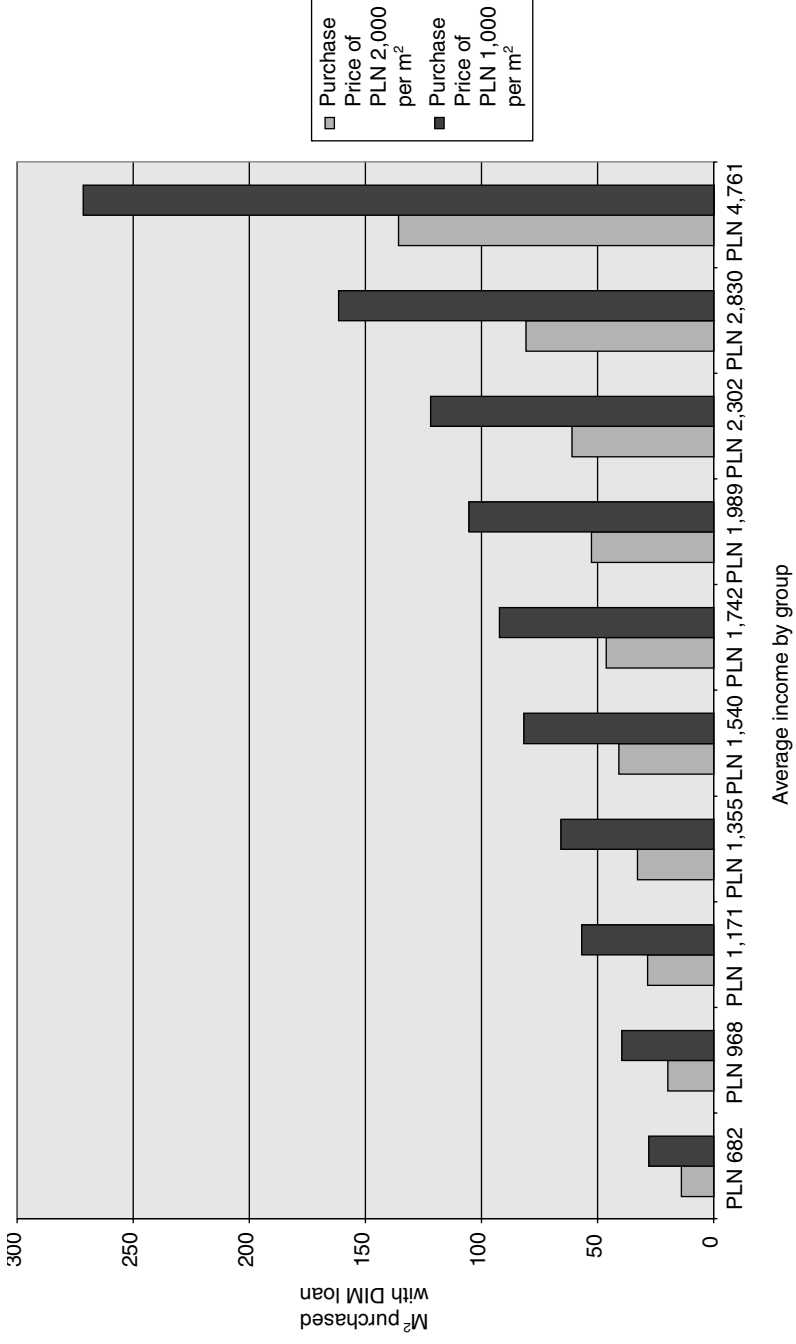
Do these improvements mean that the vast majority of households can afford to purchase a home? No, but the situation is better than generally recognized and certainly appears to have improved in the first six

months of 1999. Income relative to construction costs still remains low in Poland. However, using a DIM loan, or a conventional loan, with mortgage rates now at 16 percent, purchasing a modest apartment with a mortgage loan and a downpayment of 25 or 30 percent is certainly feasible for households with moderately high incomes. If lending rates continue to fall, consumers will begin to see major improvements in affordability.

The missing information needed to complete the affordability picture is the actual sales price of housing (per square meter) in different locales. Although there is no nationwide index for sales prices in Poland (in the United States, for example, the median sales price is published regularly to provide comparisons over time), the Housing Research Institute (HRI) regularly conducts a sample survey of 23 gminas, which provides a good overview of sales prices for small, medium, and large cities. Table 2.A.3 provides the distribution of prices (per square meter) for the HRI sample in 1997 and 1998; the sample includes large gminas (more than 100,000 persons), medium (25,000 to 100,000), and small (fewer than 25,000). Prices are given for a range of situations: the lowest cited in the sample, the most often cited (the mode), and the highest (these are asking prices for apartments in multifamily units). Generalizations from these figures about either averages or trends are hazardous. First, house prices vary tremendously between urban and rural areas, from city to city, and from large cities to small. Second, although prices have fallen slightly in some gminas, surprisingly perhaps, even in Crakow the highest prices cited fell just slightly. In other cases, such as Warsaw, prices of both moderate- and high-priced units rose considerably.

The affordability of home purchase with a mortgage loan can be addressed, however, by choosing some “representative” price. This chapter uses PLN 2,000 per square meter, which is the “lowest” price for Warsaw in the HRI data, but close to (or exceeding) the highest in Lublin, Lodz, and Torun, and much in excess of the highest in the majority of medium and smaller cities in the sample. Table 2.A.4 indicates the number of square meters that an “average” household in each of 10 income categories (deciles) is able to purchase with a DIM loan, a 30 percent downpayment, and an effort ratio (payment-to-income ratio) of 38 percent (among the highest in Poland).

Figure 2.6 The Affordability of Housing with a DIM Loan



Using these assumptions, households in the sixth income group, for example, are able to purchase an apartment of 46 square meters, while those in the ninth income group can purchase 80.7 square meters. Assuming a price per square meter of only PLN 1,000, the amount of space that can be purchased under these assumptions clearly doubles (figure 2.6). Thus, households in the third group and higher could purchase an adequate unit in smaller cities or in the less expensive neighborhoods of the larger gminas.

DELINQUENCIES AND DEFAULTS. Delinquency and default rates are among the most revealing and transparent measures of the health of a bank's portfolio. In developed financial sectors, these rates are collected, measured, and analyzed by a variety of institutions. First and foremost are the banks themselves. In addition, these rates are key indicators for regulatory authorities. Delinquency rates are generally developed for late payments of one, three, and six months. Such data are generally also collected by the banking industry's professional associations (or other institutions in the system) and published by type and size of bank, allowing individual banks to use aggregates as benchmarks against which to evaluate their own performance.

In addition, in developed markets, a variety of institutions undertake financial surveys and sample data collection efforts in order to collect files at the level of the individual borrower (household, developer, commercial property, etc.). Statistical analyses of these microeconomic databases can yield extremely useful information about which factors are most important in contributing to default, as well as rather precise estimates of what the marginal contribution of a particular factor might be. In the United States, for example, default rates are strongly associated with very high loan-to-value ratios and a variety of household characteristics. Also, the probability of prepayment is a key variable in pricing mortgage-backed securities. Similar estimation concerns regarding factors that contribute to default and prepayment will be very important in pricing Poland's mortgage bonds.

In Poland, according to data collected by the Inspector General of the National Bank (GINB), the proportion of "irregular" loans²⁷ now constitutes 11.8 percent of the banks' total loan portfolio. Another 6 percent of loans are under scrutiny. However, no data on delinquencies or

defaults have been made available for housing finance. It is still difficult for some banks to track such information on an aggregate (or centralized) basis. In addition, in Poland, declaring “default” is likely to be related to administrative difficulties with the foreclosure process. In cases where the loan is sufficiently delinquent to be declared in default, and this information might be used to force foreclosure proceedings to begin, reluctance to start along this road, given the difficulties involved, may provide an incentive not to declare the loan delinquent in the first place.

Other Key Elements of Poland’s Mortgage Finance System

REGULATION AND SUPERVISION. In 1999, GINB was in the final stages of preparing an inspection manual for housing finance. This manual, which was drafted and under review by a variety of experts outside GINB, is part of a major effort by GINB to undertake this crucial regulatory function of the overall portfolios of all of the banks.²⁸ The housing finance manual is a major document. It discusses the numerous types of risk associated with real estate lending, provides sample forms to assist in quality control of the portfolio (including appraisal practices, loan documentation, and record keeping), and notes potential problems connected with real estate management. There is relatively little history of market rate lending in Poland, however, and, as emphasized, a dearth of institutions collecting and analyzing data. As a consequence, almost no accessible data exist on loan performance over time or by property valuations by type and location. This topic is further discussed in the section on Government Support of Homeownership.

CONTRACT SAVINGS FOR HOUSING. Contract savings for housing (CSH), modeled closely on the Bauspar systems in Germany and Austria, are major features of the housing finance systems of Slovakia, Hungary, and the Czech Republic.²⁹ Germany’s Bauspar system, managed not by banks but by separate financial institutions, the Bausparkassen, is often described as a “closed” system (basically, the funds are available only to make loans to participants). The major alternative European model, that of France, is a so-called “open” system (primarily because not all savers exercise their loan rights and the funds freed up can be used for other housing loans or investments).

Poland’s history with CSH differs from that of its neighbors, and in early 2000 the final shape of its CHS system was still being debated and

was under redevelopment.³⁰ Two competing systems have been promoted: (1) Poland's first CSH, known as the *kasy mieszkaniowe*, which was established in 1996 in the National Housing Fund (NHF), and (2) the June 1997 Act, which provided the legal basis for a contract savings system modeled after the Bauspar. At this time, most *kasy* accounts have been open for less than three years and no Bausparkassen have yet been licensed. Poland is considering eliminating the Bauspar system and modifying the structure of the *kasy* system.

The two CSH systems in Poland differ in a number of ways, but the most important are through their delivery vehicles and their approach to the subsidy. The *kasy mieszkaniowe*, as originally introduced, was not modeled exactly after either the German or the French system, but it is best described as a modified closed system. The *kasy* CSH is operated by the existing universal banks (e.g., rather than by separate Bausparkassen). The NHF provides a liquidity facility for banks holding CSH accounts. Households are encouraged to enter the program because of strong tax incentives (a tax credit of 30 percent of annual savings). CSH *kasy* accounts are available in PKO BP, Bank Slaski, and BPH. There were about 35,000 savers in mid-1999.

In contrast, the second system was to be operated by Bausparkassen established in Poland. Rather than the tax incentives offered by the *kasy*, the Bauspar legislation provided for an annual bonus from the state budget of 30 percent of annual savings. In both systems, however, there is a contingent liability for the provider to grant a housing loan upon satisfactory completion of the savings contract. Thus, the providing institution potentially faces a significant liquidity risk (especially if there are not a sufficient number of new savers entering the system). This risk could ultimately have serious implications for the NHF, the regulators, or the state budget.

As noted, the Ministry of Finance is studying the options for alternative designs of a CSH system, and in the fall of 1999 it requested that Parliament consider repeal of the Bauspar Act.³¹ At issue are a number of questions, including clarification of the purpose of the CSH in the current structure of Poland's subsidy systems, reduction of the risks inherent in CSH systems, and alternative methods of delivering a subsidy. In the current economic environment in Poland, perhaps the major rationale for a CSH system is to provide an incentive for households to save for a downpayment, because personal savings rates are low. An alternative approach to this goal, for example, would be to establish a market-

rate savings system with a subsidy provided through a state grant at the end of the contracted savings period. In summary, the exact parameters for, and importance of, a future CSH system in Poland are not yet clear. It seems likely, however, that CSH in Poland will not assume as major a role as the Bauspar systems of its neighbors in CEE.

THE POLISH BANKS ASSOCIATION. The Polish Banks Association (PBA) is an increasingly effective and active professional organization supporting the interests of banking in Poland. In late 1997, in response to the clear increase in interest in housing finance among its members, PBA formed a permanent housing committee.³² Among the activities of assistance to the development of housing finance, PBA has lobbied to improve a variety of legal and administrative impediments to housing finance (such as titling and registration and the statutory lien). It has sponsored conferences and workshops to address numerous issues, including regulation and supervision and appraisal practices. It has reached out to similar professional organizations in CEE, Europe, and the United States to develop lines of communication on issues of regional and international interest, and it has sought to supply its members with educational material on housing finance from both the United States and Europe.

A transition in housing finance from a system dominated by universal banks to a possible domination by the new mortgage banks may occur in Poland. Given that PBA's membership includes the major universal banks, it has argued for a level playing field in housing finance.

Finally, it appears that PBA will be an increasingly active spokesman for Poland on regional and international issues in housing finance. PBA has ties with similar organizations in the region, and it assists those groups just beginning activities in housing finance (the Bulgarian Association of Bankers is one example). PBA works with the German Bankers Association, and, with the assistance of USAID and the Poland Housing Finance Project, it has established links with the U.S. Mortgage Bankers Association.

THE CREDIT BUREAU. During 1998–99, the Polish Banks Association and other organizations were active in initiating Poland's first credit bureau, which opened its doors for business in early 2000. This is an extremely important step for Poland. As one aspect of the legacy of the Soviet system, it is not easy to get banks—or any other real estate-related

institution—to release or share information. Furthermore, most banks do not yet have information technology systems that make it easy to release aggregate or specific information. The laws on releasing consumer information are particularly strict; but banks, appraisers, realtors, developers, and others simply have no tradition of providing mutually beneficial information in any event.

In order to underwrite mortgage loans, banks should ideally be calculating the gross debt ratio—the combined payments a household must make on all of its installment debt relative to income. In general, it has not been possible to collect such information—a bank holding a consumer's car loan, for example, would not release this information to a competing bank that was attempting to underwrite the mortgage loan. The Credit Bureau is now gaining membership and momentum to change this type of situation. Safeguards and confidentiality systems are being put in place, and one can hope that the battle will gradually be won. If banks can underwrite with more confidence about the true value of the household circumstances, including its gross debt ratio, then loan-to-value ratios and payment ratios could be made less conservative when circumstances permitted.

OTHER ORGANIZATIONS SUPPORTING HOUSING FINANCE AND THE REAL ESTATE INDUSTRY. In addition to the PBA, Poland boasts an impressive group of professional organizations and research institutions, including the Polish Association of Home Builders, the Federation of Polish Appraisers, and the Association of Realtors. Finally, the institutions that are supporting research and analysis of housing issues in Poland are the Foundation for Mortgage Credit, which supports the development of housing finance in Poland, and the Housing Research Institute, which provides data and analyses on housing need, housing condition, and subsidy policies.

The Next Stage of Development for Housing Finance in Poland

Poland is now entering a new stage of transition in housing finance, and a major shift in the institutional structure of mortgage lending is under way. Unlike the situation of many of its neighbors in CEE, mortgage finance in Poland has so far been conducted almost solely by the universal banks. Both Poland's mortgage banking legislation and that supporting a Bausparkassen system of contract savings have occurred several years later than

Table 2.12 *Applications for Mortgage Bank Licenses in Poland, Spring 1999*

| <i>Bank</i> | <i>Rank</i> | <i>Current Housing Finance Lending</i> | <i>Mortgage Bank Development</i> |
|------------------------------------|-------------|--|----------------------------------|
| Pekao SA | 3 | Small | Applied |
| PKO BP | 1 | Holds 65 percent of current portfolio | Applied |
| Bank Handlowy | 2 | None | Applied |
| BPH | 4 | Small | Applied |
| BIG Bank Gdanski | 5 | Small | None |
| BGK | 6 | n.a. (GOP Development Bank) | n.a. |
| BRE Bank/Rheinische Hypothekenbank | 7 | None | License granted |
| Bank Slaski/ING | 8 | Major competitor | Applied |
| PBK/Creditanstalt | 9 | Major competitor | Applied |
| BGZ | 10 | Small | None |
| WBK/AIB (Ireland) | 14 | Small | Considering applying |
| Hippo-Vereinbank | 17 | n.a. | License granted |
| BISE | 41 | Major competitor | None |
| PAMBank | 53 | Major competitor | None |
| PBG | 42 | Major competitor | None |

Source: Developed by author and Crakow Real Estate Institute.

in the Czech Republic, Hungary, and Slovakia. The Act on Mortgage Banking in Poland was passed in 1998, providing the legislation needed to support the development of European-type mortgage banks. The central bank, which has been developing the regulatory system to support mortgage banks and mortgage bonds, has thus far granted only one mortgage banking license (to BRE/Rheinische Hypothekenbank, in February 1999). Many other banks have applied, however, including many of the largest banks in the country as well as PKO BP. Table 2.12 notes the status of these applications in spring 1999 and the strong interest held by Poland's largest banks in mortgage finance.

Poland's main concern now may be not lack of competition, but rather an "overbanked" financial sector. Poland's banking sector has experienced a major thrust toward consolidation and the dominance of new, larger institutions—through mergers, acquisitions, privatization,

and continued entry of foreign partners. Poland boasts 6 of the 11 largest bank sales to foreign banks to take place in eastern Europe.³³ In any event, the housing finance sector, like the banking sector overall, appears to have too many players to be sustainable in the long run. Thus, more consolidation is to be expected.

Among Poland's nine largest banks (as measured by their capital), six have applied for a mortgage banking license and one license has been granted so far (to BRE). (BGK, the GOP Development Bank, was excluded from this tally.) In addition, other Polish banks and their foreign partners and other foreign banks are considering application or have already applied. In contrast, among the universal banks that are major lenders in housing finance, only three of the six have applied for a license. The questions raised by these developments, as well as other issues regarding regulatory parameters, include the following:

- Will there be a level playing field? Will universal banks also be granted licenses as mortgage banks as is the case in the Czech Republic?
- If universal banks are not granted mortgage licenses, will they continue to lend? Will legal issues favoring mortgage banks (such as the statutory lien) be dealt with to help create a level playing field?
- Will the high-risk weights that the Central Bank is now planning to apply to mortgage bonds put mortgage banking at a disadvantage with regard to cost of funds? (Despite a European Union recommendation for a 50 percent risk weight on mortgage bonds, Poland has imposed a 100 percent weight.)
- What will the outcome of these possible scenarios imply for the approach to accessing long-term funds from the capital market? Specifically, will mortgage bond (on balance sheet) funding be the only structure available for capital market funding, or will a secondary market/securitization (off balance sheet) approach also create or rejuvenate a liquidity facility such as the Mortgage Fund?

Is Housing Finance Underutilized in Poland?

Whatever the actual level of housing demand in Poland, it does appear that the relative role of mortgage credit in the economy is not large. The share is less than 0.6 percent of the 1998 GDP of PLN 511,109 million. The

total portfolio is making relative gains, because it was only 0.5 percent of GDP at the end of 1997. Nevertheless, the following questions are relevant:

- Has the demand for housing lagged behind the significant growth in GDP during the last half of the 1990s decade?
- Is this level of demand for mortgage credit what would be expected at this time?
- What determinants distinguish the demand for housing and the demand for mortgage credit?
- Are consumers' energies and funds being concentrated on consumer durables, or on some other items?

These questions are very difficult to answer for Poland (and perhaps for other transition countries), not only because there are insufficient data for analysis but also because it is not clear what should be expected in the transition process. Is demand low? Compared with which countries? At what point in the evolution of their mortgage finance sectors? What would be expected as the system finalizes its emergence from central controls and price distortions? At least one analyst has suggested that mortgage credit utilization is unduly low not only in Poland but also in Hungary, the Czech Republic, and Slovakia.³⁴ There are, in fact, a large number of plausible reasons for constraints to exist on the demand for housing and credit, and these are discussed below.

For many reasons, the levels of demand for housing and for mortgage credit evidenced in the United States and in Western Europe may hold little relevance for Poland and other transition countries, at least right now. In the first instance, of course, differences in income level, in real interest rates, in the relative price of housing and other goods, and in the ratio of the price of housing to income are all determining factors. But making a hypothetical assumption for the moment—a group of households with similar incomes and preferences—are there other factors that might distinguish differences in level of demand?

A variety of barriers may produce a gap between potential demand and effective demand. Furthermore, the variables that affect the demand for housing may differ from those that affect the demand for credit, as clearly evidenced by the (apparently) low utilization rates. In combination, the rigidities of central planning and state-owned housing production, the remuneration of households to a substantial extent via in-kind transfers, and the distortions in the pricing systems—whether of housing, interest rates, or consumer goods—have left the transition coun-

tries with very significant barriers to realization of potential demand for housing. Thus, a key problem in Poland is that of translating the “potential demand” for housing and residential credit into “effective demand.”

Problems of inadequate “effective demand,” as commonly perceived, can result from policy failures on both the demand side and the supply side of the housing market. For example, households occupying heavily subsidized housing who would, with smaller or no subsidies, consider moving to another dwelling or even another city may have little or no incentive to move as long as subsidies persist. Similarly, incentives to change dwellings will be minimal if available housing is priced beyond the means of most households—perhaps as a result of government-imposed restrictions on land development or house construction. With regard to mortgage credit, parallels exist concerning demand- and supply-side barriers to translating potential demand into effective demand. If the possibility of government-subsidized credit exists for a household, even if it must wait for years to take advantage of it, the household may be reluctant to seek credit at market rates of interest; this is a demand-side barrier to effective demand for private mortgage credit. On the supply side, any policy that either rations credit or increases its price (such as inefficient legal and administrative practices in granting credit or failure to manage credit risk properly) will restrict the ability to translate potential demand into effective demand.

BARRIERS TO EFFECTIVE DEMAND FOR HOUSING IN POLAND AND OTHER TRANSITION COUNTRIES. Factors that may act as barriers to effective demand for housing may include the following:³⁵

- Mobility constraints.
- Tenure choice barriers.
- Other supply constraints on housing types and locations.
- Rent control (artificially lowers the cost of existing housing).
- Higher relative cost of housing.
- Privatization policies that confer ownership at little or no cost (sometimes with low-cost credit from gminas); also occupancy rights that already confer ownership, so owners do not privatize.

BARRIERS TO EFFECTIVE DEMAND FOR MORTGAGE CREDIT IN POLAND AND OTHER TRANSITION COUNTRIES. Similarly, barriers to demand for mortgage credit might include:

- Liquidity constraints (inability to secure a sufficient downpayment).
- LTV (loan-to-value) constraints by conservative lenders.
- Relative cost of mortgage credit (high real mortgage lending rates); also, as noted above, low-cost gmina credit for privatization.
- Expectations/attitudes about indebtedness (by households or lenders).
- Expectations/attitudes about the cost of housing relative to other goods (especially consumer durables) and to income.
- Expectations regarding local or regional political and employment stability.

Mobility rates are indeed very low in Poland, which has been a topic of concern with regard to the impact of low labor mobility on economic growth. Tenure choice and locational barriers will gradually be overcome as the volume of new construction expands. However, rent control will inhibit both the demand for other housing and the formation of a dynamic, privately financed rental sector. Also, to the extent that occupancy rights in various types of housing convey a sense of ownership, “formal” purchase is not made. Furthermore, to the extent that privatized units are very deeply discounted, no mortgage credit may be regulated (in some cities, it is also possible to pay over time at loan interest).

LTVs are on average quite low. And real lending rates in mortgage finance appear quite high. Table 2.A.2 presents a series of interest rates and the rate of inflation for comparison. The rate of inflation and the cost of government debt are steadily falling; mortgage lending rates remain quite high.

Government Support of Homeownership

Overview

The perception of a housing shortage by many, if not most, observers in Poland has put tremendous pressure on the government to increase its support for housing in general and for homeownership and new construction in particular. Many Polish commentators continue to base their policies on a traditional, Soviet-style approach to analyzing housing problems, making the following conclusions: (1) there is a very serious housing shortage; (2) the government does not provide sufficient subsidies to ameliorate this shortage; and (3) housing, overall, is unaf-

fordable. The first of these propositions is not correct; the second, based on regional comparisons, does not seem valid; and the third, while true in comparison with the housing standards of Western Europe, is a view based on a needs assessment that is unrealistic given Poland's level of income. Also, given the system of rent control, which is still largely in place, the population at large is accustomed to spending a very small proportion of their income on housing.

As discussed in the section on the Housing Market in Poland, the estimates of a "shortage" of 2 million housing units fail to take into account whether the addition of this many units is affordable, either to individuals or to the government (or feasible from a construction standpoint in a reasonable time frame). With regard to the second issue, if tax revenues forgone from the current tax break on new construction are included with direct budget expenditures, the government of Poland's budget share for housing appears to be very adequate, and it is certainly comparable to that in Hungary and the Czech Republic. Third, however, housing costs relative to income are in fact relatively high, and the GOP has recently proposed new policies to address both demand- and supply-side constraints.

The program of housing subsidies in effect (as of July 2000) is dominated by three major themes:

- Support to homeownership through a major tax break for new construction, reflecting the conviction that Poland faces a large housing shortage.
- Support to low-income renter households, primarily in communal (public) and cooperative housing, through a housing allowance program and through funds for subsidized, long-term loans for construction of moderate-income rental housing (the TBS program).
- A commitment to paying off the major legacy of past subsidy promises, for the most part developed primarily during the Soviet period. These programs primarily benefit the cooperatives and holders of old passbook savings accounts for housing; because these groups are no longer targets for assistance, it is unfortunate that these commitments account for a very large proportion—more than 40 percent in recent years—of central government expenditures on housing.

During 1999 the government proposed major revisions to its housing policy and housing subsidy program. They were designed, on the one hand, to make the program more consistent with the proposed changes in the tax system. On the other hand, they aimed to effect a relative shift in emphasis away from support to homeownership and new construction toward support for the rental sector and housing rehabilitation. The key elements of the proposed revisions include these:

- More modest support to homeownership overall, combined with increased targeting of the homeownership subsidies to moderate-income households and elimination of the tax break to new construction (and in fact a shift away from focusing primarily on new construction).
- A greater emphasis on the rental sector, through both support to an expanded housing allowance program (which was also linked to decontrol of rents in public housing) and a relative increase in support to modest-income rental housing.
- A greater emphasis on infrastructure and housing rehabilitation.
- A revised “Poland-specific” contract savings program.

As noted, however, the president approved only two out of three portions of the tax reform legislation, declining to approve the reduction in personal income taxes. Nevertheless, the tax breaks for new construction and renovation are to be eliminated in 2001, according to the Ministry of Finance; and the VAT rate on construction materials and labor will be increased to the level relevant for most other goods. The fate of the overall housing reform package, however, was unknown as of mid-2000. The following sections describe and evaluate the major aspects of both the current program and the package of proposed revisions.

The Current Housing Subsidy Programs for Homeowners

During the period 1991–94, Poland’s primary housing programs were directed at the cooperatives, which received heavily subsidized loans, and to holders of housing savings accounts started before 1990. The legacy of these programs still places a heavy toll on the budget, even as Poland’s policies have shifted to radically different types of support. In 1992 a major new construction support program was introduced for homeowners. This program operated through a deduction from taxable

income until 1997, when the rules were changed to operate as a deduction from income tax. Homeowners are also supported through a contract savings system and a reduction in the VAT tax on building materials. The housing allowance program, which provided support primarily to low-income tenants in public and cooperative housing, was also introduced in 1994, followed by the rental housing construction support program. Finally, although rehabilitation programs now receive relatively little support, there have been ongoing attempts, none yet successfully passed by the legislature, to design comprehensive programs, often combined with historic preservation and inner-city restoration.

Table 2.13 presents the expenditures in the major budget categories. It should be noted that these totals combine the central government's housing budget with estimates of tax revenues forgone from those programs

Table 2.13 *Central Government Expenditures and Tax Revenues Forgone for Housing^a*

| <i>Program and Year</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|
| Homeownership Tax Relief Programs | n.a. | n.a. | 2,600* | n.a. | 2,931* |
| Tax Relief for New Construction | n.a. | n.a. | 1,560* | n.a. | 1,759* |
| Renovation Tax Relief | n.a. | n.a. | 910* | n.a. | 1,026* |
| Contract Savings | n.a. | n.a. | 26* | n.a. | 29* |
| “Old Portfolio” Programs | 2,631 | 2,423 | 2,682 | 1,594 | 2,992 |
| Benefits to Cooperatives | 1,226 | 1,297 | 1,864 | 686 | 1,266 |
| Premiums for Savings Accounts | 1,405 | 1,126 | 818 | 908 | 826 |
| Rental Sector Support | 39 | 289 | 607 | 649 | 767 |
| Housing Allowance | 39 | 230 | 265 | 429 | 497 |
| TBS Rental Housing (NHF) | none | 59 | 342 | 220 | 270 |
| Thermal Renovation | none | 10 | 40 | 50 | 84 |
| Subsidies to Cooperatives | none | 10 | 40 | 50 | none |
| Other Thermal Programs | none | none | none | none | 84 |
| Total | n.a. | n.a. | 5,929 | n.a. | 6,774 |

Source: Ministry of Finance, Tax Study, 1996; budget preparations, 1999.

* Represents tax revenues forgone.

a. Notes: The totals presented here include tax revenues forgone as well as budget authorizations. The figures marked with “*” represent tax revenues forgone, based on a Ministry of Finance tax study for 1996. The 1998 tax relief total was estimated during budget preparations in 1999; the proportions for 1998 are based on the 1996 study. No estimates have been made for tax relief in prior years, although the program was in operation. Thus, no total expenditure figure is estimated for these years.

operating through the tax system. Also note that the figures do not include funds spent by local governments on housing. Local governments, for example, provide approximately the same level of support for the housing allowance program (i.e., it is shared roughly half and half with central government depending on the composition of the local housing stock), as well as support to a variety of local programs in housing and infrastructure (infrastructure expenditures are borne primarily by local government).

HOMEOWNERSHIP TAX RELIEF PROGRAMS. Currently, new subsidies to homeowners are conveyed almost entirely as tax deductions. These include deductions for new construction—by far the largest category—renovation credits, and a contract savings system. One reason for the belief that the GOP spent relatively little on housing assistance was that the value—in taxes forgone—had not been calculated and therefore was never included in budget discussions. The Ministry of Finance conducted a special study of tax revenues forgone in 1996 for housing-related deductions. Total deductions were estimated to be PLN 2,600 million, compared with PLN 2,931 million for 1998 and 3,273 million for 1999. Nearly 60 percent of the total was provided for new construction. The next largest category—renovation of existing owned homes—garnered 35 percent. Only 1 percent was used for the contract savings program. Note, furthermore, that these estimates do not include the special VAT rate for construction materials; no estimates exist for the revenues forgone; but this program, too, is proposed for elimination.

The results of the ministry's study are summarized as follows:

- Number of taxpayers receiving deductions: 25 percent of all taxpayers.
- Total deductions: PLN 2,600 million.
- Deductions for new construction: 59 percent of total housing-related deductions.
- Deductions for renovation: 35 percent of the total.
- Deductions for contract savings: 1 percent of the total.
- Other miscellaneous deductions: 5 percent of the total.

CONTRACT SAVINGS SYSTEM. Poland instituted its own Polish-based version of a contract savings system in 1996 (the *kasy mieszkaniowe*), which relied on a tax deduction mechanism to convey the subsidy. Legislation to introduce a classic German/Austrian Bausparkassen system

was subsequently passed into law, but the GOP is attempting to have it repealed and at the same time is modifying the *kasy* system. The parameters of the original system are now being redesigned.

The New Proposals for Housing Subsidy Policies

GENERAL POLICIES. The revised housing policies originally proposed by the GOP in mid-1999 attempted to provide a program consistent with the general goals of the government.³⁶ Because the GOP is very cognizant of the importance to housing and mortgage finance of continuing improvement in the macroeconomy, and thus the need to constrain expenditures, the proposal gradually decreased the level of expenditures on housing after 2000. Eliminating the current large tax benefit program for new housing construction was also dictated in part by the GOP's overall tax reduction/tax reform proposals.

Homeownership is to be supported by either a mortgage interest deduction or an interest rate buy-down, directed at specific income groups below the highest. The revised homeownership subsidy policies are better targeted to low- and moderate-income households, another important aspect of overall GOP policy. Poland's contract savings system is being redesigned to fit with the overall subsidy program. The rental sector is to be supported by an expanded housing allowance system, incentives for ending rent control, and subsidies for development of rental units by not-for-profit owners, targeted at low- and middle-income households. The proposed housing allowance program includes a requirement that local governments gradually end rent control or their housing allowance subsidies will be partially forfeited. Increasing demand-side subsidies and improving pricing of communal housing is clearly supportive of incentives for private-sector participation in the rental market.

The proposed housing subsidy programs and the estimated expenditures to 2003 are presented in table 2.14. Please note once again, however, that the fate of many of the proposed reforms is uncertain, given the collapse of the government coalition in early 2000. Only the changes in the tax deduction and VAT policies have been announced by the new government.

A NEW PROGRAM OF HOMEOWNERSHIP SUBSIDIES: THE "OWN HOME" PROGRAM. Just as market-based housing finance is about to

Table 2.14 *Proposed State Budget Expenditures and Forgone Revenues*
(in millions of PLN)

| <i>Program and Year</i> | <i>1999</i> | <i>2000</i> | <i>2001</i> | <i>2002</i> | <i>2003</i> |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|
| Homeownership Program: Option 1 | 3,273 | 3,240 | 1,794 | 1,557 | 1,374 |
| Own Home: Option 1 ^a | 0 | 191 | 462 | 579 | 667 |
| Tax Relief (until expiration) | 3,273 | 3,043 | 1,310 | 917 | 585 |
| Contract Savings | 0 | 6 | 22 | 61 | 122 |
| Homeownership Program: Option 2 | 3,273 | 3,122 | 1,521 | 1,244 | 1,038 |
| Own Home: Option 2 ^b | 0 | 73 | 189 | 266 | 331 |
| Tax Relief (until expiration) | 3,273 | 3,043 | 1,310 | 917 | 585 |
| Contract Savings | 0 | 6 | 22 | 61 | 122 |
| “Old Portfolio” Programs | 1,460 | 1,674 | 1,680 | 1,614 | 1,602 |
| Benefits to Cooperative | 592 | 527 | 480 | 396 | 345 |
| Premiums on Savings Accounts | 868 | 1,147 | 1,200 | 1,245 | 1,257 |
| Rental Sector Support | 620 | 970 | 1,290 | 1,490 | 1,830 |
| Housing Allowance | 416 | 720 | 950 | 1,080 | 1,350 |
| TBS Rental Housing | 204 | 250 | 340 | 410 | 480 |
| Rehabilitation | 5 | 80 | 150 | 198 | 235 |
| Thermal Modernization | 5 | 30 | 60 | 85 | 110 |
| Residential Rehab | 0 | 50 | 90 | 113 | 125 |
| Other | 0 | 160 | 278 | 403 | 370 |
| Housing-Related Infrastructure | 0 | 100 | 190 | 311 | 266 |
| Social Housing | 0 | 40 | 68 | 72 | 84 |
| Natural Disasters | 0 | 20 | 20 | 20 | 20 |
| Grand Total: Homeowner Option 1 | 5,373 | 6,139 | 5,252 | 5,289 | 5,429 |
| Grand Total: Homeowner Option 2 | 5,373 | 6,021 | 4,979 | 4,976 | 5,093 |

a. Homeowner Option 1: Interest rate buy-down approach to the subsidy.

b. Homeowner Option 2: Mortgage interest deduction approach to the subsidy.

Note: The grand totals may include other minor amounts.

enter a new era of funding through mortgage banks, so too has the GOP proposed major changes to the manner in which it supports homeownership and the relative share of the state budget dedicated to support of homeownership versus the rental sector and other programs. There are two major points here:

- First, the major tax deduction policy is proposed to be replaced with a more modest and much more targeted “own home” program. The current system of tax breaks for new construction was to

be phased out once current eligibility for the program has ended. The own home program would consist of either an interest rate buy-down (option 1 in table 2.14) or a tax deduction for mortgage interest payments (option 2 in table 2.14). Both options were being analyzed by the Ministry of Finance, with the interest rate buy-down approach being slightly less costly. In both cases, the subsidies would be targeted to specific income groups and not available to those who have already used the prior tax deduction policy. The new proposals are considered to be more consistent with the major decrease in tax rates that is a keystone of this government's program and to better address the needs of the middle class.

- Second, under the proposed plan, the share of the budget dedicated to homeownership will gradually fall over the next several years. The tax deduction policy was quite costly, and the new "own home" program is much more modest.

Both programs are very modest in size in comparison with the current program (in fact, only option 1 ever exceeds the size of the declining tax relief, and only in 2003, when the interest buy-down is estimated to reach PLN 667 and the tax deductions have fallen to PLN 585). Also, the programs are targeted at those in relative need, unlike the tax relief program. Both are expected to benefit households in the sixth to ninth deciles of the income distribution. In both programs, only units of 50 square meters or less are eligible and the price per square meter must not exceed a regionally based amount. Finally, the own home program will support the development of the private housing finance system. Under the new program, households are expected to take a 20-year mortgage to purchase, construct, or rehabilitate a home or condominium unit. The maximum loan-to-value ratio is 70 percent.

THE REVISED CONTRACT SAVINGS PROGRAM. The other GOP homeownership program includes the contract savings program discussed earlier. As shown in table 2.14, it is expected to remain a very modest program, reaching only 2.2 percent of the budget by 2003. The main justification for the program is to increase household savings for a downpayment.

Table 2.15 *Percentage of Housing Budget Spent on Homeowner, Rental Housing, and Other Housing Programs^a*

| <i>Program and Year</i> | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|-------|------|-------|-------|-------|-------|-------|-------|
| Homeownership Programs | 43.9 | n.a. | 43.3 | 61.1 | 52.8 | 34.2 | 29.4 | 25.3 |
| Old Portfolio Programs | 44.2 | n.a. | 44.2 | 27.2 | 27.3 | 32.0 | 30.5 | 29.5 |
| Rental Housing: Housing Allowance and TBS | 11.3 | n.a. | 11.3 | 11.5 | 15.8 | 24.6 | 28.2 | 33.7 |
| Rehabilitation and Thermal | 0.7 | n.a. | 1.2 | 0.1 | 1.3 | 2.9 | 3.7 | 4.3 |
| Other | — | n.a. | — | 0.3 | 2.6 | 5.3 | 7.6 | 6.8 |
| TOTAL* | 100.0 | n.a. | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Derived by author from the data presented here. Homeownership data based on option 1.

* Totals are rounded to nearest tenth of a percent.

a. Table 2.15 statistics assume option 1 is used for the new own home program.

Trends in Support to Homeownership and Other Housing Programs

Table 2.15 indicates the trends in the share of total expenditures by category of subsidy, with actual amounts during the last few years and amounts projected if the GOP's proposed housing policies were adopted. Note again that the expenditure totals include estimates of tax revenues forgone but do not include local government expenditures on housing (no estimates are available for local government spending on housing; however, as noted, the gminas spend a comparable total on the housing allowance program).

The following observations on the new budget proposals provide a summary of GOP intentions, and provide a framework for analyzing the change in approach to homeownership support:

- **Total Expenditures.** After the year 2000, housing expenses are proposed to fall absolutely and as a proportion of GDP.
- **Old Program Legacy.** The legacy of the old subsidies to housing, which has put pressure on the budget for many years, will fall in 1999 but does not diminish in share thereafter. It still commands a substantial share of the total budget. These are subsidies to cooperatives and to potential or actual homeowners, but they are neither targeted nor controllable.

- **Support for Homeownership.** The proposals for the new own home program are much more modest than the tax relief approach to homeowner subsidies. According to the government's proposals, the tax relief program will be continued until eligibility expires. It will be gradually replaced by the own home program. When the tax relief and own home programs are considered together, however, support for homeownership remains very large until 2001. It then decreases relative to that for the rental sector and by 2003 commands a lesser share of the budget. However, when the old legacy programs are considered together with the current and newly proposed programs, support for homeownership takes the lion's share of the budget.
- **Support for the Rental Sector.** The TBS rental housing program and support for the sector via the housing allowance program are growing in relative importance. The housing allowance and TBS rental programs exceed expenditures planned for homeownership by 2003. In fact, the housing allowance program is proposed to become Poland's flagship subsidy program by 2002. Analysis has indicated that unless the eligibility ceiling for the housing allowance is increased, many households would face unacceptable rent burden levels as rents are decontrolled toward more normal market levels.³⁷
- **Support for Rehabilitation and Infrastructure.** Some recognition is finally being given to the importance of rehabilitation of existing housing, although it reaches only 4.3 percent of the budget by 2003. Although the Housing and Urban Development Administration has stressed that supply constraints on infrastructure are an important bottleneck to housing development, only modest funds are planned for assistance at this time.

Quantitative Assessment: Illustrative Calculations of the Present Value of Current and Proposed Homeowner Subsidies

This section provides illustrative calculations of values of the homeowner subsidy programs to households of different income levels, ranging from moderate to very high income. The part titled Quantitative Assessment of the Value of Current Homeowner Subsidy Programs provides estimates of the present value of a "full package" of homeowner subsidies under Poland's current set of programs, while the part titled

Quantitative Assessment of the Value of the Proposed Homeowner Subsidy Programs repeats the illustrative examples for the newly proposed programs. As will be discussed, both the level of support and the targeted beneficiaries differ greatly.

QUANTITATIVE ASSESSMENT OF THE VALUE OF CURRENT HOMEOWNER SUBSIDY PROGRAMS. For those building a new home, the current homeowner subsidy package could typically include the tax deduction for new construction, the tax deduction for the contract savings program, and the value of the reduced VAT on building materials. The example used here assumes that households began a contract savings program in 1996 and saved through 1998, at which time they began construction of their home; construction continued during 1999 and 2000, and the home was completed in 2000.

The assumption with regard to the calculation of the tax break for new construction is that households construct a home worth roughly three times their annual income and that the construction period is three years, with equal amounts being spent in each year. Thus, for example, households with the average income for decile 7 (PLN 23,868 in 1998) built a house worth PLN 60,000 during 1998 to 2000, spending PLN 20,000 each year. The maximum deduction for each year is based on the ceiling expenditure set for that year.³⁸ The corresponding figures for the value of the house for the other income groups are PLN 75,000 for decile 8, and PLN 90,000, 150,000, and 300,000 for deciles 9 through “very high.”

The assumption with regard to the tax break subsidies accruing through the contract savings system is that households save roughly 10 to 20 percent a year of their gross income. Thus, decile 7 is assumed to save PLN 3,000 in 1998, or roughly 12.5 percent; decile 8 saved PLN 3,300 in 1998, or 12 percent of annual income; and so forth. The very high-income group saved 20 percent of income, or PLN 40,000, in 1998. The tax deduction equals 30 percent of savings, but it may not equal more than 6 percent of the house cost cap established under the tax break for new construction programs described above. Based on the assumed savings rates, the cap affects the eligible tax break only for the very high-income group in this example.

The value of the reduced VAT is assessed as follows: The value is assumed to accrue to the household by reducing the total cost of the home (although this may not be the case, as the builder/developer could

also capture some of the benefit). Twenty percent of the cost of the house and land is assumed to consist of building materials; these materials are assumed to be eligible for the lower VAT rate. While the normal VAT is 22 percent, the reduced tax on building materials is only 7 percent. Thus, for example, the decile 7 households would save approximately PLN 750 per year in reduced VATs on building materials.

Finally, the present value of the subsidy benefits is calculated with reference to 1998. For benefits accruing over the period 1998–2000 (i.e., the tax break and the VAT reduction), the discount rate is assumed to be the rate of inflation, or roughly 8 percent. This figure is used to discount the annual values in 1999 and again in 2000. Conversely, the present value of benefits (for the contract savings system) accrued during 1996 and 1997 has been calculated by “augmenting” the subsidy; the inflation rate was again used. Thus, all benefits have been adjusted to be consistent with the 1998 reference point.

The results of the subsidy analysis are presented in table 2.16. The fifth column notes the present value of the total subsidy package over the 1996–2000 period, with reference to 1998. This is then expressed as a percentage of 1998 income for the relevant income group. Several comments are pertinent:

- The subsidy package is a very significant proportion of income for all but the very highest-income households. (The focus is on deciles 7 through 10; the income group with annual income of PLN 200,000 would represent only a handful of households in Poland). Similarly, the package represents a significant proportion of the cost of the house. Decile 7, for example, built a home worth PLN 60,000; the subsidy package represents 24.3 percent of this cost.
- The subsidies are slightly regressive. Based on the assumptions described above, decile 7 receive a benefits package equaling 61.2 percent of their 1998 income, and the percentage increases to 65.3 for decile 10. The various caps built into the subsidy program are likely to affect only a few very high-income households. This raises questions as to whether the subsidies are cost-effective at the higher income levels—in other words, these are households that could afford to build or purchase an adequate home without assistance. Public funds could be redirected toward households not able to fully finance a home or toward some other use.³⁹

Table 2.16 Illustrative Present Value in 1998 of Current Homeowner Tax Credit Subsidies for 1996–2000 by Income Level (in PLN)

| Annual Average 1998 Income by Decile | Present Value of Tax Deduction for New Construction and Land: 1998–2000 | Present Value of Tax Deduction for Contract Savings: 1999–98 | Present Value of Reduced VAT on Building Materials: 1998–2000 | Present Value of Total Tax Deductions and Benefits | Present Value of Total as Percentage of 1998 Annual Income |
|--|--|---|--|--|--|
| | Decile 7: 23,868 | 10,518 | 2,410 | 1,669 | 14,597 |
| Decile 8: 27,624 | 13,139 | 2,787 | 2,085 | 18,011 | 65.2 |
| Decile 9: 33,960 | 15,775 | 3,520 | 2,504 | 21,799 | 64.2 |
| Decile 10: 57,132 | 26,293 | 6,767 | 4,222 | 37,282 | 65.3 |
| Very high: 200,000 | 27,796 | 15,814 | 7,515 | 51,125 | 25.6 |

Notes: Annual average income is extrapolated from monthly income for the average size household, the average of the decile group. The highest income group was chosen arbitrarily. The tax deduction for new construction is based on construction over the period 1998–2000. The total cost of the house is roughly three times annual income; equal amounts are spent each year. The maximum deductions from taxable income are based on the annual caps of 19 percent of the house ceiling price (the caps are PLN 19,258 in 1998, 25,270 in 1999, and an estimate of 28,500 in 2000). In the example, the cap affects only the “very high” income category. The tax deduction for contract savings is calculated on 30 percent of savings in a contract savings account (*kasy mieszkaniowe*), capped at six times the house cost cap used in the new construction tax deduction. The benefits for new construction and reduced VAT are discounted during 1999 and 2000, using an average inflation rate of 8 percent; similarly, the values of the contract savings, which began in 1996, are “reverse-discounted,” or augmented, for 1996 and 1997 using the same rate.

Table 2.16 illustrates the potential results for hypothetical households who could actually take advantage of all four tax benefits: new construction, land purchase for new construction, contract savings, and reduced VAT. Be aware that there are no data to indicate how many households actually could do this; so this represents a very upper limit of the potential. The table reveals that the upper limit is very substantial. The tax credit on new construction is by far the largest component. When considered together with the contract savings tax credit and VAT reduction, the present value of the entire package is just under 20 percent of average annual income for all but the very highest group (in this calculation, it is assumed that income grew at 12 percent per year in 1998 and 2000).

Table 2.17 provides the GOP's estimates of the total cost of the tax-related subsidy programs for homeowners. The totals by type of program shown above have been allocated using the same proportions found in the 1996 study by the Ministry of Finance. While these estimates are illustrative, they are no doubt an understatement of what the total cost (in revenues forgone) would be of the tax break program if the GOP's new subsidy program is not adopted, because these figures represent the cost of the program until its expiration, assuming the new program were to be adopted. This then is the total subsidy for those already participating, but it assumes no new entrants to the new construction program.

Table 2.17 *Estimated Total Cost—Revenue Forgone—of Current Homeowner Subsidies, 1996–2000 (PLN millions)*

| <i>Year</i> | <i>New Construction</i> | <i>Rehabilitation</i> | <i>Contract Savings</i> | <i>Land and Other</i> | <i>VAT Deduction</i> | <i>Total</i> |
|-------------|-------------------------|-----------------------|-------------------------|-----------------------|----------------------|--------------|
| 1996 | 1,534 | 910 | 26 | 130 | No | 2,600 |
| 1998 | 1,729 | 1,026 | 29 | 146 | estimates | 2,931 |
| 1999 | 1,931 | 1,146 | 33 | 164 | available | 3,273 |
| 2000 | 1,795 | 1,065 | 30 | 152 | | 3,043 |

Note: The calculations for the value of tax deductions for each category are made on the basis of the proportions found in the 1996 study by the Ministry of Finance. Figures for 1998–2000 are based on Ministry of Finance budget deliberations, 1999. Comparable estimates for 1997 are not available.

QUANTITATIVE ASSESSMENT OF THE VALUE OF THE PROPOSED HOMEOWNER SUBSIDY PROGRAMS. The GOP's proposal to put in place a new set of homeowner subsidies—more targeted and more limited in scope—cannot be precisely assessed. Not only is the fate of the overall package uncertain, but the details of both the own home program and the revisions to the contract savings systems have not yet been specified. For purposes of comparison with the tax subsidy for new construction, however, the interest buy-down component of the new own home program has been arbitrarily selected. In addition, the same contract savings system now in place and illustrated in the previous section has been used. Neither the tax deduction for new construction nor the reduction in VAT would be operative under the newly proposed policies.

There is a very wide range of possibilities for structuring an interest buy-down (IBD) subsidy: the depth of the buydown, the duration, and the use of a percentage discount to the interest rate as compared with a percentage-point reduction.⁴⁰ A buy-down could recognize that nominal income and thus the repayment capacity of a household rises over time. For illustrative purposes, the subsidy might work as follows in Poland:

- The government would develop eligibility guidelines for borrowers. Because the GOP intends to target the subsidy according to borrower income, this study has arbitrarily determined that the higher-income groups—decile 10 and above—would not be eligible.
- Participating banks would screen borrowers based on application data and determine whether a borrower qualified for the subsidy.
- The bank would grant a market-rate mortgage loan to the borrower; this study has assumed a market rate of 20 percent for a 20-year fixed rate loan.
- The government would either make a monthly payment to the bank for the difference between the market interest rate and the rate charged to the borrower or deposit the annual total difference in interest due in the bank at the beginning of the year. The bank would then debit the account on a monthly basis to make up the shortfall.

Table 2.18 *Illustrative Interest Buy-Down Subsidy Program*

| <i>Year</i> | <i>Effective Interest Rate (percentage)</i> | <i>Approximate Annual Household Payment (PLN)</i> | <i>Subsidy (PLN)</i> |
|-------------|---|---|----------------------|
| 1 | 15 | 15,852 | 4,860 |
| 2 | 16 | 16,776 | 3,936 |
| 3 | 17 | 17,724 | 2,988 |
| 4 | 18 | 18,969 | 1,743 |
| 5 | 19 | 19,692 | 1,020 |
| 6 | 20 (market rate) | 20,712 | — |

Note: These calculations are based on a fixed rate loan of PLN 100,000 for 20 years, at a market interest rate of 20 percent. The program could also work with variable rate loans, with the government providing a declining percentage of the interest payments.

For example, for a loan with a market rate of interest of 20 percent on a 20-year loan for PLN 100,000, a 5 percentage-point buy-down that phases out over five years could work as shown in table 2.18.

The cost of the home for each income group is the same as that used in the example above, roughly three times annual income. The loan amount is based on a loan-to-value ratio of 60 percent, a typical ratio in Poland during the last several years and at present. The discount rate and income growth factor are the same as assumed for the calculations in the example above for the current subsidy programs. The total benefit package as a proportion of income was calculated over the average for three years to make it comparable to that for the current subsidy package, even though the benefits accrue over five years in the IBD program (table 2.19).

Comparing the current and proposed programs reveals a number of important differences in both the magnitude and the approach to homeowner subsidies:

- The subsidies currently available to homeowners—or would-be homeowners—are very generous, much more so than the proposed revisions to homeowner subsidies. For all income groups except “very high,” the present value of the full package of subsidies could potentially equal about 60 percent of average income over a three-year period.
- In contrast, the present value of the newly proposed IBD subsidy (i.e., the hypothetical version of it described above), in combina-

Table 2.19 Illustrative Present Value in 1998 of Proposed Homeowner Subsidies

| Annual Average 1998 Income by Decile | Loan Amount (PLN) | Interest | | Present Value (PLN) of Interest Buy-Down Subsidy (years 1-5) | | Present Value (PLN) of Tax Deduction for Contract Savings (years 1-3) | | Present Value (PLN) of Total Benefits | | Present Value (PLN) of Total as Percentage of Average Annual Income |
|--|-------------------------|---------------------------------|---------------------------------|---|---------------------------------|--|---------------------------------|--|---------------------------------|--|
| | | Buy-Down Subsidy (years 1-5) | Buy-Down Subsidy (years 1-5) | Buy-Down Subsidy (years 1-5) | Buy-Down Subsidy (years 1-5) | Buy-Down Subsidy (years 1-3) | Buy-Down Subsidy (years 1-3) | Buy-Down Subsidy (years 1-3) | Buy-Down Subsidy (years 1-3) | |
| Decile 7: 23,868 | 36,000 | 5,237 | 4,619 | 2,052 | 6,671 | 8.6 | | | | |
| Decile 8: 27,624 | 45,000 | 6,546 | 5,977 | 2,425 | 8,402 | 9.4 | | | | |
| Decile 9: 33,960 | 54,000 | 7,855 | 7,172 | 2,999 | 10,171 | 9.2 | | | | |
| Decile 10: 57,132 | 90,000 | Not eligible | n.a. | 5,764 | 5,764 | 3.1 | | | | |
| Very high: 200,000 | 180,000 | Not eligible | n.a. | 21,055 | 21,055 | 3.2 | | | | |

Table 2.20 *Estimated Total Cost of Newly Proposed Homeowner Subsidies, 2000–03 (PLN millions)*

| <i>Year</i> | <i>Interest Buy-Down or Interest Deduction</i> | | <i>Contract Savings</i> | <i>Total with Interest Buy-Down</i> | <i>Total with Interest Deduction</i> |
|-------------|--|-----|-------------------------|-------------------------------------|--------------------------------------|
| 2000 | 191 | 73 | 6 | 197 | 79 |
| 2001 | 462 | 189 | 22 | 484 | 211 |
| 2002 | 579 | 266 | 61 | 640 | 327 |
| 2003 | 667 | 331 | 122 | 789 | 453 |

tion with the contract savings, equals about 9 percent of average income over three years for the eligible groups.

- The current subsidy program is somewhat less targeted and more regressive than the new proposals. In the new proposals, households above decile 9 are not eligible for the IDB, although it is assumed that all households are still eligible for the subsidy accruing to the contract savings program.

Finally, a comparison of the figures in table 2.20 on the total spending proposed for the own home program with the (unrevised) contract savings program indicates the vast reduction in homeowner subsidies that the GOP had tried to institute during 1999. The mortgage interest deduction program is the smallest by far, but either of these approaches to homeowner subsidies is dwarfed by the combination of the new construction tax break and the tax break for rehabilitation now in force.

Qualitative Assessment of Government Support for Homeownership

The criteria used in this study for assessment of the various homeownership subsidy programs include the ability of the program to target households in need of assistance; the transparency of the program to potential beneficiaries, including the extent of awareness of the general population and their ability to understand the value of the program's subsidy; the program's administrative ease; and the transparency of the program from a budgetary point of view and the related ability to control program costs. Also included are its impact on the development of a market-based housing finance system—a component of the housing

Table 2.21 *Summary Evaluation of New and Proposed Homeownership Subsidy Programs*

| <i>Program/ Criteria</i> | <i>Target- ing</i> | <i>Transparency to Potential Beneficiaries</i> | <i>Admin- istrative Ease</i> | <i>On-Budget Transparency and Cost Control</i> | <i>Impact on Housing Finance</i> | <i>Other</i> |
|--------------------------------------|------------------------|--|---|--|--|--|
| Tax Deductions | None | Good | Good | Very poor | Very little | Very costly and not cost-effective |
| Tax Deductions for Rehabilitation | None | Poor | Good | Very poor | None | Not directed at the important problem: capital repairs |
| New Own Home Proposals | Fair | Fair/Poor | Fair/poor (square-meter limits should be removed) | Fair | Excellent | Limits mobility |
| Contract Savings | None | Fair/Poor | Good | Poor | Too small to impact | Need to see redesign |
| Mortgage Fund | n.a. | Poor | Fair (very complex) | Good | Good | Probably being phased out |
| VAT Reduction for Building Materials | None | Good | Good | Poor | Poor | Not cost-effective |

sector that was missing in the Soviet era but that is now particularly important to homeownership, labor force mobility, and development of the financial sector.

Together, these criteria define not only a program's overall cost-effectiveness but also its perceived fairness and the access of the intended beneficiaries to the program. Table 2.21 provides a summary of the assessment.

TAX DEDUCTIONS. Criticisms of the tax deduction program include the following: (1) it is inconsistent with the government's proposals for reduction in tax rates and simplification of the tax system; (2) it is not targeted to households in need; (3) it is extremely costly in the view of some (deductions for new construction may simply result in households who would have constructed new housing in any event building larger or higher-quality units than they would have without the subsidy); and (4) if supply constraints are in effect (as they are likely to be in the large cities with building booms), then the subsidy simply results in higher prices.⁴¹

This approach is regressive. Because the subsidies are operated through the tax system, administration was relatively simple. However, it has been difficult to analyze the utilization of the benefit, and thus extremely difficult to estimate or control costs. Finally, the system does not promote the use of the housing finance system and it tends to prolong housing completions as long as possible to maximize the use of the subsidy.

NEW OWN HOME PROGRAMS. Based on the criteria established for evaluation, Poland should benefit in the long term from replacing the various tax deduction programs with the new own home programs. The proposals are somewhat more targeted to those in need and would generally seem to be directed at first-time homebuyers or those who have not previously benefited from the tax break for new construction. It may be possible to predict costs reasonably accurately after a few years of operation; at the moment, there is no real way to predict program demand with any certainty.⁴² The impact on the housing finance system should be positive in the long run, especially because it will bring borrowers into the system who might not have access to it without this assistance.

Finally, there are several drawbacks to the own home program. The major problem is that recipients cannot move within five years of purchase; if they do so, they will have to repay the assistance. The rules for limiting moving should be modified, because forcing households to remain in a unit for five years could place a serious constraint on mobility. This is already a problem in Poland because the rental housing sector is so limited, and both cooperative and communal tenants often act as if they were virtual owners. Other means can be found to avoid speculation and “transference” of subsidy to noneligible buyers.

In addition, it must be noted that Poland has a penchant for overdefining its subsidy programs in terms of size constraints (the housing allowance program, e.g., has numerous rules and ceilings on space allocated by size of household). Limiting the eligible homes to 50 square meters would curtail freedom of choice and perhaps inhibit development of the type of housing stock for which there will be long-run demand. Income targeting should be done in a straightforward and transparent manner, rather than through constraints on unit size. The 50-square-meter rule will also be extremely burdensome administratively and may be ignored on a random basis, thereby setting up the potential for inequitable treatment.

It would be advisable for the government to facilitate the timely participation of all eligible households who wish to participate. If funds, and therefore participation, are severely rationed, the program may produce a barrier to the use of housing finance, as would-be participants put off the home purchase decisions while they wait for the subsidy. Some households who wish to become homeowners may wait for years for the subsidized credit, rather than seeking to undertake the transaction without government help.

Finally, in the case of the own home program, it seems excessive to limit house size to 50 square meters. Income limits should suffice in this regard, and households should be permitted to build or buy the unit of their choice. Furthermore, reviewing such rules to see that they are in compliance presents an administrative burden.

NOTES

1. For a more complete discussion of data on housing, both microeconomic and macroeconomic, see Merrill et al. (1998c).

2. *Central European Economic Review* 1999. Poland fares somewhat better if the comparisons are made in terms of PPP (purchasing power parity); in 1993, for example, Poland's GDP per capita was only slightly less than that of Hungary but was only one-fourth that of Germany and one-third that of most other Western European countries.
3. The Urban Institute Consortium, on behalf of USAID's Poland Housing Finance Program, has developed a study on estimation of the demand for housing and for housing finance, and the data requirements for such estimations. See Merrill et al. (1998c).
4. See Herbst (1998) and Hegedus, Tosics, and Mayo (1996).
5. See, for example, Telgarsky and Struyk (1990) and Struyk (1996).
6. See Diamond (1999).
7. Lee 1999a.
8. See the discussion in Merrill et al. (1997); Gray and Holle (1996); and Financial Services, Ltd. (1996).
9. These included Bank Slaski, which today is a major housing finance lender and, as discussed later in this chapter, plans to form a mortgage bank.
10. See Chiquier (1998).
11. Much of the data cited here stem from a survey of banks in Poland carried out in August and September 1999 by the Crakow Real Estate Institute (CREI). The design and implementation of the survey were completed with the assistance of the Polish Banks Association (PBA). This should be the first of many surveys of housing finance that will provide the PBA, and the banks, with a timely assessment of the market and the trends over time in mortgage finance and commercial and developer credits.
12. See the comments in Lea (1999b). It is noted there that commercial banks in developed countries hold between 20 and 40 percent of their assets in mortgages, and thus Poland might reasonably expect to head toward this share in the longer term.
13. The CREI/PBA survey was conducted at all banks that are members of the Housing Committee of PBA.
14. Mortgage lending (residential lending) is the sum of credits to individuals and short-term credits to builders on behalf of individuals. It may include a small volume of nonmortgage housing loans.
15. See *Polish News Bulletin* 1999, p. 7, for remarks by PKO BP.
16. See *Estates News Warsaw* 1999, p. 8, and *Estates News Bucharest* 1999, p. 19, for discussions of office space in CEE and NIS.
17. Diamond (1999).
18. See Lea (1999b) for a discussion of the advantages and disadvantages of the universal bank versus mortgage bank funding model.
19. Merrill et al. 2000.
20. The weighted average mortgage lending rate for variable rate loans is a composite of rates for PKO BP, Pekao S.A./PBG, GE Bank Mieszkaniowy, PBK, and BISE. The weight for PKO is 0.6, while each of the others was assigned a weight comparable to market share.

21. The mortgage lending rate is a weighted average rate on variable mortgage products, as noted above.

22. *Rzeczpospolita* 1999, no. 228, p. B9; *Prawo i Gospodarka* 1999, p. 12; and *Polish News Bulletin* 1999, 87/99.

23. The Mortgage Fund rate is the cost to banks of borrowing (refinancing eligible mortgages) with the Mortgage Fund. It is a monthly rate calculated as a function of the average rate of 13-week Treasury bills, a National Bank of Poland refinancing rate, and the BudBank margin.

24. Stepien 1999. Lech Gajewski, executive director of Bank Slaski, notes that this, which was put into effect by the Monetary Policy Council, is the first significant increase in short-term rates that the banking system has had to face since the market economy was introduced in Poland.

25. It must be noted that during this time the National Bank of Poland has generally increased reserve requirements. The reserves-to-assets ratios for the quarters beginning in the first quarter of 1997 (I/97) are as follows: I/97, 5.2 percent; II/97, 5.7 percent; III/97, 6.5 percent; IV/97, 6.5 percent; I/98, 6.7 percent; II/98, 6.7 percent; III/98, 6.6 percent; and IV/98, 6.7 percent. In addition, beginning in 1999, banks must create reserves for deposits of foreign banks, which is also felt to increase the degree of burden.

26. The effort ratio is the payment-to-income level as noted above.

27. According to the Attachment to the Ordinance No. 13/98 of the Banking Supervisory Committee on principles of reserve collection for banking risk, with consumption credits (housing credits are excluded) for individuals are tied three categories of amounts due (irregular loans): below standard due—payments of principal or interest delayed to the schedule above one but below three months, borderline (doubtful) due—payments of principal or interest delayed to the schedule above three but below six months, and lost due—payments of principal or interest delayed to the schedule above six months. According to these rules banks must fill in appropriate parts of statistical reports.

28. Development of regulation and supervision has been heavily supported by USAID. The Urban Institute Consortium (UIC) has provided a number of reports to assist this effort; UIC has also developed a mortgage bank simulation model to assist GINB with training in this new area of lending.

29. Diamond (2000).

30. Merrill et al. (1997) and Lea, Laszek, and Chiquier (1998).

31. The Urban Institute Consortium for USAID/Warsaw, particularly Michael Lea, is assisting the Ministry of Finance in analyzing alternative designs and parameters for revising the *kasy* system.

32. The housing committee of the PBA has been an active and effective counterpart organization for USAID's Poland Housing Finance Project.

33. In order of sale size, as ranked by price, these include Pekao (second place), BPH (third place), Bank Zachodni (fourth place), Bank Slaski (seventh place), Bank Handlowy (10th place), and WBK (11th place). The other largest sales occurred in the Czech Republic (CSOB first place, IPB sixth place), Hungary (CIB fifth place), Hansapank (Estonia seventh place), and BDR (Romania ninth place). *Business Central Europe*, p. 50.

34. See Diamond (1999).

35. See the discussion of effective demand in Merrill et al. 1998c.

36. For extensive discussion of GOP housing and macroeconomic policies, see Merrill et al. (1998b) and Merrill et al. (1999).
37. See Merrill (1998b). A simulation model was prepared for analysis of the housing allowance and homeownership affordability. The Housing and Urban Development Administration is now using the model for its own analyses of program alternatives.
38. This tax break is based on the rules established during 1997, which result in a ceiling on the allowable deduction from tax payments of PLN 19,285 during 1998, PLN 25,270 during 1999, and an estimate (made by the author) of PLN 28,500 in 2000.
39. See Merrill et al. (1999) for a lengthy discussion of this point. Chapter 2.0 presents criteria for assessing the effectiveness of subsidies in general, and Chapter 5.0 discusses the new construction subsidies.
40. See the discussion in Merrill et al. (1999).
41. See the analysis in Merrill et al. (1999).
42. See Merrill et al. (1999) for a discussion of the steps needed to begin to estimate demand in Poland.

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Annex 2.A

Table 2.A.1 *Comparison of Mortgage Interest Rate, 12-Month Deposit Rate, and Mortgage Fund Rate (percentages)*

| <i>Month/ Year</i> | <i>Gap between the Mortgage Interest Rate and the Minimum 12-Month Deposit Rate</i> | <i>Gap between the Mortgage Interest Rate and the Maximum 12-Month Deposit Rate</i> | <i>Gap between the Mortgage Interest Rate and the Mortgage Fund Rate</i> |
|------------------------|---|---|--|
| 1/97 | 9.16 | 5.16 | 6.28 |
| 6/97 | 9.10 | 5.20 | 3.72 |
| 12/97 | 6.60 | 2.80 | 2.70 |
| 6/98 | 7.10 | 4.60 | 3.68 |
| 10/98 | 10.78 | 4.58 | 5.39 |
| 5/99 | 9.17 | 4.17 | 3.20 |
| 7/99 | 8.95 | 3.95 | 2.98 |

Table 2.A.2 *Interest Rate Comparisons: Comparison of Mortgage Interest Rates, Government Paper, and Inflation (percentages)*

| <i>Year/Month</i> | <i>Gap between Mortgage Interest Rate and Treasury Bills</i> | <i>Gap between Mortgage Interest Rate and Consumer Price Index</i> |
|-------------------|--|--|
| 1/97 | 5.74 | 7.56 |
| 6/97 | 4.02 | 10.30 |

(Continued)

Table 2.A.2 *Interest Rate Comparisons: Comparison of Mortgage Interest Rates, Government Paper, and Inflation (percentages) (Continued)*

| <i>Year/Month</i> | <i>Gap between Mortgage Interest Rate and Treasury Bills</i> | <i>Gap between Mortgage Interest Rate and Consumer Price Index</i> |
|-------------------|--|--|
| 12/97 | 1.70 | 12.40 |
| 6/98 | 5.16 | 13.40 |
| 10/98 | 8.13 | 13.68 |
| 5/99 | 4.53 | 10.27 |
| 7/99 | 4.21 | 10.15 |

Table 2.A.3 *Housing Research Institute Data
Apartment Asking Prices by Gminas: PLN per Square Meter*

| <i>Gmina</i> | <i>December 1997: lowest</i> | <i>December 1998: lowest</i> | <i>December 1997: mode</i> | <i>December 1998: mode</i> | <i>December 1997: highest</i> | <i>December 1998: highest</i> |
|----------------|----------------------------------|----------------------------------|--------------------------------|--------------------------------|-----------------------------------|-----------------------------------|
| Largest | | | | | | |
| Warsaw (Praga) | 1,900 | 2,000 | 2,250 | 2,600 | 3,000 | 3,800 |
| Bytom | 390 | 600 | 550 | 900 | 900 | 1,000 |
| Kalisz | 1,000 | 1,100 | 1,100 | 1,300 | 1,300 | 1,500 |
| Krakow | 1,370 | 1,400 | 1,950 | 2,240 | 3,110 | 3,030 |
| Lublin | 1,700 | 1,600 | 1,800 | 1,800 | 2,300 | 2,100 |
| Lodz | 1,150 | 1,200 | 1,250 | 1,350 | 1,700 | 1,630 |
| Poznan | 1,980 | 1,980 | 2,300 | 2,400 | 2,900 | 3,600 |
| Torun | 900 | 1,130 | 1,100 | 1,200 | 1,600 | 1,800 |
| Zielona Gora | 800 | 1,200 | 1,000 | 1,350 | 1,500 | 1,600 |
| Medium | | | | | | |
| Bilgoraj | n.a. | n.a. | n.a. | 1,000 | 1,300 | 1,500 |
| Dzierzonlow | n.a. | n.a. | n.a. | 1,000 | 1,100 | 1,300 |
| Inowroclaw | 900 | 1,200 | 1,050 | 1,300 | 1,200 | 1,500 |
| Lebork | 420 | 800 | 750 | 850 | 1,000 | 1,360 |
| Pila | 800 | 900 | 1,250 | 1,250 | 1,400 | 1,500 |
| Radomsko | 800 | 850 | 950 | 1,100 | 1,100 | 1,300 |
| Stargard Szoz. | n.a. | 950 | 1,300 | 1,250 | 1,530 | 1,900 |
| Small | | | | | | |
| Kolo | 1,100 | 1,000 | 1,150 | 1,200 | 1,300 | 1,450 |
| Mrzgowo | 1,000 | 1,000 | 1,000 | 1,200 | 1,600 | 1,600 |
| Pruszcz Gd. | 950 | 1,700 | 1,300 | 1,900 | 1,500 | 2,100 |
| Slerpc | 1,100 | 1,000 | 1,250 | 1,100 | 1,600 | 1,600 |
| Strzelce Op. | 1,000 | 1,050 | 1,100 | 1,200 | 1,200 | 1,500 |
| Zambrow | 900 | 1,000 | 1,100 | 1,200 | 1,400 | 1,300 |

Table 2.A.4 *Household Affordability in 1998*
Total Square Meters Able to Be Purchased with a DIM Loan

| <i>Average Monthly Household Income by Decile (PLN)</i> | <i>Available Credit: DIM Loan (PLN)</i> | <i>Total Funds with 30 Percent Downpayment (PLN)</i> | <i>Total Square Meters That Can Be Purchased</i> |
|---|---|--|--|
| 1. 682 | 21,365 | 27,775 | 13.9 |
| 2. 968 | 30,321 | 39,417 | 19.7 |
| 3. 1,171 | 43,651 | 56,746 | 28.4 |
| 4. 1,355 | 50,484 | 65,629 | 32.8 |
| 5. 1,540 | 62,724 | 81,541 | 40.8 |
| 6. 1,742 | 70,939 | 92,221 | 46.1 |
| 7. 1,989 | 80,980 | 105,274 | 52.6 |
| 8 2,302 | 93,727 | 121,845 | 60.9 |
| 9. 2,830 | 124,089 | 161,316 | 80.7 |
| 10. 4,761 | 208,771 | 271,402 | 135.7 |

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3

Russia: Dramatic Shift to Demand-Side Assistance

One of the most important results of the economic reforms in the housing sector initiated by the law “On Privatization of Housing in the RSFSR” in July 1991 is a fundamental change in the role played by the federal government in the functioning and development of the housing sector. Critically, the government stopped operating as the principal centralized source of housing construction finance. Simultaneously, an attempt was made to improve targeting of government investments in the housing sector, which, despite acute budget deficits, the state continued to provide for the social policy goals.

The intensive restructuring of the housing finance system driven by the critical condition of the state budget was truly unprecedented. Before the economic reform started in 1991, the budget was responsible for almost 80 percent of the total volume of new housing. By mid-1999 the share of developers in state ownership was down to 11.3 percent, with only 8.6 percent of the housing built by developers in federal ownership.

Transformation of the old system of housing finance called for formulating a new conceptual framework and defining the government’s place in it. Three key tasks were identified for the government to create the new system of housing finance:

- Identification and promotion of new nonbudgetary sources of finance for the housing sector.

- Rationalization of the structure of the financial contributions made by governments of different levels.
- Identification of priorities and the most efficient mechanisms for state investments in the housing sector (shift to demand-side allocation of state investments).

By mid-1999 progress had been achieved in all the three tasks, particularly the first two. Pursuant to the state housing policy, a series of legislative and regulatory acts passed during 1993–98 created a basis for the attraction of nonbudget resources to housing construction finance; development of long-term residential mortgage lending and creation of a secondary facility; formation of regional and municipal funds for housing construction; and implementation of improved subsidies for construction or purchase of housing, including the issuance of housing certificates (to subsidize unit downpayment) in a way that guaranteed the use of public funds for housing.

Nonbudget funds have become the principal source of funds for the construction of housing. Subjects of the Russian Federation (similar to states in the United States) and local self-governments play an increasingly important role in the decisions about housing finance. The state on the federal level has retained responsibility for programs of national importance, while the burden of making housing available to the population has been transferred to the municipalities.

But these positive developments have had limited impact because of the turbulent economic conditions. Negative economic growth combined with very high and extremely volatile interest rates discouraged households from borrowing and banks from extending long-term loans. Moreover, during this period the State Duma (parliament) enacted an extremely generous deduction for home purchase costs from the personal income tax. The huge benefits to the well-to-do from this provision substantially offset the improved targeting of assistance in other policies.

Today explicit national policy for housing investments has two priorities. The first priority is provision of housing to specific groups—active-duty military and retirees, migrants from the Far North, forced migrants, victims of accidents and natural calamities, and some other groups such as employees of closing coal mining enterprises. This priority is financed by federal budget sources. The second priority is to meet the needs of citizens requiring improved housing conditions

(including young people and other citizens with low to moderate incomes). These citizens are first placed on a waiting list, and then they receive assistance either through allocation of an existing municipal dwelling or through the construction or purchase of a dwelling financed partly through their own funds and partly from a downpayment subsidy. The financing is the responsibility of municipalities.

Thus, on the one hand Russia's experience is very special. Macroeconomic instability has prevented the expansion of traditional mortgage lending from almost "pilot levels," although the legal and financial infrastructure for such lending is in place. The government has done well in reorienting and rationalizing its expenditures, although the allocation of responsibilities among levels of government is rather atypical. On the other hand, like other nations in the region, Russia has tax breaks for housing that are large and badly targeted. In short, very substantial efficiency gains are possible from further policy reforms.

This chapter first reviews housing-sector developments and the state of housing finance. It then presents a detailed description and analysis of state policies for promoting construction and purchase of housing.

Key Economic and Housing Trends

Privatization of Urban Housing

The first steps toward privatization of the housing stock were taken in 1988 when, for the first time, ownership of apartments was permitted in so-called cooperative housing. A member of the cooperative became an owner after he had paid his participation share in full. A year later the process was expanded to permit sale of apartments in the state housing stock to the sitting tenants. However, during 1990 the privatization rates were quite modest: By the end of that year only 53,000 units were privatized (table 3.1).

The process accelerated with enactment in June 1991 of the law "On Privatization of Housing Stock in the RSFSR," which established new procedures for the transfer of state and municipal housing into private ownership through a "voucher" mechanism. According to the established procedure, registered tenants received, free of charge, vouchers issued on the basis of the cost of one square meter of an "average apartment" in their city multiplied by a norm of freely transferred square

Table 3.1 *Privatization of the Housing Stock*

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|------|------|-------|-------|-------|--------|--------|--------|--------|--------|
| Number of privatized units (thousands) | 42.5 | 122 | 2,631 | 5,770 | 2,396 | 1,529 | 1,203 | 1,198 | 1,198 | 959 |
| Cumulative units privatized (thousands) | 10.5 | 53 | 175 | 2,789 | 8,593 | 10,963 | 12,495 | 13,690 | 14,815 | 15,774 |
| Total floor space (million square meters) | n.a. | n.a. | 132 | 282 | 114 | 72 | 57 | 56 | 56 | 46 |
| Percentage of eligible units privatized | 0.03 | 0.13 | 0.4 | 8.4 | 18.0 | 9.0 | 6.0 | 5.0 | 5.0 | 5.0 |

Source: *Russian Statistical Yearbook* (1998).

meters. Housing (square meters) above the norm had to be purchased at a locally set price. Nevertheless, the second phase of “partially paid” privatization similarly failed to produce material results—during 1991 only 122,000 units were privatized.

The new phase of housing privatization started in the end of 1992 when the Russian Federation Supreme Soviet approved amendments to the above law that simplified the privatization procedures and increased the housing stock subject to privatization. First, the procedure for appraisal of an apartment and its repayment was abolished: Housing was now transferred into ownership without charge regardless of the total floor space. Second, certification of the application by a notary, which often created bureaucratic delays, was not required; no state duty for privatization of housing was to be charged. Third, housing owners and organizations that had housing on their balance sheets (typically municipalities and enterprises) were granted the right to make independent decisions on privatization of units provided for the period of employment and on communal apartments (apartments shared by multiple families). Fourth, it permitted privatization of residential buildings in need of rehabilitation, with the former owner retaining the obligation for rehabilitation of the stock.

The beginning of the “era of free privatization” was marked by a dramatic increase in the share of privatized sector (from 175,000 units privatized in 1991 to 2.2 million in 1992). However, the rate of privatization reached its peak by mid-1993, after which the process started to slow down. While in early 1993 more than 700,000 units were privatized every month, the number decreased to 150,000 by the end of 1994, and then to about 100,000 in 1997.

Analysis of the characteristics of privatized units and the social structure of citizens who privatized their housing early in the process (table 3.2) shows that the process of privatization was concentrated mainly in two sectors of the housing stock:

- Housing occupied by pensioners, primarily single persons, for whom privatization means the chance to give the property to their heirs.
- Housing with potentially high market value, reflected in both the quality of the apartment and building, and the location (both regional and metropolitan) of the unit.

Table 3.2 shows that units privatized in Moscow in 1992 were clearly more valuable, except among the lowest income group, which is dominated by pensioners who have a strong motivation to privatize. The trend continued into the next years, although the gap between the average cost of one square meter of privatized (including old housing) and nonprivatized housing became smaller.

It seems evident that the potential for privatization, in its present form, is essentially exhausted. For those who do not expect marked advantages from privatization in the near future, a positive decision is largely offset by negative incentives. First, tenants enjoy very strong rights: They are almost impossible to evict, even for nonpayment of rent; and they have the right to bequeath the occupancy right for their unit to adult children or grandchildren registered as living in the unit. Thus, the gains in tenure security from privatization are minimal. In addition, the poor condition of the buildings in which many units are located is a powerful deterrent—taking a unit is essentially receiving the obligation to pay for future rehabilitation. Moreover, uncertainties exist about the cost of the new property tax and future maintenance fees. (During the transition period, the duration of which has been extended, from 1998 to 2003 and then to 2008, the owners of privatized housing pay rates for maintenance and repair of the housing and for utilities that are practically equal to the rates that people who remain in the state or municipal housing stock pay, with a few negligible exceptions.)

Various negative consequences of such total and termless privatization have become especially evident in recent years. In particular, the municipal authorities are unable to work out a long-term policy for the development of social housing and housing for low-income households,

Table 3.2 *Value of Moscow Housing Units (December 1992, per square meter)*

| <i>Income Quintile</i> | <i>All Units</i> | <i>Privatized Units</i> |
|------------------------|------------------|-------------------------|
| Lowest quintile | 7,556 | 6,766 |
| 2nd quintile | 7,885 | 8,646 |
| 3rd quintile | 9,068 | 11,898 |
| 4th quintile | 9,232 | 13,038 |
| Highest quintile | 9,840 | 13,244 |

Source: J. Daniell and R. Struyk (1994), table 4.

because they do not know which units will remain in the municipal stock and which are to be privatized. The practice of charging commercial rents for municipal housing is just now being developed, even though the necessary legal basis was given in 1992 in the Russian Federation Law "On the Fundamentals of the Federal Housing Policy." The reason is that it is now possible for any renter of a state unit to privatize it, after which he continues to pay maintenance and utility fees at the rates established for social housing. Since 1996, multiple attempts have been made to address the situation through amendments to the law "On Privatization of Housing Stock in the Russian Federation," but these attempts have been rejected by the State Duma.

Nevertheless, free privatization of housing and abolition of restrictions on the number and size of residential units that may be owned by a private individual have led to significant changes in the ownership structure of the housing stock in Russia (table 3.3).

Table 3.3 *Russian Federation Housing Stock by Ownership Type (millions of square meters/percentage)*

| | 1990 | | 1993 | | 1998 | |
|--|----------------------------------|-------------------|----------------------------------|-------------------|----------------------------------|-------------------|
| | <i>Millions of Square Meters</i> | | <i>Millions of Square Meters</i> | | <i>Millions of Square Meters</i> | |
| | <i>Percentage</i> | <i>Percentage</i> | <i>Percentage</i> | <i>Percentage</i> | <i>Percentage</i> | <i>Percentage</i> |
| Total Housing Stock | 2,425 | 100.0 | 2,546 | 100.0 | 2,715 | 100.0 |
| Private | 791 | 32.6 | 1,189 | 46.7 | 1,539 | 56.7 |
| Private Property of Citizens (Included in Private) | 641 | 26.4 | 943 | 37.0 | 1,312 | 48.3 |
| State-Owned | 1,011 | 41.7 | 496 | 19.5 | 199 | 7.3 |
| Municipal | 611 | 25.2 | 664 | 26.1 | 854 | 31.5 |
| Public Organizations | 12 | 0.5 | 3 | 0.1 | 2 | 0.1 |
| Mixed Form of Property | | | 194 | 7.6 | 121 | 4.4 |

Source: *Russian Statistical Yearbook* (1998).

As of the end of 1998, after transfer of 42 percent of eligible housing into private ownership, the private housing sector in Russia constituted 55 percent of the total housing stock. A privatization process of such intensity created a solid foundation for the development of the housing market. This observation is confirmed by data on the number of transactions involving housing units. Estimates of the Russian Guild of Realtors indicate that in major cities of Russia every year, 1.5 to 2 percent of the total number of privately owned apartments are involved in sale transactions.

Housing Construction

The high point of housing construction in the Russian Federation was reached in 1987, after two years of the “Housing 2000” program initiated by Mikhail Gorbachev, which mobilized state funds to produce 72.8 million square meters of housing in that banner year. By 1992, though, production volume had fallen sharply to 41.5 million square meters, or 57 percent of the 1987 level (table 3.4). The drop in the volume of housing construction paused briefly and remained stable during 1993–95, but it began to decrease again in 1996, and by 1998 the volume of completed housing had fallen to 30.7 million square meters, or 45 percent of the 1987 level.

The essential elements of the previous policy on housing construction were centralized distribution of capital resources; strict standardization in the planning of the volume of housing construction and of its distribution around the country; and excessive monopolization of the construction industry by the state, primarily in the form of large construction enterprises. The state was a monopolist and acted as investor, client, contractor, and owner at the same time.

Until recently the key figure, taking the place of the *investor* and the *producer* in market systems, was the *customer*. A World Bank report (1993) points out that “the difference between the customer in Russia and the developer in market economies is the main feature distinguishing the construction process in the market conditions from the Soviet-type centralized planning.” The local authorities and the enterprises that needed new housing had to apply to a unified customer. The customer allocated the development site, prepared the design documentation, obtained the appropriate permits from the chief architect and other authorities, selected the housing construction enterprise (although the

Table 3.4 *Total Commissioned Housing*

| | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| New housing constructed (million square meters) | 62.6 | 61.7 | 49.4 | 41.5 | 41.8 | 39.2 | 41.0 | 34.3 | 32.7 | 30.7 |
| Population (millions) | 143.8* | 148.0 | 148.5 | 148.7 | 148.3 | 148.0 | 147.9 | 147.6 | 146.1 | 147.6 |
| Per capita construction (square meters) | 0.435 | 0.417 | 0.333 | 0.279 | 0.282 | 0.265 | 0.277 | 0.232 | 0.222 | 0.209 |
| Construction as percentage of 1990 level | 101.5 | 100.0 | 80.1 | 67.3 | 67.7 | 63.5 | 66.5 | 55.6 | 53.0 | 49.8 |

Source: *Russian Statistical Yearbook* (1998).

*Data for 1996.

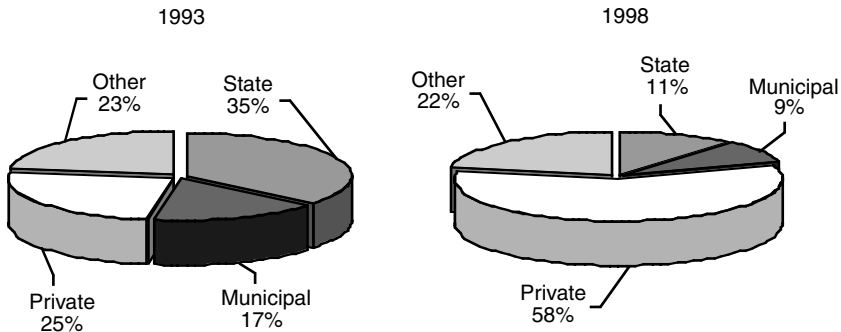
possibility of choice was limited as a result of the rigid specialization of the builders in specific types of construction), obtained the necessary materials, and did the contracting. Under such a scheme those who ordered the housing (i.e., the clients) had practically no rights and very limited opportunity to influence the quality of what they were given.

The reforms have resulted in fundamental changes in the system of housing finance. State budget financing was largely replaced by private investments of individuals and legal entities, with a smaller share financed by loans from commercial banks that launched operations in the real estate sector. Municipal customers controlling the entire construction cycle and allocation of housing gave way to independent developer firms who work with the newly created private or privatized construction companies (table 3.5). Conversely, large construction companies in many cities have retained close ties with the municipal authorities, as a result of which their contractors and funders, while maintaining formal independence from the city, receive important benefits *de facto* when city land is allocated for development and during various competitions for the contracts. This is equally true for both small and big cities, including Moscow.

Until 1991 the main client for newly constructed housing was the state (including municipalities and state enterprises and organizations). In 1990 they accounted together for 80 percent of the total volume of completed new housing. In later years, in response to two factors—budget cuts made to contain the ballooning state deficit and the start of the privatization process—state organizations, municipalities, and state enterprises played a steadily diminishing role. By 1998 their contribution amounted to only 20 percent of newly constructed housing (figure 3.1), with units built by enterprises and organizations in federal ownership accounting for a mere 8.6 percent of the total (table 3.5). The share of municipalities also has fallen dramatically in recent years, from 6.9 million square meters in 1993 to 2.6 million square meters in 1998. Note that many municipalities are acting as the developer but are selling a large share of the completed units on the open market, resulting in an even smaller role than indicated.

One of the two bright spots in the otherwise dismal production record has been the preservation of a positive trend in private-sector housing construction. The trend is led by the investments of individual households. In 1998 such households built residential units with a total space of 12.1 million square meters—more than 39 percent of total con-

Figure 3.1 *Share of Enterprises and Organizations of Different Type of Ownership in Residential Construction in Russian Federation, 1993 and 1998*



Source: *Russian Statistical Yearbook* (1998).

struction. The balance of private activity in new housing construction has slipped modestly in the past two years. Nevertheless, private clients accounted for 58 percent of all construction in 1998.

The second positive development has been the sustained increase in the percentage of new housing projects for which the client has been a consortium of enterprises, private developers, and a municipality (row “In mixed Russian ownership” in table 3.5). This type of client emerged in 1991; it already accounted for 23 percent of all new housing in 1993 and about 30 percent of the total from 1994 to 1997. New housing developed for such consortiums plus fully private clients totaled 79.4 percent of all residential construction in 1998.

Nevertheless, the volume of new housing construction may not be much above the level that would redress the shortage of residential property, although large regional population migrations will generate greater housing needs. Until 1996 the annual volume of commissioned new housing in urban areas was substantially above “housing needs,” as the data in table 3.6 show. Note that this apparent surplus was driven by a decline in the number of households—a development that may well be sustained.

A serious problem in Russia is the large volume of uncompleted residential construction. An avalanche-like growth in the number of frozen projects took place in early 1990s as a consequence of deficient budgetary finance and high inflation rates, which resulted in discontinued

Table 3.6. *Correlation of New Housing Units and Needs of Urban Economics*

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-------|------|------|------|------|------|------|------|------|
| 1. Number of new housing units (thousands) | 1,044 | 828 | 682 | 682 | 611 | 602 | 482 | 430 | 388 |
| 2. Growth in number of urban households (thousands) | 187 | -42 | -251 | -153 | -42 | -72 | -109 | -88 | -120 |
| 3. Number of units needed to replace worn-out housing (thousands)* | 430 | 437 | 445 | 459 | 471 | 479 | 485 | 492 | 499 |
| 4. Ratio of new urban housing to housing needs (lines 2+3) | 1.69 | 2.10 | 3.52 | 2.23 | 1.42 | 1.48 | 1.28 | 1.06 | 1.02 |

Source: Calculations are based on Russian Goskomstat publications: *Russian Statistical Yearbook* (1998) and *Russia in Figures* (1999).

* Calculated as 5 percent of the urban housing stock in a correspondent year.

construction of thousands of residential projects. In March 1992, the government passed Resolution 59, which permitted organization of public sales of uncompleted projects, but this did not dramatically improve the situation. As a consequence, in 1993 only 241 uncompleted projects were sold. More than half of the sold projects (69 percent) had social designation (multi-service health clinics, schools, etc.) and initially were owned by municipalities.

In the second half of the 1990s, when the economic situation in the country in general and the financial standing of developers in particular improved, the volume of uncompleted construction dropped (table 3.7). Still, the backlog was too great to overcome in three to four years. Moreover, progress was not consistent throughout the whole country.

Urban Housing Standards

Some key indicators of housing conditions in urban areas and the average structure of consumption expenses of households are given in tables 3.8 and 3.9.

Table 3.8 shows the increase in the percentage of dwellings having central heating and hot water supply throughout the 1985–97 period. The fact that some increase was sustained after 1992 is especially notable because of the restrictions on local government investment, which in previous years would have had the opposite consequences.

According to the available data, average housing and utilities in Russia in 1997 were 9.43 Rb per month per square meter. Even by 1998 the

Table 3.7 *Unfinished Residential Construction*^a

| | 1995 ^b | 1996 | 1997 | 1998 |
|--|-------------------|------|------|------|
| Number of buildings (thousands) | 87.9 | 80.8 | 68.7 | 54.6 |
| Their total floor area (millions of square meters) | 97.0 | 90.1 | 76.6 | 59.3 |
| Percentage of previous year | — | 93.0 | 85.0 | 77.0 |

Source: *Russian Statistical Yearbook* (1998).

a. Data as of beginning of each year.

b. Statistical reports on unfinished construction are available only since 1995.

Table 3.8 *Key Indicators of Housing Conditions in Urban Areas in Russian Federation*

| | 1985 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|------|------|------|------|------|------|------|------|------|
| Average residential total floor area per person at the end of the year in urban areas (square meters) | 14.9 | 16.4 | 16.5 | 16.8 | 17.4 | 17.7 | 18.1 | 18.3 | 18.6 |
| Level of utilities infrastructure (percentage) | | | | | | | | | |
| Water supply | 98 | 99 | 99 | 99 | 99 | 98 | 98 | 98 | 98 |
| Waste water | 90 | 94 | 95 | 95 | 96 | 95 | 95 | 95 | 93 |
| Central heating | 79 | 82 | 83 | 83 | 84 | 85 | 85 | 86 | |
| Gas | 68 | 69 | 69 | 69 | 68 | 68 | 67 | 67 | |
| Hot water supply | 60 | 67 | 68 | 68 | 69 | 71 | 72 | 73 | |
| For information: Level of utilities infrastructure in rural areas (percentage) | | | | | | | | | |
| Water supply | 2 | 16 | 19 | 20 | 20 | 21 | 22 | 23 | 22 |
| Waste water | 1 | 3 | 4 | 4 | 4 | 4 | 3 | 3 | 3 |

Source: *Russian Statistical Yearbook* (1998).

Table 3.9 *Structure of Consumer Expenses of Households (results of selective survey of households, percentages)*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|-------|-------|-------|-------|-------|-------|
| Consumer expenses, total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Expenses on purchase of food for home nutrition | 43.5 | 43.9 | 49.0 | 47.2 | 43.0 | 51.4 |
| Expenses on nutrition outside home | 2.8 | 2.9 | 3.0 | 3.0 | 2.8 | 2.0 |
| Expenses on purchase of alcohol | 3.1 | 2.9 | 2.5 | 2.5 | 2.8 | 2.6 |
| Expenses on purchase of industrial goods | 42.4 | 40.2 | 31.8 | 31.3 | 36.5 | 30.1 |
| Expenses on purchase of services | 8.2 | 10.1 | 13.7 | 16.0 | 14.9 | 13.9 |
| Housing and utilities | 0.7 | 1.8 | 4.2 | 5.7 | 5.1 | 5.2 |

Source: *Russian Statistical Yearbook* (1998).

average household devoted only 5.2 percent of its total spending to housing and utilities.

The sources of the resources at the disposal of households and the dynamics of average wages are illustrated in tables 3.10 and 3.11.

Table 3.10 shows that the largest portion of a household's disposable resources originates from current income, and total borrowing and spent savings amount to only a small part of those resources. Remarkably, in 1998, after seven years of the transition, in-kind subsidies still accounted for 11.3 percent of the average household's economic resources.

The data in table 3.11 show that the purchasing power of wages (in constant rubles) has declined steadily during the transition. The adverse impact of the August 1998 collapse is evident in the figures for that year.

In 1993–97 nearly all regions of Russia witnessed a steady growth in prices of housing, no matter whether it was a standard residential property or a higher-quality property with an improved plan, custom design, and better location. Comparison of the dynamics of standard housing prices with the dynamics of inflation for the same period leads to the conclusion that investments in residential properties had a positive rate of return, because on average housing prices went up faster than consumer prices (table 3.12). Nevertheless, house prices fell sharply in fall 1998 throughout the country. Moreover, in comparison with current bank deposit rates, the rate of return for such investments was negative over much of the period.

One of the key factors restricting the demand for mortgage finance has been the very high ratio of unit prices to household incomes for most households. Data on this ratio in table 3.13 from 1994 to 1998

Table 3.10 *Structure of Resources at the Disposal of Households, 1998*
(results of selective survey of households)

| | |
|---|-------|
| Disposable resources, average per household member, U.S. \$ per month | 75.82 |
| Percentage of total: | |
| Gross income | 96.2 |
| Cash receipts | 84.9 |
| Cost of in-kind subsidies received | 11.3 |
| Borrowed funds and spent savings | 3.8 |

Source: *Russian Statistical Yearbook* (1998).

Table 3.11 *Average Wages, 1991–98*

| | Wages in Terms of Current ^a Prices | | Wages in Terms of 1991 Prices | Wages per Household | | |
|-------------------|---|-----|-------------------------------|------------------------------------|---|---------------------------------|
| | U.S. \$ (at current official exchange rate) | | Rubles | Rubles, in terms of current prices | U.S. \$, in terms of current prices (at current official exchange rate) | Rubles, in terms of 1991 prices |
| | Rubles | | | | | |
| 1991 | 548 | – | 548 | 651 | – | 651 |
| 1992 | 5,995 | 22 | 369 | 9,652 | 35 | 594 |
| 1993 | 58,663 | 57 | 370 | 94,447 | 92 | 596 |
| 1994 | 220,351 | 98 | 341 | 354,765 | 158 | 549 |
| 1995 | 472,392 | 103 | 246 | 760,551 | 166 | 396 |
| 1996 | 790,210 | 154 | 278 | 1,272,238 | 248 | 448 |
| 1997 | 950,205 | 164 | 291 | 1,529,830 | 264 | 469 |
| 1998 ^b | 1,101 | 109 | 264 | 1,773 | 175 | 425 |

Source: *Russian Statistical Yearbook* (1998).

a. Current means the exchange rate in effect in each year or prices in that year (i.e., not adjusted for a different exchange rate or for inflation).

b. The ruble was redenominated in January 1998, with the face value of each note reduced by 1,000.

across Russian cities and regions show a significant range in values, caused by substantial differences in local economic conditions and the size of additions to the housing stock. Ratios had fallen quite low in Moscow (because of substantial overbuilding) and below 6 in most areas by 1997, but then jumped back up in 1998 when incomes declined more sharply than prices.

Macroeconomics

Liberalization and restructuring of the Russian economy go back to 1992, when the collapse of the centralized and planned economy was quite apparent. The most significant changes in the Russian economy were under way in 1992–93. The following years also witnessed the process of reforming, which involved virtually all national markets. Russia has turned out to be a country where the process of economic liber-

Table 3.12 *Standard Housing* Prices and Selective Macroeconomic Indicators Behavior in 1993–98*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|--------|--------|--------|--------|--------|--------|
| Standard housing prices in Russian cities and regions (U.S. \$) | | | | | | |
| Moscow | 40,608 | 60,534 | 65,718 | 54,810 | 51,300 | 46,980 |
| St. Petersburg | 18,468 | 23,868 | 25,488 | 28,242 | 30,996 | 20,000 |
| Nizhny Novgorod region | 15,660 | 22,680 | 24,300 | 27,000 | 32,400 | 13,500 |
| Samara region | 18,360 | 31,320 | 32,940 | 33,480 | 35,100 | 15,100 |
| Saratov region | 18,900 | 14,580 | 26,298 | 24,300 | 18,900 | 9,380 |
| Irkutsk region | 17,280 | 19,656 | 22,140 | 29,160 | 25,380 | 11,150 |
| Mean price index for standard housing (percentage change to the previous year) | — | 33.5 | 14.0 | 0.1 | -1.5 | -8.4 |
| U.S. \$ consumer price index (percentage change from the previous year) | 201.7 | 8.1 | 75.3 | 1.7 | 3.6 | -74.4 |
| Three-month bank <i>ruble</i> deposit rate (percentage per year) | 116.1 | 125.6 | 103.0 | 53.9 | 21.7 | 42.0 |

Sources: *Russian Statistical Yearbook* (1998); Russian Guild of Realtors.

* A residential unit of 54 square meters is considered to be the standard unit.

alization was very complicated and painful and was accompanied by a dramatic fall (more than 60 percent) in GDP level and living standards. Wages and pensions fell steadily over the 1991–98 period (table 3.14).

The period of extreme inflation that began in 1992 and was still as high as 131 percent in 1995 made credit and interest rate risks of long-term lending so high that banks just refused to think about mortgage finance as a profit-yielding operation. In 1991–94, bank interest rates were negative in real terms, and the maturity periods for most borrowing did not exceed three to four months.

Reduced inflation, a decline in housing prices, and more stable ruble exchange rates triggered banks' interest in residential mortgage finance.

Table 3.13 *Ratio of House Prices to Average Household Income, across Cities and Regions*

| <i>Cities and Regions</i> | 1994 | 1995 | 1996 | 1997 | 1998* |
|---------------------------|------|------|------|------|-------|
| Moscow | 6.0 | 6.6 | 3.2 | 2.6 | 5.7 |
| St. Petersburg | 4.7 | 5.0 | 4.9 | 5.3 | 8.9 |
| Nizhny Novgorod region | 5.7 | 9.6 | 7.8 | 8.7 | 9.7 |
| Samara region | 7.6 | 12.9 | 9.0 | 6.3 | 8.4 |
| Saratov region | 4.4 | 12.6 | 8.3 | 5.9 | 7.2 |
| Irkutsk region | 5.1 | 6.0 | 5.2 | 4.4 | 6.7 |

Sources: *Russian Statistical Yearbook* (1988); Russian Guild of Realtors.

* 1998 ratios estimated.

The year 1997 and the first six months of 1998 was a period of relative financial stability in Russia, with inflation dropping to an annual rate of 12 to 14 percent, a growing volume of longer-term lending, and the emergence of middle-class purchasers capable of creating an effective demand for mortgage loans. These factors made it possible for banks to start mortgage operations involving not only dollar-denominated loans but also ruble-denominated loans extended for terms of three to five years. As a result of the financial policy that set the official ruble

Table 3.14 *Major Social and Economic Indexes, 1990–98*

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP, percentage change from 1990 | 0 | -13.6 | -54.9 | -56.8 | -51.2 | -46.9 | -39.5 | -35.8 | -61.7 |
| Mean per capita cash income of the population (U.S. \$ per month) | 40 | 11.65 | 19.5 | 47.0 | 90.7 | 112.4 | 147.3 | 161.2 | 95.7 |
| Average real monthly wage as percentage of the previous year's level | - | 97.0 | 67.0 | 100.4 | 92.0 | 72.0 | 106.0 | 105.0 | 87.0 |
| Real level of pensions received as percentage of the previous year's level | - | 97.0 | 52.0 | 131.0 | 97.0 | 81.0 | 109.0 | 95.0 | 95.0 |

Sources: *Russian Statistical Yearbook* (1998); *Russia in Figures* (1999).

exchange rate below the rate of inflation, incomes during this period demonstrated a steady growth, in terms of hard currency as well as rubles.

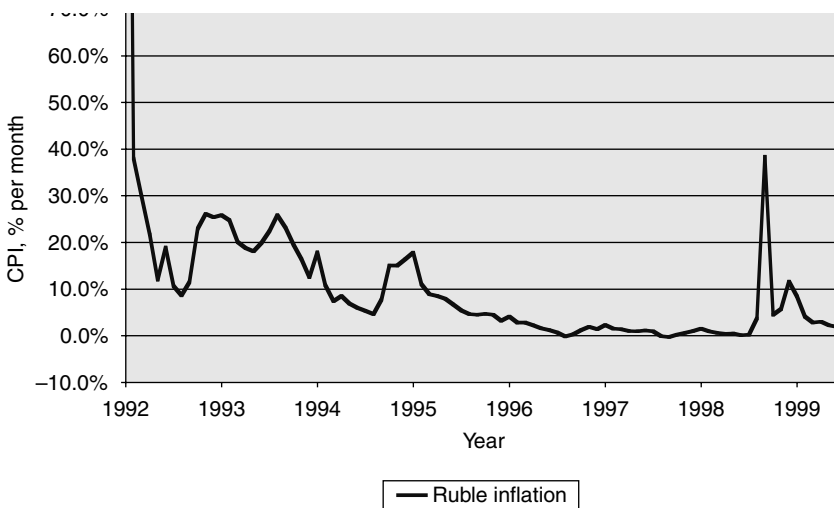
However, the remaining macroeconomic imbalances impeded the development of long-term mortgage lending. The continuous federal budget deficit and growing public debt produced increased expectations of inflation and ruble devaluation, which led to higher interest rates. Moreover, during this period the key concern of bankers was the extraordinary Treasury bill earnings. From late 1997, the balance of payments, traditionally positive thanks to energy exports, gradually ran into the red. This, combined with heavy government borrowing, set the stage for further ruble devaluation. Notwithstanding these adverse developments, many banks, with the goal of high speculative gains, persisted in closing forward currency contracts.

The August 17, 1998, financial turmoil—brought on by a sharp ruble devaluation and moratoriums on both government T-bills and foreign debt—was a direct outgrowth of the backlog of unsettled macroeconomic problems in Russia. The turmoil brought the Russian banking system to an acute crisis—a sharp drop in capitalization because of exchange rate losses, the freeze on T-bills, and an urgent need to expand reserves to cover likely credit losses. As of mid-1999 the capital of the banking sector, excluding RF Sberbank (the quasi-state Russian Savings Bank), had shrunk to 60 percent below the August 1, 1998, level. The size of assets of insolvent banks has grown from 12 to 42 percent of the country's aggregate banking assets. Banks' assets have also worsened in quality with simultaneous growth of outstanding debt, or even bad debt. Ruble devaluation resulted in material losses on previously signed forward contracts, mass withdrawal of individual deposits, and a complete breakdown of the payment system. Unlike the 1995 financial crisis, this one involved first and foremost major "backbone" banks. Nevertheless, not all banks experienced such strains. A substantial number of regional banks remained rather stable and even received applications for new accounts.

By mid-1999 it was possible to identify some positive signs that the situation was slowly changing for the better. For example, the rate of consumer price inflation showed a stable downward tendency (figure 3.2). In general, for the first five months of 1999, consumer prices rose by 22.2 percent. In June the inflation rate slowed to 1.5 to 1.7 percent.

With respect to the ruble-dollar exchange rate, following the 45 percent drop recorded in the fall of 1998, the exchange rate became more

Figure 3.2 *Consumer Price Index, January 1992 to June 1999*
(percentage change from the previous year)



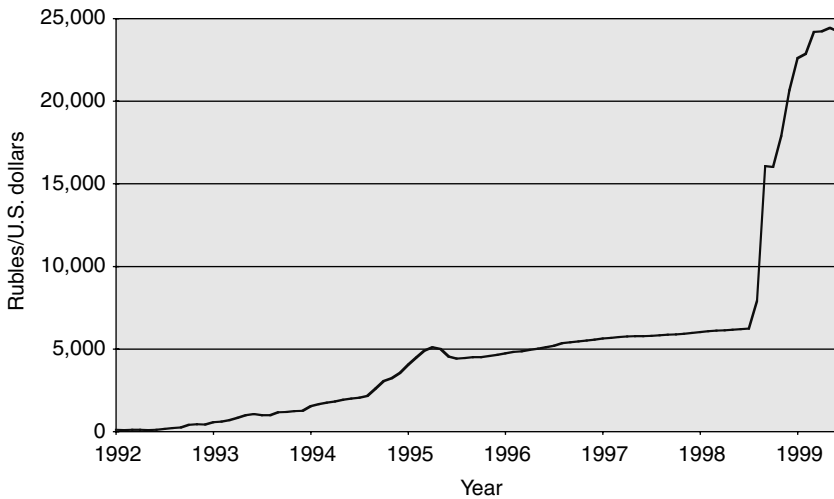
Source: *Short-Term Economic Indicators for Russian Federation*, July 1999.

stable in the first half of 1999, when it fluctuated at a level similar to the pattern recorded in late 1994 to early 1995 (figure 3.3).

One of the key factors that allowed the macroeconomic situation in the country to stabilize in 1999 was the primary surplus of the federal budget (i.e., excluding official payments to foreign entities). With the rise in world oil prices, the hard currency earnings of oil exporters increased, resulting in a sharp improvement of the national balance of payments.

The banking community is also gradually riding out the crisis. In 1998 Russian banks had to meet losses in general, but in the first quarter of 1999 the aggregate earnings of 200 major Russian banks were distinctly positive. Remarkably, individual clients continue to place deposits in the banking sector, especially Sberbank, whose deposits are government-insured. Before August 1998, nearly 30 percent of the deposits of individual savers were kept in commercial banks (other than Sberbank). But after the collapse, the majority of large banks experienced a significant outflow of deposits, and the Sberbank share in the overall volume of private deposits grew to more than 85 percent. Considering that Sberbank offers a far narrower range of services to its clients than many private banks, it is reasonable to suppose that the withdrawal of private

Figure 3.3 *Fluctuation of the Ruble-to-U.S. Dollar Exchange Rate, 1992–99*



Source: *Short-Term Economic Indicators for Russian Federation*, July 1999.

Note: The left-hand scale does not use redenominated rubles for 1998 and 1999.

banks from retail finance has limited even further the services available to individual bank clients.

In July 1999 individual deposits in banks showed a 19 percent growth over January 1999. However, many banks lacked reliable investment opportunities and developed excess liquidity. As of late-summer 1999 the balance on correspondence accounts opened with the RF central bank and the newly created Agency for Restructuring Credit Institutions was 50.5 billion rubles. (The exchange rate in 1999 was about 25 rubles to the dollar.) Under such circumstances mortgage lending might be attractive. Nevertheless, banks are concerned about intermediation risks, given their short-term liabilities structure.

It is rather difficult to estimate the cost of long-term (5 to 10 years) loans because few such loans are being made. It is just this lack of long-term resources that prevents banks from penetrating the residential loan market. Hence, the design of mechanisms allowing banks, and subsequently individual clients, to mobilize long-term resources at an affordable price continues to be seen as the major prerequisite for successful mortgage finance expansion.

The 1998 crisis had a severe impact on the volume of individual savings. According to the RF central bank and the Russian Committee on Statistics, savings of the population in 1998 expanded by 260 billion rubles versus 415 billion rubles in 1997 (significant devaluation of the ruble also should be taken into account). The overall dynamics and distribution of money incomes of the population are shown in table 3.15.

According to Sberbank data, by late 1998 the balance of individual ruble deposits in Sberbank made up 126 billion rubles (U.S. \$5 billion) plus \$1.3 billion in dollar deposits. Considering that Sberbank serviced 85 percent of all ruble and currency individual deposits, the aggregate balance of individual accounts in all Russian banks was approximately 150 billion rubles and \$1.5 billion.

This is just a minor portion of individual savings kept by Russian residents within the country. The major part of their savings is kept in dollars at home (table 3.15). According to RF central bank estimates, individual savings totaled about U.S. \$40 billion. These estimates are consistent with the suggestion that 85 to 90 percent of individual savings are converted to foreign currency.

Home Purchase Finance

Before the economic reform no mortgage finance system existed in Russia in the normal sense of the term. Housing loans were not explicitly

Table 3.15 *Dynamics of Money Income and Savings of the Population, 1995–98*

| <i>Indicator</i> | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> |
|--|-------------|-------------|-------------|-------------|
| Money income (billions of rubles) | 910.7 | 1,346.8 | 1,619.4 | 1,700.5 |
| Total savings (billions of rubles) | 217.4 | 330.9 | 414.8 | 260.5 |
| Percentage of income | 24.0 | 25.0 | 24.5 | 15.3 |
| Deposits and securities (billions of rubles) | 49.1 | 59.2 | 37.9 | 19.0 |
| Percentage of total savings | 22.6 | 17.9 | 9.1 | 7.3 |
| Hard currency purchase (billions of rubles) | 135.1 | 252.9 | 349.4 | 213.6 |
| Percentage of total savings | 62.1 | 76.4 | 84.2 | 82.0 |
| Money kept at home (billions of rubles) | 33.1 | 18.8 | 27.5 | 27.8 |
| Percentage of total savings | 15.3 | 5.7 | 6.6 | 10.6 |

Source: *Russian Statistical Yearbook* (1998).

secured by the property as collateral before 1992, when the law “On Collateral” was adopted, and eviction of the borrower from the mortgaged residential unit in case of default was most unlikely. In practice, lenders typically protected themselves by having employers deduct loan payments from wages; where possible, guarantors were sought, and the bank could have wages garnished for nonpayment.

Under the Soviet system, long-term financing of housing for households had been the function of one or two state banks. After 1988 the only bank offering such loans was Sberbank, which became a joint-stock commercial bank in 1991, wholly controlled by the state; the majority of shares belong to the Central Bank of Russia. An open joint-stock company is an optimum legal organizational form for operations in the mortgage market. Sberbank is the only joint-stock commercial bank in the country whose depositors’ money is protected by the state.

The long-term housing finance offered by Sberbank was for three basic groups and purposes: (1) individual households for single-family home construction, reconstruction, and rehabilitation; (2) housing construction cooperatives for construction; and (3) individual households for the building, purchase, and repair of garden cottages and summer houses (dachas) in the country. Thus, in the pre-reform period practically no loans were made for purchase of existing housing (except loans for garden cottages and summer cottages). The bulk of financial resources went toward new housing construction. Before 1993 only fixed rate loans were offered in the Russian housing finance system, and only thereafter did Sberbank shift to adjustable rate loans.

On the eve of the government’s introduction of a new strategy in 1993 and the commercial banks’ search for their place in this sector, the main features of housing finance can be characterized as follows:

- Rather limited amounts of budgetary resources that could be used to support housing finance, and extremely ineffective use of subsidies.
- High and volatile inflation rates, implying great interest rate risk for long-term lending, because the banking system’s liabilities were heavily concentrated in short-term accounts.
- Possibly grave credit risk associated with housing lending, because of confusion about the enforceability of foreclosure in case of default, legal provisions notwithstanding.

- Extremely low housing affordability, combined with strongly negative real interest rates on deposits because of high inflation, making it impossible for households with average incomes to purchase housing with cash or to accumulate funds for home purchase.

These limitations determined the direction of new government policy in designing the necessary legal framework for the development of long-term housing lending. They also drove the activities of banks in testing the acceptance by the general public of mortgage lending for the construction and purchase of housing.

The new housing financing policy, most comprehensively formulated in the state targeted program “Housing” (summer 1993), became the basis for several legislative and normative documents during 1992–94. Its main provisions were the following:

- Formation of market-oriented, long-term mortgage lending that should lower the risk to banks and increase the affordability of loans for the general public, including the use of mortgage instruments for ensuring loan repayment, the creation of conditions for foreclosure when a borrower fails to fulfill his obligations, and the introduction of alternative lending instruments to be used under conditions of high and variable inflation.
- A shift from subsidized interest payments to a more effective system of targeted support for groups of lower- and middle-income households, in the form of up-front (downpayment) subsidies for construction and purchase of housing.
- Provisions to allow other groups of households that have not accumulated savings and are not eligible for a subsidy to accumulate funds necessary for purchase or construction of housing or for making downpayments on mortgage loans.

Signs of an initial interest on the part of the commercial banks in becoming involved in real estate began to emerge in 1993. Because of the rapid rise of real property prices, including housing, capital investments in real estate became an attractive opportunity, with a profitability that proved to surpass that of investment in securities, commodity production, and other activities. Between 1992 and 1997 the price of housing

rose steadily against the background of a developing housing market. The process was also actively stimulated by the ongoing rapid privatization of housing.

A survey conducted at the end of 1995 by the agency *Investitsii i Nedvizhimost* revealed that more than half of Russian banks were operating on the real estate market to some extent. From that time on, the most popular types of banking operations in this market have been business loans secured by real estate, lending for construction projects, and direct investments. Nevertheless, only several dozen Russian banks made real estate a central part of their activity, and the number declined after the August 1998 crisis. The reason, though, lies in competing investments open to banks outside the real estate sector. Several of those high-profit alternative investment instruments disappeared after the middle of 1998.

Legal Framework

After the dissolution of the Soviet Union in 1991, the Russian Federation initiated active efforts to create the basic legal framework for housing reforms. While the first series of laws was not free from defects, on the whole the legislation enacted between 1991 and 1994 represents a major achievement. The legislative activities after 1994 were driven by the desire of federal and local authorities to implement already existing laws and extend the housing reforms to the areas not covered during the initial phase. By the middle of 1999, the Russian Federation had created a sound legal framework for the formation of a market-based housing sector, including the laws "On Mortgage," "On Registration of Real Estate Rights and Transactions," and "On Homeowners' Associations (Condominiums)." The basic documents that are still needed for the full development of mortgage lending are the Land Code and the comprehensive Housing Codex.

A decisive step in the development of federal law on mortgage lending was the enactment of the new Civil Code of the Russian Federation Part I (1995) and Part II (1996). The Civil Code establishes basic provisions related to the pledging of real estate, including housing, to secure a loan; the right of ownership and other real rights to residential premises; grounds for foreclosure of mortgaged premises; and so forth. The new Civil Code contains basic provisions governing origination and

security of loans and has thus created a favorable environment for the development of every type of entrepreneurial activity. In addition, the Civil Code provided for enactment of special federal laws regarding state registration of real estate rights and transactions and specific features on mortgage (pledge of real estate). To implement this requirement of the Civil Code, the federal law “On State Registration of Real Estate Rights and Transactions” was adopted on July 21, 1997. The new law had a direct bearing on real estate lending activities. Relevant provisions include the following:

- A unified system of state registration of real estate rights and transactions.
- State registration is regarded as sole evidence of the existence of a registered right.
- State registration is required for the right of ownership in real estate, transactions with real estate, and limitations of real estate rights (attachment, mortgage, trust management).

A key piece of legislation enacted in 1998 is the federal law “On Mortgage (Pledge of Real Estate).” The law expands the opportunities for use of a mortgage as a reliable instrument to secure a loan. The principal deficiency of the existing mortgage legislation is that it may not adequately protect the right of lenders to foreclosure on the loan, which certainly increases credit risk. A lender may also encounter serious problems in trying to evict the mortgagoree in case of default on the loan. The problem arises from the contradiction between provisions of the law “On Mortgage (Pledge of Real Estate)” on the one hand and the RSFSR Housing Codex on the other, with respect to the legal implications of nonfulfillment of the obligations under loan and mortgage contracts.¹

These and other laws and regulations created a legal basis that permitted the launch of practical housing mortgage lending operations in Russia, as proved by the experience of several banks. Despite the remaining obstacles of both legal and economic origin, these banks have generally abandoned quasi-mortgage arrangements and are now issuing traditional mortgages (mortgage lending instruments are described below).

Organizations Engaged in Housing Mortgage Lending

Russia has a two-tier banking system formed by the Central Bank and universal commercial banks that have the right to carry out all banking operations. No specialized banking institutions are in place yet, but their creation is under discussion. Players in the mortgage markets are thus represented by universal commercial banks. In mid-1999 few of these banks regarded mortgage lending as a strategic long-term development task.²

Sberbank and its regional branches are the main banking institutions that continue to offer retail services. However, Sberbank has never had any active policy on residential mortgage lending. Some Sberbank regional banks are working to obtain some independence in structuring their own mortgage programs.

An active player in the mortgage market was SBS-AGRO bank, which launched mortgage operations in May 1994 and by 1998 had issued more than 1,700 loans totaling more than \$60 million, with an average loan amount of \$40,000 to \$50,000. Only 20 of those loans were reported to have ended in default. The bank implemented loan origination procedures that followed the “traditional” mortgage. The effort was supported both by the bank’s experience in working with the borrowers and by its desire to improve long-term lending procedures and overcome the limitations of the “lease” mechanisms of securing a loan. (Methods used to finance housing construction and purchase are described in detail in the next section.) Loans were made in rubles and in U.S. dollars for terms up to 10 years. Interest rates ranged from 10 to 23 percent on currency (dollar) loans and were set at the level of the central bank discount rate for ruble loans. The August 1998 crisis left the bank in severe financial trouble, which forced it to suspend origination of mortgages.

The Russian Federation government has sought to promote a national mortgage market, and for this purpose it established a federal Agency for Housing Mortgage Lending in 1997. The primary impetus for the Agency’s creation was the illiquidity of Russian banks and the concentration of their liabilities at the short end of the term distribution. Activities of the Agency during the first two years were aimed at formation and development of the primary mortgage market, as well as the secondary market infrastructure, including development of mortgage lending standards. The Agency intends to buy mortgage loans from

the banks according to standards it establishes. Therefore, the principal functions of the Agency for Housing Mortgage Lending include the following:

- Development and implementation of reliable mortgage lending standards and procedures that the Agency recommends for use by the lenders.
- Assistance to banks and other lending institutions in the introduction of rational mortgage lending practices and design of new loan instruments that are more affordable to the borrowers and less risky to the lenders.
- Formation of the secondary mortgage market through the purchase of mortgage loans originated by banks, and assistance to such banks in addressing liquidity problems.
- Attraction of investors to housing mortgage lending by sale of its own securities backed by the purchased mortgage loans.

The key function of the Agency as the national secondary market facility is to provide liquidity to the commercial banks in Russia that originate long-term housing loans to the households through sale of bonds issued by the Agency to investors. The bonds will carry the guarantee of the Russian Federation government or its local governments. The Agency's securities backed by government guarantees may become an attractive investment instrument, and their issuance will ensure a continuous flow of nonbudget funds to the housing sector.

In addition to the government guarantee, the Agency's bonds will be secured by the following:

- Purchased mortgage loans—that is, real debt obligations, which entail monthly payment of interest and repayment of the principal debt by the borrower.
- Real estate (housing) securing the mortgage loan.

The Agency was established as an open joint-stock company. However, the state exercises control over its activities in the following two ways:

- A controlling package of shares (at the initial stage, 100 percent of the authorized capital).
- Membership in the supervisory board of the Agency.

The Agency for Housing Mortgage Lending is designated to unite the efforts of banks to create and test an optimum model of the housing mortgage market and introduce the most reliable and risk-protected mortgage-lending standards and procedures. The Agency's operations should cover every region of Russia to create channels for a rational redistribution of financial resources, and to reduce the risks by geographic diversification of investments.

In 1999 the Agency launched its pilot project in St. Petersburg. Four banks—in particular, Promstroibank (St. Petersburg), Petrovsky Bank, Baltiysky Bank, and Bank St. Petersburg—were committed to the project. The Agency concluded agreements on refinancing of mortgage loans issued by these banks to the households for purchase of housing. The first five mortgage loans were signed on March 1, 1999, for a total of \$80,180. The size of individual loans ranged from \$6,000 to \$35,000. Interest rates vary from an annual rate of 15 to 18 percent (on a dollar basis). The relatively low interest rate was possible because funds for the pilot come from the Agency's capital and a loan on favorable terms from the U.S.-Russian Investment Fund, an enterprise fund established by the U.S. government.³ Loan term is 3 to 10 years.

The Agency is planning to refinance from 1,000 to 2,000 mortgages issued by St. Petersburg banks. The pilot project will be a test for mortgage-lending procedures and schemes for structuring relations between the Agency and partner banks. In the future, the Agency intends to expand the scope of its loan purchase operations.⁴

While the Agency has not yet moved to the desired position of the key player on the mortgage market, it has made certain progress in dealing with its first two tasks. The Agency's future has been clouded by the reluctance of the Central Bank to give it the necessary banking license. It seems probable that the Agency will begin operations under corporation law provisions in the year 2000 if the license is not obtained. In this case its supervisory agency will be the Russian Securities Commission.

It also should be noted that the city of Moscow created a liquidity facility in 1998. However, after it entered into contracts for mortgage loan refinance, it was unable to honor these commitments because of problems following the August 1998 financial crisis.⁵ Nevertheless, the city continues to assert that it will have a program.

Mortgage Lending

Traditional mortgage lending had become common bank practice by 1998, beginning to displace a number of other “intermediate” financing schemes. In mid-1999 mortgage loans were being originated on the following standard terms:

- A repayment term of three to five (occasionally up to 10) years.
- U.S. dollar-denominated.
- An interest rate of 20 to 30 percent per annum.
- A loan amount not exceeding 70 percent of the collateral value.
- Residential property as a loan security.

Loans are also originated in rubles, but the interest rate on such loans is higher—Moscow Sberbank, for example, provides them at 42 percent per annum. In some other banks the rate varies from 45 to 60 percent per annum.

Generally, the repayment term on mortgage loans is lengthening, and now several banks issue loans for 5 or even 10 years. Traditional mortgages are substantially replacing the lease-purchase scheme described below. The accumulated experience is that risk of default on mortgage loans can be minimized by proper loan underwriting and vigorous loan servicing. Banks consider loans with a variable interest rate that is adjusted to changes in the market price of funds to be best tailored to the current economic environment, significantly lowering the interest rate risk.

Overall loan volume remains low. Because the Central Bank does not collect data on mortgage lending, inferences must be drawn from various surveys. The best estimate appears to be that 10,000 to 15,000 loans per year were being originated nationally before the 1998 financial crisis.

ALTERNATIVE METHODS USED TO FINANCE CONSTRUCTION AND PURCHASE OF HOUSING. During the transition, Russia’s macroeconomic environment has been one that generates low incomes and the accompanying weak effective demand for housing. This has forced market participants to seek some “intermediate” solutions to the problem of raising funds for the development of the housing sector and making housing more affordable. Following is a description of currently avail-

able financing possibilities for home purchase—exclusive of traditional mortgage loans by universal banks.

SHARE PARTICIPATION AND PURCHASE OF HOUSING BY INSTALLMENTS. This method of financing is usually initiated by developers. Russian developers began to use widely the practice of obtaining capital from private individuals by actually suggesting that they purchase housing “by installments” (so-called share participation in construction). The August 1998 financial turmoil and several celebrated legal proceedings initiated by private investors who paid their contribution in advance but failed to obtain housing, though, caused developers to shift to a new finance scheme in which already completed residential units are sold by installments. This scheme implies a payment of 30 to 50 percent of a unit’s cost in advance of construction, with the remaining debt to be repaid within a year or two.

The key disadvantage of this scheme is that only a very limited group of wealthy people find it affordable. Moreover, unlike the lump sum payment scheme, purchase of a unit by installments allows overpricing. In case of a unit under construction, the developer has an incentive to continuously postpone the completion in order to have the chance to use the funds for other investments at zero interest. There is also the risk that construction will not be completed or that its cost will substantially increase over time.

CONSTRUCTION AND HOUSING SAVINGS PROGRAMS. Using the experience accumulated abroad as the basis, several Russian banks (regional branches of the Russian Federation Savings Bank, the SBS-AGRO Bank, and some others) made an attempt to design and introduce various long-term housing savings programs employing a combination of savings and mortgage instruments. Essentially, housing savings programs work as follows:

- A person signs a contract with the bank according to which he is supposed to accumulate within a specified period (more than one year) a certain amount of funds that will be used as a downpayment on a mortgage loan.
- According to the contract, the bank is obliged to extend a mortgage loan to the client for purchase of housing, once all terms of the sav-

ings program and the standard mortgage loan requirements of the bank are met.

The majority of banks consider the option of long-term residential savings accounts as the initial stage of their work with a client, enabling them to collect additional data about his income, paying capacity, and sources of funds. Given the benefit of housing loans and their favorable role in forming analogs of loan repayment histories, some banks are showing considerable interest in housing savings programs and are coming to regard them as an essential attribute of their lending activities. Nevertheless, these schemes still perform an auxiliary role for these reasons:

- Private individuals are reluctant to deposit large sums of money in long-term savings accounts for two key reasons—a continuous growth of inflation (which often implies negative or very low real interest rates) and remaining lack of confidence in banking institutions.
- The public authorities are unable to support housing savings programs and to protect individual deposits in the forms widely used in Germany or France and, more recently, in the Visegrad countries.⁶

Developers have also initiated contacts with banks to work out arrangements for attracting funds to housing construction through special housing savings schemes. A potential buyer should accumulate up to 50 percent of the apartment price in a special savings account during a specified period (from one to two or three years). At the end of that time he acquires the apartment and pays the remaining 50 percent of the price by installments over two to five years. Ownership of the apartment is granted only when the price is paid in full. These schemes are used for specific construction projects. The schemes have all of the shortcomings of the shared participation model.

REGIONAL PROGRAMS BASED ON LOCAL BUDGET RESOURCES. These programs are based on an active role for local self-governments in attracting people's funds for construction, combined with funds from local budgets. The idea of creation of special extra-budgetary funds

to support residential construction has found a limited use in some Russian regions and localities (e.g., Sarov). The key objective of such funds is to use municipal (regional) budgetary funds to finance construction of residential property. Units are to be sold to residents on condition that they agree to sell their previous housing to the fund, often at a below-market price, and to cover the balance in part at their own expense and in part through a loan to be repaid in installments. As a rule, the value of the previous housing covers 50 to 60 percent of the price of the new unit, and the remaining part is repaid through a down-payment (20 to 25 percent) and credit (15 to 30 percent).

Actually, under this scheme the local fund operates as both a developer and a real estate broker, because in fact it organizes a barter trade with a consideration for private individuals who have money and agree to sell their previous housing to the firm, often at a below-market price to the fund.

Several other municipalities and regions (Orenburg, Belgorod, Udmurtia) have implemented a slightly different scheme, which involves subsidized lending for home purchase through off-budget funds. However, such schemes are limited in scale, and they place a heavy burden on the local budgets. Taking into consideration the currently ballooning local budget deficits, this scheme is virtually unfeasible for the majority of Russian localities.

MUNICIPAL HOUSING BONDS. Municipal housing bonds have become a popular form of mobilizing individual and corporate savings for residential construction (in particular, in Moscow, St. Petersburg, Saratov, Ulyanovsk, and some other cities).

Essentially, such bonds are designed to provide an opportunity for residents to gradually accumulate funds necessary to purchase a residential unit by buying housing bonds denominated in square meters (for example, 0.1 square meters of housing floor space). The term of such bonds may be as long as 10 years. Having accumulated the required amount of bonds, a household has to exchange them for an apartment of corresponding floor space, typically located in multifamily buildings constructed on order of the municipality. The value of the bond is determined on the basis of construction cost estimates and is subject to adjustments with changes in the cost of residential construction. If for some reason a bondholder refuses to buy an apartment, he has the right to a refund—that is, his bonds will be repurchased at par.

This scheme of housing finance has the following disadvantages:

- Such housing bonds are not income-bearing securities; their adjustment in accord with the fluctuation in housing construction costs fails to reflect the actual situation on the market; so the bonds are not a well-defined savings instrument.
- These bonds are of interest only to those who wish to purchase housing because they are practically unmarketable and, in addition, they are not able to attract large private investments.
- The proposed schemes fail to offer the clients an option to choose an apartment; the investors can purchase units only in specific buildings, which frequently are buildings that do not meet their requirements.

ENTERPRISE HOUSING PROGRAMS. These programs are also based on the co-finance principle, according to which an enterprise extends a loan to an employee in the amount of 70 to 80 percent of the full cost of a purchased residential unit, and the remaining 20 to 30 percent is covered by the employee's downpayment. As a rule, these are long-term loans offered for an extended term (up to 10 to 15 years), free of interest, with the option of partial or even complete writing-off of the debt.

If an enterprise has its own construction capacity, it can sell the housing it has constructed to its employees at the construction cost, or with a proviso that the employee pay 20 to 40 percent of the cost and that the balance will be paid by the enterprise out of its own resources. Obviously, such programs can be implemented only by financially healthy enterprises that are keenly interested in keeping their personnel. Frequently purchase of enterprise housing on subsidized terms carries an obligation for the purchaser to work for this enterprise for a fixed period of time.

LEASE-PURCHASE LOANS. Starting in 1994, several commercial banks began to develop and launch their own programs of residential mortgage lending. Initially, banks, like financially sound enterprises, extended subsidized loans only to their employees or to their most valued clients. Such loans can hardly be called real market instruments. Moreover their objective was to settle particular problems (to keep personnel and most valued clients), rather than to tackle a major task of further expanding and diversifying the banking market. As financial capabilities of com-

mercial banks have grown stronger, their interest in retail mortgage lending as a field for dynamic activity has increased. As noted, the substantial credit risk surrounding residential mortgage lending in Russia has been associated with the uncertainty of foreclosure and eviction in the event of loan default.

As a consequence of credit risk, in 1995–98 the most widely used lending scheme was the so-called “lease-purchase agreement.” The main provisions of this scheme are as follows:

- The bank originates a loan not to a client but to the bank subsidiary realty company, which purchases a residential unit for the client.
- The client signs a lease agreement with the realty company with a provision that the client will eventually purchase the rented unit and pay 30 to 40 percent of the purchase price out of his own resources (with this payment documented as a first rent payment).
- During the entire lease period, the unit is owned by the realty company, thus allowing the bank to secure its bank interest in the event of the client’s failure to make payments.

In the event of default, the unit can be sold without the borrower’s consent, and the sale proceeds will be returned to the bank. Under this scheme, the settlement with the borrower is quite strict; a significant part of the funds he paid to purchase a unit, but formally just to rent it, are often not paid back to him. The client’s rights are also left unprotected in the event of a foreclosure, or in the event of the bank’s bankruptcy. This type of lending has been found legally deficient; a series of court proceedings have declared lease-purchase transactions null and void because they conceal lending operations.

Simultaneously with this scheme some commercial banks launched traditional residential mortgage lending programs concluding two types of agreements with a borrower—a loan document (note) and a mortgage agreement. Compared with the lease-purchase scheme, traditional mortgage loans are seen as a step forward in the direction of a civilized market for banking operations.

The foregoing shows the kinds of attempts various actors in the housing market have made to mobilize household savings for financing the residential property sector using a variety of schemes, even extraordinary ones. The common drawback of all these schemes (with the exception of bank mortgage programs) is their fundamentally limited nature.

For this reason, they cannot serve as a basis for the strategic development of housing finance, and their importance is limited to addressing local problems arising at certain development phases.

However, a breakthrough in attracting household savings to the housing market may be achieved if a systemic approach to residential mortgage lending is adopted at the federal government level. Without it, sporadic attempts to address the issue will be nipped in the bud by the adverse economic forces and inadequate legislative and regulatory support of the mortgage lending process.

Government Support of Homeownership

Development of a Housing Subsidies System

In the Soviet Union, improvement of the system of subsidizing home purchase or construction was not on the agenda because the dominating share of housing was constructed and allocated at the expense of the state budget (the exception being some housing in the rural areas, and summer cottages). Consequently, all housing programs were based on the key role of the state as the biggest owner and the real master of the real estate sector.

The first wide-scale housing program, naturally with direct participation of the state, was implemented in the period 1955–65. As a result of this program, housing construction nearly doubled and reached 54.9 million square meters per year. Substantial improvement was achieved in the living conditions of millions of people who had resided in dilapidated housing without modern conveniences. However, in a nonmarket economy the stepped-up volume of housing construction could not be achieved without damage to other features of the housing construction sector. Indeed, higher construction volumes were accompanied by a lowering of the quality of construction. This result was by design—the housing built during this period was intended to have a maximum service life of 20 years because the state expected to be able to provide better-quality housing in 20 years. In reality, even 30 years later the newer housing was not in place, but the buildings of 1955–65 had worn down to a hazardous state.

The second major phase of Soviet housing policy changes was a 1985–2000 housing program that was slated to provide every family

with an individual apartment or house. Also, elimination of the disparity in the size and quality of housing available in different regions was seen as an important social task. While state capital investment continued its priority role, housing cooperatives using members' savings, and individual housing in the rural areas and in small towns and settlements, saw substantial development.

The result of the measures taken by the state was the highest volume of housing commissions in the Soviet Union and Russia (table 3.16).

The figures show that the 1987 peak (which was achieved in part through increased individual housing construction) was followed by stagnation and decline. To sustain such high production, fundamental changes had to be made in the system, which, in addition to prohibiting individual housing construction in cities with more than 100,000 residents for many years, created obstacles for individual developers in getting land, building materials, and loans.

The characteristics of the early 1990s were the lack of market institutions along with speedy withdrawal of the state from housing construction finance, underestimation of the importance of the housing sector in the macroeconomic restructuring process, and the crisis in housing production caused by these factors. As shown earlier, the annual volume of housing construction dropped as the prices for the housing products shot up. Capital investments by the state, enterprises, and organizations allocated for implementation of social programs were cut, and as a result the rate at which housing was allocated to those on the waiting lists slowed down.

This situation increased the urgency of the problems the state had to address. To avoid outbreaks of social tension, the state had to act quickly to formulate new policy principles for the support of housing construction and provision of housing to the most needy citizens. Fundamental

Table 3.16 *Total Housing Space Completed in the Russian Federation Using All Sources of Finance*

| <i>Indicator</i> | <i>Year</i> | | | |
|---|-------------|-------------|-------------|-------------|
| | <i>1986</i> | <i>1987</i> | <i>1988</i> | <i>1989</i> |
| Completed housing (millions of square meters) | 66.2 | 72.8 | 72.3 | 70.4 |

Source: *Russia in Figures* (1999).

changes in the functions and role of the state in housing sector finance began with enactment in July 1991 of the law "On Privatization of Housing Stock in the RSFSR," a critically important political initiative that gave impetus to the reorientation of the housing sector toward market principles. The next step was the law "On the Fundamentals of Federal Housing Policy," passed in December 1992, which obligated the local authorities to allocate land for housing construction to private individuals and developers, following the local urban development plans. The law gave every individual the right to take a mortgage for construction or purchase of housing, and, most important, the right to a subsidy if the housing was acquired in the market (under certain conditions) by those on the waiting list for better housing.

With respect to the policy for housing finance early in the transition, in the first half of 1992 the government turned to the problem of accelerating inflation that made the 3 percent long-term loans of the Soviet era unviable. But the state still wanted to provide low-cost finance by subsidizing interest rates on fixed rate housing loans. These subsidies were intended to keep housing affordable to the people. Two examples illustrate the government's inclination toward large-size subsidies during the initial period of reforms. First, all households who had begun construction of cooperative housing before January 1992 were granted subsidies to compensate for 70 percent of the increase in construction cost or loan interest rates. It was expected that respective expenditures would be shared by federal and regional governments.

Second, according to an agreement among the Finance Ministry, the Central Bank, and Sberbank that came into force in April 1992, Sberbank launched a lending program for the development of farm, individual, and cooperative housing construction, with the loan rate set at 20 percent annually, of which 8 percentage points were to be paid by the borrower and the remaining 12 percentage points by the federal budget. Whereas these loans were profitable to Sberbank in the spring and summer of 1992, close to year-end the bank forecast major losses in 1993 as a result of higher interest rates payable on deposits. Subsidizing of these loans in 1993 amounted to about 55 billion rubles (or \$96 million at the exchange rate at the beginning of 1993); but one should note that the money was paid to Sberbank by the government of Russia only with substantial delays. For this reason, the subsidies were revoked and Sberbank started to issue adjustable rate loans.⁷

Subsidies in both of these programs were nontargeted, and no eligibility restrictions were imposed on the borrowers in connection with household income, occupied housing, or other parameters. Indeed, a rich Muscovite who had acquired an apartment for free through the privatization program could have gotten a Sberbank loan. Apparently the decision to implement these programs was not backed by any analysis of the aggregate cost of subsidies.

The first official document that clearly formulated the new directions of the state housing policy was the city of Moscow's reform program developed in 1992. The program contained the following basic provisions:

- Activities aimed at promoting construction in the immediate future should be governed by three principles:
 - Given the restricted financing available for the construction of new municipal rental housing, all newly constructed apartments or a major portion of them should be earmarked for sale.
 - Subsidizing of new construction should be in the form of a one-time (partial) payment for the cost of the unit purchased or the downpayment under a mortgage loan. The amount of subsidy should be tied to total household income. The amounts of subsidies should be paid directly to the households, rather than to developers or construction companies. Effective support to developers may be provided by means of construction loans, and guaranteed availability of mortgage loans for the purchase of completed units.
 - In order to increase effective demand for new housing, affordable mortgage loans on reasonable terms should be made available to the population, but lenders should refrain from subsidizing of interest rates on the loans.
- Every possible effort should be made to demonopolize the housing construction industry.
- Subsidies intended to promote new construction should go exclusively to housing buyers, because of the following:
 - The experience of different countries shows that it is more efficient to allocate subsidies directly to units, rather than to construction companies or developers. Very often the subsidies given to the builders fail to reach the buyers in the form of lower prices. Rather, the subsidies permit developers to increase profits or

lower efficiency. Subsidies to developers give rise to another problem: The assistance is provided equally to all buyers, rather than to the poorest households in need of better housing.

- If the subsidies are provided to housing buyers, builders will be forced to produce the housing that better satisfies consumer needs.
- The subsidies should be given as a one-time payment of a specified amount for full or partial coverage of the cost of the purchased unit or downpayment under a mortgage loan; the money should be remitted in full at the time of purchase or construction of a housing unit. The advantages of such subsidy (compared with subsidizing interest rates under housing loans) are evident: First of all, it offers both the recipient and the government a simple procedure for setting the amount of subsidy, and second, the household gets maximum assistance at the time it acquires the housing.
- The subsidies should be given only to households registered as needing improved housing, not to households that have already acquired an adequate unit. The amount of subsidy should be bigger for households with lower income and those who spent more time on the waiting list for housing.⁸

In the summer of 1993, the Russian government approved the federal targeted program “Housing,” which marked a shift from subsidizing housing construction, characterized by extremely low efficiency, to demand-side subsidies. The state initiated the introduction of new and more efficient subsidies that could assure the flow of nonbudget funds into the housing sector and create additional opportunities for reversing the trend of falling effective demand for housing. The program provided for several tax benefits to the companies that invested in housing construction. On the whole, the “Housing” program substantially strengthened and sharpened the policy directions reflected in several laws passed during 1991–92. However, the document did not state whether the ultimate purpose of the program was promotion of housing construction in general, which requires that small amounts of subsidies be paid to those who need modest assistance to purchase the housing, or an increase in the volume of housing constructed for moderate- and low-income households, which would entail substantial subsidies, and consequently construction of a smaller number of new apartments.

From that time on, federal investments in the housing sector have been made mainly within the framework of this program. Outside of the program, direct federal financing of housing construction for the military was made from the defense budget, and the housing construction cooperatives were compensated for the increase in construction costs as a separate expense budget item.

By way of elaborating the “Housing” program, in December 1993 the Russian Federation government passed the resolution “On Allocation of Gratuitous Subsidies for Construction and Purchase of Housing to Citizens of the Russian Federation in Need of Improving Their Housing Conditions.” Its key provision was the introduction of a new type of subsidy for the construction and purchase of housing as a regular program that incorporated the positive experience accumulated in this area through a pilot program. The subsidy could be provided only to citizens registered on the waiting list for free housing allocation. The amount of subsidy was based on the price of a unit of a specified size (floor space) for a household of specified size (i.e., “social standard of housing space” for a household). The amount of the subsidy ranged from 5 to 70 percent of the price of housing meeting this standard, with higher amounts payable to lower-income households and those who had spent more time on the waiting list. The resolution also advised regional and municipal authorities to use this approach to subsidize construction and purchase of housing, while leaving them the right to independently define the parameters of their subsidy programs.

Table 3.17 gives an example of subsidy calculation (as a percentage of the price of a unit meeting the relevant social standard) depending on the household size, aggregate income, and time spent on the waiting list.

This scheme gave a better understanding of the purpose of the subsidy program—assistance to moderate-income households. The authors acted on the assumption that lower-income households could expect to be given a municipal apartment, while households with higher income would take care of themselves.

This provision, initially stated in the December 1993 resolution, was reiterated in the resolution under the same name that was adopted in 1996 (No. 937 on August 3, 1996). The government adopted this approach aimed at reducing budget funds spent by the local administrations for direct financing of housing constructed for free-of-charge allocation to those on the waiting list and for subsidizing interest payments under concessional loans. Instead, the national government initi-

Table 3.17 Determination of Lump-Sum Subsidy as a Percentage of House Price

| Ratio of per capita household income to the minimum wage amount | Number of complete years passed from the date of registration on a municipal list of households in need of better housing conditions | | | | | | | | | | | | | | | |
|--|---|----|----|----|----|----|----|----|----|----|----|----|----|----|----|------------|
| | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 or more |
| 4 and less | 64 | 66 | 68 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 |
| 5 | 60 | 62 | 64 | 66 | 68 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 | 70 |
| 10 | 40 | 42 | 44 | 43 | 48 | 50 | 52 | 54 | 56 | 58 | 60 | 62 | 64 | 66 | 68 | 70 |
| 15 | 20 | 22 | 24 | 26 | 28 | 30 | 32 | 34 | 36 | 38 | 40 | 42 | 44 | 46 | 48 | 50 |
| 19 | 5 | 6 | 8 | 10 | 12 | 14 | 16 | 18 | 20 | 22 | 24 | 26 | 28 | 30 | 32 | 34 |
| 20 and more | 5 | 5 | 5 | 6 | 8 | 10 | 12 | 14 | 16 | 18 | 20 | 22 | 24 | 26 | 28 | 30 |

ated the transition to allocating of subsidies to support effective demand for housing, which in turn would support construction. In June 1994, the Russian Federation president signed the decree “On Housing Loans,” which officially confirmed the policy shift from interest rate subsidies to the use of commercial loans for construction and purchase of housing on a commercial basis. The decree stressed that state financial assistance would be provided to eligible households in the form of a downpayment subsidy.

Demand-side subsidies for purchase or construction of housing are the most efficient form of state investment in the housing sector. Compared with support of housing supply by financing construction companies, or interest rate subsidies under long-term concessional loans, they have several advantages:

- *Freedom of choice for the consumer.* Having the money that can be spent exclusively for construction or purchase of housing, subsidy recipients are free to choose the best way to address their housing problem. Given such choice, they will acquire housing that better meets their needs rather than take whatever they are given under the municipal waiting list. For example, those who prefer a small cottage in the suburbs to a unit in a multifamily residential building can buy or build such a cottage.
- *Faster economic effect.* Because of the freedom of choice provided by such subsidies, recipients can buy available units on the market in addition to acquiring new housing.
- *Similar or lower economic costs.* It has been argued on occasion that the state (budgetary) financing of construction is less costly because the developer does not have to pay interest on the funds used during the construction period. However, the advantage is illusory. Under this arrangement, it is the state that ultimately borrows the funds to cover a budget deficit and pays interest for use of the funds. Consequently, the total construction costs are the same in case of both construction period finance and subsidizing, given that developers have the same efficiency. In reality, developers who use state (interest-free) funds are more likely to be less efficient. Because other developers have to pay for attracted funds, those who use interest-free funds have an evident advantage in terms of construction costs. Such companies tend to become less efficient because they do not feel the pressure to be efficient: Both

efficient and inefficient operators can set the same market price for their products. The argument that a “unified” customer can exercise real control over the costs and prices of the companies that have interest-free financing is not convincing, as has been proved by experience internationally.

- *Subsidies are cheaper for the state.* In the case of construction period finance, the state bears all expenses for providing housing to the people in need of improving their living conditions. In contrast, for downpayment subsidies, recipients cover a portion of the apartment cost (depending on the amount of subsidy, the contribution may vary from 30 to 95 percent of the price of the purchased unit). As a result, given equal amounts of available budgetary funds, the construction finance mechanism will provide housing to a smaller number of households than the upfront subsidies.
- *Simple calculations.* The amount of such subsidy is understandable for both the government and the recipients, unlike the interest rate subsidies and several other types of subsidies related to savings deposits schemes.
- *Definite budget.* Because the subsidies are easy to calculate, it is just as easy to make annual adjustments to the total subsidy budget—which cannot be said of some other types of subsidies that obligate the state to make annual payments for many years or direct allocations for origination of the loans. Moreover, downpayment subsidies have a clearly defined budget position, and the Federation Council (upper house of parliament) makes annual decisions on the program budget as a normal procedure.
- *Social targeting of the subsidies.* Because the amount of subsidy should be equal for borrowers with the same income and time spent on the waiting list, this program meets the requirements of horizontal equity. It also directs greater subsidies to lower-income families.
- *Co-financing options.* The subsidy recipient can use every opportunity to raise additional funds (personal savings or a bank mortgage) for the construction or purchase of housing.
- *Improved efficiency of construction.* The subsidy recipients can choose the housing that offers the best combination of quality, location, and price. Because the subsidy covers only a portion of the price, and the remainder has to be provided by the buyer, whose contribution will be lower for a cheaper unit, there is a strong

incentive for the subsidy recipient to seek the best price/quality combination. Developers who offer better housing will have a stronger position on the market. With time this will make inefficient developers turn to better projects or leave the business.

- *Immediate ownership.* Housing constructed for free-of-charge allocation to households on the municipal waiting list is provided under a *naim* (social housing) contract, with the right to apply for privatization. By contrast, under the downpayment subsidies program recipients acquire ownership of the apartment from the moment they sign the purchase contract.
- *Uncertainty.* And finally, Russian banks had their own reasons for refusing to participate in interest rate subsidy programs. According to established procedures, the budget for the subsidies is approved on an annual basis, which made the banks especially vulnerable to policy changes and fluctuations in market interest rates. Moreover, there have been numerous cases of incomplete remittance of state funds—in particular to Sberbank.

Current Subsidy Programs

The evolution of housing subsidies was outlined above. This section describes current subsidies in greater detail.

Rental Municipal Housing Allocated Free of Charge

Despite the end of the old socialist housing system, one of the major forms of housing subsidies is still direct financing of residential construction from federal and local budgets, with the allocation of new and vacant existing units to people from the waiting lists. The traditional policy of the state and municipalities in solving housing problems of people was to provide them with poor-quality and small units. The annual allocation of such municipal units has decreased markedly since 1990—by nearly 75 percent, from 1.3 million in 1990 to 344,000 in 1998. Some people from the waiting lists (it is difficult to estimate the exact number) also improve their housing conditions and are removed from the waiting lists after a change in their demographic situation. For example, the family size may decrease as a result of divorce, death, and other factors. According to current practices, a household can be registered on

a municipal list of families who need better housing conditions if the size of its unit is less than a normative minimum area per person (it also depends on the number of people in the unit). Chances to get an apartment through such a mechanism do not depend on the household income. However, there is no reason for waiting more than 10 years (if rates of providing free housing stay at the current level) for households who have other ways to improve their housing situation.

Table 3.18 and figure 3.4 give an idea of the results of this program in recent years. The dramatic decline in units allocated is evident. Interestingly, the number of households on the waiting list has declined by about one-third over the same period. This appears to be mostly a result of families solving their housing problems by themselves.

Regional and Municipal Up-Front Subsidies

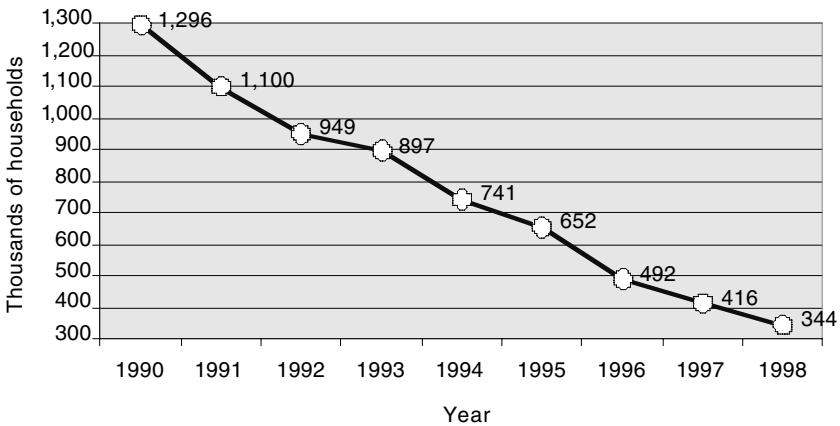
The chief alternative to the municipal construction and allocation program has been a lump-sum (up-front) subsidy scheme. There are two

Table 3.18 *Number of Households Who Received Free Housing Units, 1990–98*

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-------|--------|-------|-------|-------|-------|-------|-------|-------|
| Number of households who received free housing units, per year | | | | | | | | | |
| Thousands | 1,296 | 1,100 | 948 | 897 | 741 | 652 | 492 | 416 | 344 |
| Percentage of the number of households registered on the waiting lists | 14 | 11 | 10 | 9 | 8 | 8 | 6 | 6 | 5 |
| Number of households registered on the waiting lists | | | | | | | | | |
| Thousands | 9,964 | 10,029 | 9,646 | 9,104 | 8,467 | 7,698 | 7,248 | 6,760 | 6,286 |
| Percentage of the total number of households and singles | 20 | 20 | 19 | 18 | 17 | 15 | 14 | 13 | 13 |

Sources: *Russian Statistical Yearbook* (1998); *Russia in Figures* (1999).

Figure 3.4 *Providing of People on the Waiting Lists with Free Housing Units in Russian Federation, 1990–98 (thousands of households per year)*



Source: *Russian Statistical Yearbook* (1998); *Russia in Figures* (1999).

levels of lump-sum housing subsidies in Russia, one from the municipal administrations and the other from the federation government. This type of subsidizing home purchase in the market is being used in many Russian cities (according to different estimates, from 10 to 30 percent of municipalities), but the volumes of such subsidies remain small. Municipalities have the right to introduce the terms of housing subsidies provided, or to start their own programs with different mechanisms. However, most municipalities use the parameters of the general scheme developed at the federal level, described above.

In 1994–95 the Nizhny Novgorod region was used as a site for launching a pilot program of payment of lump-sum subsidies to retired servicemen from the federal budget. In October–November 1994 (the first phase of the program) subsidies were paid to 750 of 4,000 eligible households residing in the Nizhny Novgorod region. By September 1995, the subsidized households purchased new apartments either in already constructed buildings or in partly completed multifamily buildings whose construction was at least 70 percent completed. Some officers used their own savings to augment the funds available for the purchase. Some, after assessment of their creditworthiness, received long-term “top up” loans from banks involved in implementation of the pilot program.

Over the period of program implementation—that is, starting from the moment of opening until the moment of the closing of frozen (unused) targeted accounts—the six authorized banks transferred nearly 35 billion rubles (about U.S. \$10 million). The total amount of bank loans extended to servicemen (in all, eight loans) made up nearly 54 million rubles (\$15,200). The key objectives of the program were attained—namely, to reduce the time required for a household to settle its housing problem, to make better use of budgetary resources, and to ensure the consistency of federal budget allocations with their designated purpose.

Beginning in 1995, other regions (e.g., Moscow and St. Petersburg) initiated their own housing subsidy programs covering various groups of eligible households. The greatest advance in this area was made by Moscow authorities. They started to provide subsidies ranging in amount from 5 to 75 percent of the cost of a purchased unit meeting minimum social standards to households registered as needing to improve their living conditions. Nearly 50,000 households expressed their wish to receive these subsidies. This is far short of the 450,000 households (15 percent of Moscow residents) who, according to the Moscow government data, were not able to solve their housing problems with their own resources, but the city budget does not have enough funds to pay subsidies to all applicants. For example, in 1997 the city spent more than 200 billion rubles (almost \$34 million) for this purpose. Considering that the cost then of standard housing in Moscow was approximately \$600 per square meter, and the average unit purchased by households had floor space not exceeding 50 to 60 square meters, the allocated amount was sufficient to assist no more than 2,000 to 2,500 households. During 1996–98 the mean subsidy was about \$17,000. Similar program levels were expected in 1999 and 2000. Simultaneously, Moscow authorities are pinning their hopes on a possible new mortgage program that, if successful, would significantly extend the financial capacities of households. (It is interesting to note that according to the data available, subsidies are paid to households who originally registered as needing to improve their living conditions before 1989.)

On the whole, however, the practice of subsidizing of individual households willing to purchase housing failed to enjoy wide application throughout Russia. This was mostly because of scarcity of local funds, in general, and unwillingness of some local officials to try the new approach.

Federal Housing Subsidies

The second level of housing subsidies are those issued by federal authorities based on the special laws and financed with federal money. Table 3.19 lists principal areas of federal budget financial assistance to households in construction or purchase of housing in 1999 that have been developed and implemented to differing degrees. As can be seen from the names of subprograms, they addressed the housing problems of a

Table 3.19 *Areas of Financial Assistance for Construction and Purchase of Housing at the Expense of the Federal Budget*

| <i>Subsidy Description</i> | <i>Subsidy Type</i> |
|---|----------------------------|
| 1. Subsidies to citizens having an employment record or residing in the Far North and regions of equal status for at least 15 years, with no housing in other regions of the Russian Federation. | Up-front payment |
| 2. Assistance to citizens who have lost housing as a result of extraordinary circumstances or natural disasters (according to the lists provided by the Emergencies Ministry of Russia and executive authorities of the territory in which such circumstances took place). | Free municipal housing |
| 3. Subsidies to permanent residents of Kizel, Gubakha, Greymachinsk, and Chusovaya dismissed during 1995–98 from coal mining enterprises in those cities with a record of working in the mining industry for at least five years and registered in the local employment agencies of those cities. | Up-front payment |
| 4. Subsidies to citizens of the Russian Federation officially recognized as forced migrants who need better housing but have not used benefits in constructing (buying) a unit that comes with the status of a forced migrant. | Interest-free 10-year loan |
| 5. Subsidies to retired military officers with at least 10 calendar years of service who have no permanent residence in the territory of the Russian Federation or abroad and are officially recognized as needing improvement of their housing conditions; and to citizens subject to resettlement from closed military units. | Up-front payment |

specified population category in which the state had duties to fulfill under various laws.

Most of the subsidies shown in table 3.19 are lump-sum subsidies that in some instances reach 100 percent of the market value of a standard unit in Russia (within social norms of housing per person). One exception is subsidies to forced migrants (number 4 in the table), which are given in the form of interest-free loans. The second exception is program number 2 in the table; in this case the selected group of people are provided with apartments from the municipal housing stock. But even for this category of assistance, downpayment vouchers have been used on occasion—for example, vouchers were given to families on Sakhalin Island in Russia's Far East whose units were destroyed by a devastating earthquake in 1997. The vouchers could be used anywhere in the country.

Federal Budget Up-Front Subsidies

The biggest up-front housing subsidies program financed by the federal budget is the program of issuing housing purchase vouchers for retiring military officers. These subsidies are granted by transfer from the federal treasury through the local branch of Sberbank to the personal blocked account of the recipient, and then to the housing unit seller's account. The subsidy is established with regard to the duration of service (from 10 to 25 years, 80 percent; more than 25 years, 100 percent). The place of the new residence may be any place within the territory of the Russian Federation. The voucher can be used only to buy an already completed unit on the market, but it may be either newly constructed or already existing.

Another similar program is for migrants from the Far North regions. According to the subsidy mechanism, they are given a guarantee letter issued by respective executive authorities of the subject of the Federation (equivalent to a U.S. state), which states the total housing space qualifying for the subsidy, household size, and the amount of subsidy (from 80 to 100 percent of the housing price depending on the years of service). The subsidy is not paid to the recipient in cash, but transferred from the Ministry of Finance to the regional administration and then to the appropriate developer (seller) against housing construction or a purchase contract. This transferring mechanism is different from the military program and is considered less efficient.

All programs from the federal budget appear to have a common deficiency: Their eligibility criteria do not include the level of household income. As a consequence, the programs fail to establish the relationship between a decision to pay a subsidy and the financial status of a household. However, the reason for this is compelling: These obligations are supposed to be fulfilled by the government by law in any event, no matter what the financial status of an eligible household.

The Putin government in March 2000 adopted a middle-term housing policy, which reaffirms the continued shift to downpayment subsidies. It also calls for uniform and strengthened program administration.⁹

Interest-Free Loans

Interest-free loans using federal budget resources are provided to citizens officially recognized as forced migrants who need better housing. This program is quite small and payments from the Ministry of Finance are erratic. Forced migrants are granted a long-term (up to 10 years) interest-free loan in the amount of the full cost of either constructed or renovated housing within the social standard. The amount of the loan may not exceed actual costs of the purchased (constructed or renovated) housing. The local agency of the Russian Migration Service issues instructions to the branch of Sberbank that maintains the accounts for the program. The loan money is placed into personal blocked targeted accounts that the borrowers have opened with Sberbank. The borrowers must provide appropriate documents for the purchase of construction works performed within two weeks to get permission to use the loan funds. In an environment of high inflation, the present value of loan repayments will be very low and possibly negative once loan servicing costs are taken into account.

Tax Subsidies

Along with direct subsidies, several indirect subsidies are used in Russia. The largest is the deduction of the purchase cost of new or existing units or housing construction, as well as mortgage loan payments, from income tax for a period of up to three years. An amendment to the tax law of December 1993 established the maximum amount that may be deducted from income as an amount equivalent to 500 minimum

monthly wages; in 1994, this amounted to 8 million rubles (or a little more than \$5,000 at the exchange rate at the beginning of 1994). The income tax rates in 1994 ranged from 12 percent a year for an annual income below 3 million rubles, up to 30 percent for an annual income exceeding 10 million rubles. The maximum tax-exempt sum was lower than the minimum cost of housing, but the progressive scale provides higher benefits to households with higher incomes.

In March 1995 the government enacted amendments that increased the total volume of benefits to an amount equivalent to 5,000 minimum monthly wages. In January 1997, it was established that the benefit may be granted only once. In the first half of 1998 the maximum sum equaled 417,000 rubles, or about \$65,000, but by December the dollar value had fallen to \$20,000 after the crash of the ruble. At the same time, there was a significant decrease—about 30 percent—in the prices of housing in dollar terms.

These subsidies are granted not only for new housing but also for existing houses. But new units and units purchased with a loan receive a distinct advantage: The deductions can be taken over three years, whereas only a one-year deduction is allowed for the cost of a unit purchased with cash.

The total number of housing transactions (including home purchases and housing self-construction) can be estimated at the level of 400,000 to 500,000 per year (there are no official statistics). If one assumes an average price of \$11,000 (the low value is explained by the fact that many renter households are using the deduction for summer homes), the stock of deductions created each year would be around \$5.5 billion. Because the maximum income tax for Russians is currently 35 percent, one might assume an average rate of 20 percent. Under these assumptions, the tax subsidies cost to the budget would be as much as \$1.1 billion per year.

This estimate, however, is more than the upper limit. It assumes that the annual income of purchasers of new units is at least one-third of the purchase price and that the annual income of purchasers of existing units is as high as the purchase price. It also assumes very high incomes for all purchasers—as demonstrated below, most households face a tax rate of 12 percent. Additionally, most households have their tax returns filed on a pro forma basis by their primary employer. To adjust the standard tax return requires visits to the tax inspection offices, which could result in a comprehensive review of the household's tax liability. More-

over, people have to know about this deduction. For these reasons one could probably assume that the tax revenue loss is not more than 35 to 40 percent of the nominal amount. But \$385 to \$440 million is still a great deal of money in the budget of the Russian Federation.

Besides housing purchase transactions, capital gains from the sale of housing are also exempted from income tax. Since 1994, amounts received from the sale of residential units, family houses, or land plots are exempt if they do not exceed the amount of 5,000 minimum monthly wages (near \$20,000 at the ruble exchange rate of the second half of 1998).

This subsidy was addressed in the Putin government's proposal for reform of the personal income tax sent to the State Duma in June 2000. The proposal calls for a single 13 percent tax rate, versus rates now ranging from 12 to 35 percent. But in exchange for the lower rates, nearly all deductions, including the home purchase deduction, would be eliminated.

Another type of indirect subsidy of the housing sector is a reduced VAT rate for construction companies involved in new housing construction projects with more than a 40 percent share of state participation (this provision does not apply to self-construction). However, the new Tax Code (Part II), which has been signed by President Putin and will be enforced after January 1, 2001, has reduced this provision.

Financial Performance of Subsidy Programs

Russian housing subsidy programs are very resistant to financial analysis. The main problem is that information is not available on programs' financial outcomes. There are two main reasons for this. First, the monitoring procedures used for budget-supported programs of the federal government do not trace the actual flow of funds at various stages. The problem is further complicated by the fact that most subsidy programs have multiple sources of finance, implying use of federal, subfederal, and local budgets. Second, official authorities are often not interested in establishing a really effective control over the performance of subsidy programs, because many such programs are only partially funded and the broad access of the public to authentic financial statements might create serious complications for authorities.

Given these limitations, the financial analysis of the Russian Federation programs of housing subsidies in this chapter is based exclusively on broad data—the only available information about them. Under cur-

rent legislation the burden of financial support to eligible households is placed chiefly on local governments, which are advised to use their own revenues for payment of downpayment subsidies, operating subsidies on municipal housing, housing allowances, and other programs.

Analysis of the actual financial performance of different federal and subfederal housing subsidy programs is hardly possible because one of the most serious problems of the transition period in Russia is the complicated access to real indicators of public spending. Such numbers may also contradict each other because the federal budget was constantly sequestered during 1992–98. So the relation between the official budget contained in the legislation passed by the State Duma and actual spending is often unclear. Therefore, the financial evaluation of government efforts in terms of homeownership subsidies is based on the official budget (table 3.20). For certain these figures give the upper limits for government spending in the sector.

Analysis of the data in table 3.20 shows that total federal housing spending was 0.41 percent of GDP in 1996 and was cut to about one-third of this level by 1999. Of the funds available, an increasing majority has gone for retired military officers—initially for new construction and later for downpayment subsidies. The most significant decreases came in subsidies for liquidators of the Chernobyl accident; compensation for inflated construction costs for buildings started by housing cooperatives and youth housing cooperatives before January 1, 1992; and other expenses for housing construction in compliance with Russian Federation presidential decrees and government resolutions. Smaller cuts occurred in housing construction and housing mobility subsidies for migrants from the Far North or similar regions and interest-free housing loans for refugees and forced migrants.

The critical point is the clear shift of the federal housing expenditures from the direct financing of housing construction for several selected groups to demand-side subsidies of the same groups. For example, demand-side subsidies to migrants from the Far North or similar regions increased from 12.6 percent of the total in 1996 to 19.1 percent in 1999. Demand-side subsidies also increased, in roughly the same proportion, in the assistance provided to retiring and retired servicemen of the Defense Ministry and the Interior Ministry and their households.¹⁰

The decrease in absolute and relative volumes of interest-free housing loans for refugees and forced migrants can be explained by the absence of effective administrative mechanisms for the program. In reality this

Table 3.20 *Distribution of Russian Federation Federal Budget Funds Allocated to Housing Subsidies, 1996–99*

| Program Components | 1996 | | | 1997 | | | 1998 | | | 1999 | | |
|---|----------------|-----------------------|---------------|----------------|-----------------------|---------------|-----------------|-----------------------|---------------|-----------------|-----------------------|---------------|
| | Billion Rubles | % of the Total Volume | % of GDP × 10 | Billion Rubles | % of the Total Volume | % of GDP × 10 | Million Rubles* | % of the Total Volume | % of GDP × 10 | Million Rubles* | % of the Total Volume | % of GDP × 10 |
| Total funds allocated | 9,494.2 | 100 | 4.13 | 6,525.3 | 100 | 2.39 | 4,446.6 | 100 | 1.57 | 6,271.0 | 100 | 1.57 |
| Downpayment subsidies to migrants from Far North or similar regions | 1,200.0 | 12.6 | 0.52 | 400.0 | 6.1 | 0.15 | 1,200.0 | 27.0 | 0.42 | 1,200.0 | 19.1 | 0.30 |
| Housing construction for migrants from Far North or similar regions | 143.0 | 1.5 | 0.06 | 224.0 | 3.4 | 0.08 | 102.8 | 2.3 | 0.04 | 110.0 | 1.8 | 0.03 |
| Interest-free housing loans to refugees and forced migrants | 450.0 | 4.7 | 0.20 | — | — | — | 15.9 | 0.4 | 0.01 | 200.0 | 3.2 | 0.05 |
| Downpayment subsidies (including housing construction) for retiring and retired servicemen of Defense Ministry, | 4,770.4 | 50.2 | 2.08 | 3,985.8 | 61.1 | 1.46 | 2,100.0 | 47.2 | 0.74 | 4,500.0 | 71.8 | 1.13 |

| | | | | | | | | | | | | |
|---|---------|------|------|-------|------|------|-------|-----|------|-------|-----|------|
| Interior Ministry, and their households | 538.0 | 5.7 | 0.23 | 200.0 | 3.1 | 0.07 | 297.2 | 6.7 | 0.10 | 100.0 | 1.6 | 0.03 |
| Housing subsidies for liquidators of Chernobyl accident consequences | 986.8 | 10.4 | 0.43 | 965.0 | 14.8 | 0.35 | 308.6 | 6.9 | 0.11 | — | — | — |
| Compensation of inflated costs of housing construction started by Housing Cooperatives before January 1, 1992 | 350.0 | 3.7 | 0.15 | — | — | — | 103.8 | 2.3 | 0.04 | 44.0 | 0.7 | 0.01 |
| Other expenses for completion of housing construction projects initiated by Youth Housing Cooperatives before January 1, 1992 | 1,056.0 | 11.1 | 0.46 | 750.5 | 11.5 | 0.28 | 318.3 | 7.2 | 0.11 | 117.0 | 1.9 | 0.03 |
| Other expenses for housing construction in compliance with Russian Federation president decrees and government resolutions | | | | | | | | | | | | |

Sources: Federal Laws "On the Federal Budget in 1996," "On the Federal Budget in 1997," "On the Federal Budget in 1998," "On the Federal Budget in 1999,"

* The ruble was redenominated on January 1, 1998.

program disbursed less than 10 percent of even the small budget amounts planned for 1996–99.

The most effective program from the point of view of financial performance has been the program of housing subsidies (so-called state housing certificates) for retiring and retired servicemen of the Defense Ministry and the Interior Ministry and their households. Throughout the period of the program's existence, from April 1998 through August 1999, about 9,400 certificates totaling 1.47 billion rubles have been paid out. Under the 1999 budget another 4.5 billion rubles were to be given to this program for 23,600 certificates. The average amount of the up-front subsidy for a household in 1998 was 143,000 rubles (\$14,130) and in 1999 it was expected to average 191,000 rubles (only \$7,800).

In several cases, households are able to combine subsidies. For example, a one-child family of a retiring military officer is eligible to obtain a housing subsidy for an amount equal to 100 percent of the average sale price of an apartment on the market. In the first quarter of 1999, this price was \$240 per square meter, so for a 54-square-meter apartment the subsidy was \$12,960. The average income of the household in 1999 is approximately 3,000 rubles per month, or 36,000 rubles per year (\$1,500 at the November 1999 exchange rate). The household decides to purchase a more expensive apartment at a price 1.5 times higher (\$15,550). It pays the difference between the subsidy amount and the unit price at its own expense. The taxed three-year income will be reduced by this amount (\$2,590), from \$4,500 to \$1,910. The household will pay only \$229 in income tax during the period instead of \$540. Moreover, the tax will only be paid after the third year, because the total income for the first two years will be sheltered. Accordingly, the three years' income tax subsidy for this household will be \$311. Thus, the size of combined subsidies provided to the household (a housing subsidy plus income tax exemption) is \$13,271. The balance (\$2,590, which is 17 percent of the actual unit cost) will be paid by the household out of its own funds.

It is also possible to combine receiving a free-of-charge apartment (for a family on the waiting lists), which is then privatized and sold, with tax deduction for the further purchase of a bigger unit. This does not happen often, though, because families provided with free housing are normally from lower-income groups of the population. In general, subsidy policy tries to eliminate the possibility of using the budget-assisted home purchase more than once. For example, housing may be priva-

tized free of charge only once in a lifetime; up-front and tax subsidies are also granted once in a lifetime; and so on.

A better picture of the importance of existing subsidy programs can be shown by calculating their present value to certain households. In principle, there are two types of subsidies for which the present value of benefits for beneficiary households can be calculated: three-year income tax deductions and multiyear zero interest rate loans to citizens officially recognized as forced migrants who need housing. The latter program, however, receives very little funding and actually is not being implemented because of the combination of lack of funds and unclear terms of loan repayment. The value of downpayment subsidies is fully realized in the year the unit is purchased.

Incomes of households by quintiles, calculated from the official data from Goskomstat of Russian Federation in 1998, are shown in table 3.21.

Given the fact that the purchase price of the average housing unit of about \$14,000 (141,000 rubles at the average 1998 exchange rate) is greater than the total three-year income of households in the lower four income quintiles, the tax deductions are clearly limited by the household's income. The final column of table 3.21 shows the household's tax expenditure. Only for the highest-income quintile will three years' tax liabilities exceed the purchase price of the average unit. Table 3.22 shows the cumulative tax expenditures over three years and their present value (with the rate of inflation used as the discount rate).

In certain cases, as mentioned above, recipients can combine several types of housing subsidies. An example is the situation where a household needing a better dwelling receives an up-front subsidy after 10 years on the waiting lists, which is a typical waiting period. It is important to add,

Table 3.21 *Average Household Incomes and Income Tax Liability by Income Quintile, 1998*

| <i>Quintile</i> | <i>Annual Income per Household (in rubles)</i> | <i>Income Tax to Be Paid (in rubles)</i> |
|-----------------|--|--|
| 1 | 8,995 | 1,079 |
| 2 | 15,255 | 1,831 |
| 3 | 21,650 | 2,598 |
| 4 | 30,510 | 3,661 |
| 5 | 68,862 | 8,263 |

Table 3.22 *Value of Income Tax Deduction, 1998*

| <i>Income Quintile of Households</i> | <i>Total Subsidy Benefits per Household (by Year of Tax Subsidy Performance, in rubles)</i> | | | <i>Present Value of Total Subsidy Benefits per Household^a</i> | |
|--|---|----------|----------|--|-------------------------------------|
| | <i>1</i> | <i>2</i> | <i>3</i> | <i>Rubles</i> | <i>U.S. dollars^b</i> |
| 1 | 1,079 | 2,158 | 3,237 | 1,981 | 196 |
| 2 | 1,831 | 3,662 | 5,493 | 3,361 | 332 |
| 3 | 2,598 | 5,196 | 7,794 | 4,769 | 471 |
| 4 | 3,661 | 7,322 | 10,983 | 6,671 | 664 |
| 5 | 8,263 | 16,526 | 17,005 | 12,882 | 1,273 |

a. The discount rate assumes 84.5 percent CPI (actual inflation in 1998).

b. The exchange rate is the average for 1998, 10.12 rubles = U.S. \$1.

however, that up-front subsidies are not provided by the federal budget (they are normally provided by municipalities—see the section titled “Development of Housing Subsidies System” above). Table 3.23 shows different subsidy amounts for which recipient households are eligible depending on their per capita income (column 3). The rest of the unit purchase price will be paid as the household’s equity. Thus, the three-year tax benefit ceiling is decreased by the downpayment subsidy (column 4). The present value of total subsidy benefits and its correspondence with the average unit price (\$7,800) are presented in table 3.23.

The lowest three quintiles all get the maximum downpayment subsidy of \$5,460 (70 percent of the standard unit’s value) according to the federal program rules. Only households in the highest-income quintile receive a significantly smaller subsidy—\$3,457, or 25 percent of the purchase price of the standard unit. The value of the downpayment subsidies dwarfs the tax subsidies. Even for the highest-income quintile, the downpayment subsidy constitutes 63 percent of the total subsidies.

The subsidies for homeownership are deep for most households, expressed as a percentage of the average unit price (column 7 of table 3.23). Only for the highest-income households are they as little as one-fourth of the purchase price of the standard unit.

But three points should be kept in mind in reviewing these figures. First, the downpayment subsidies are available only to households on

Table 3.23 Combining Subsidies: Value of Benefits, 1998

| <i>Income Quintile of Households</i> | <i>Annual Income per Household (in U.S. dollars)</i> | <i>Value of Up-Front Subsidy (in U.S. dollars)</i> | <i>Tax Benefit Ceiling (in U.S. dollars)</i> | <i>Present Value of Tax Benefits (in U.S. dollars)</i> | <i>Present Value of Total Subsidy Benefits per Household (in U.S. dollars)</i> | <i>Present Value of Total Subsidy as Percentage of the Average Unit Price</i> |
|--------------------------------------|--|--|--|--|--|---|
| <i>1</i> | <i>2</i> | <i>3</i> | <i>4</i> | <i>5</i> | <i>6</i> | <i>7</i> |
| 1 | 889 | 5,460 | 2,340 | 196 | 5,656 | 40.4 |
| 2 | 1,507 | 5,460 | 2,340 | 332 | 5,792 | 41.4 |
| 3 | 2,139 | 5,460 | 2,340 | 471 | 5,931 | 42.4 |
| 4 | 3,015 | 5,304 | 2,496 | 664 | 5,968 | 42.6 |
| 5 | 6,805 | 2,184 | 5,616 | 1,273 | 3,457 | 24.7 |

* The exchange rate is the average for 1998, 10.12 rubles = U.S. \$1.

the waiting list for improved housing. Survey data for Moscow show that most higher-income households are seeking market solutions to their housing problems rather than waiting for help from the municipality. Second, households on the waiting lists for only a few years receive substantially smaller downpayment subsidies. Households on the waiting lists choose whether to take the downpayment subsidy. Hence, the typical beneficiary is likely to receive a smaller subsidy than the figures in the table suggest—because these families will have both more income and shorter times on the waiting list than those who hold out for a municipal unit to be allocated to them. Third, under current legislation, the municipality retains responsibility for providing housing to those on the waiting list. From the city's perspective, a partial subsidy is cheaper than providing a household with a newly constructed unit.

Under the forecasts for Russia's economy for the next few years, federal budget allocations for the housing sector are not likely to increase in real terms. This inevitability points to the urgent need to lower the announced role of the state as a key investor in the housing sector and to support investment chiefly through indirect means—above all, through further development of the mortgage lending system.

Conclusions

Russian reforms in housing sector finance during 1991–99 have led to a dramatic decrease in federal spending on housing. This was one result of the general macroeconomic crisis and the large deficit in the federal budget. But at the same time, the success of the reforms is allowing the housing finance sector to develop more effectively.

Prominent in the transition is the changing role of government at different levels, especially federal spending, in the development of the markets for new and existing housing. In spite of the low level of federal spending, reforms have been quite successful in the financing of housing. In 1992–99, government financial support shifted significantly to support consumer demand. Before that, public money had been used primarily to finance new housing construction, with the units produced distributed free of charge. Clearly, this distribution pattern was far from effective or fair. The dramatic shift to demand-side subsidies has permitted better targeting of the available resources.

It is critical that the housing subsidies system has been reoriented in the direction of downpayment, or up-front, subsidies and away from the subsidizing of mortgage loan interest rates. In comparison with interest rate subsidies, downpayment subsidies represent a step forward, because this mechanism is much more transparent to all parties involved and because it is administratively simple.

In contrast, the large tax expenditures that result when a household is allowed to deduct the price of a dwelling purchased from its taxable personal income over a three-year period constitute a badly targeted subsidy that disproportionately benefits higher-income households. The Tax Code enacted in July 2000 limits the deduction of the cost of a unit to 600,000 rubles (about \$21,400 at July 2000 exchange rates) and permits deductions not used in one year to be carried forward. However, additional deductions for mortgage interest payments can be made without limit. Both the purchase price and mortgage interest deductions may only be used for one unit. (This provision, however, is enacted in the new Tax Code as well.)

By far the greatest service by the government of Russia thus far in encouraging homeownership has been the highly successful mass privatization program. While inaugurated mainly for political reasons, it succeeded in making Russia a nation of homeowners—with an ownership rate greater than Germany's. It has also provided a large number of households with equity to use as a downpayment in buying a better unit with a mortgage loan. For the future, by far the most critical action for the government is to produce consistent economic stability and growth. Lower and more stable interest rates will encourage banks to make mortgage loans with terms greater than five years and households to apply for them. The government, certain private banks, and the donor community have worked hard to establish a credible legal and institutional infrastructure for housing finance in Russia. The potential of this system cannot be realized, however, without economic stability.

NOTES

1. The disputed point is the rights of the borrower's family residing in the mortgaged unit. The law "On Mortgage (Pledge of Real Estate)" stipulates an obligation to vacate the unit bought with the loan funds in case of foreclosure binding on the borrower and members of his family if the latter agreed to assume such obligation at the time of settlement into the unit. However, because the

Housing Codex lacks a specific provision on the matter, foreclosure procedures may become highly cumbersome and time-consuming, which makes the banks reluctant to issue loans secured by mortgage of residential premises.

2. Such banks include Probusinessbank, Petrovsky bank, Investsberbank, Promsteroibank (St. Petersburg), St. Petersburg Bank, Investment Banking Corporation, Guta-Bank, First Mutual Fund, and Sobinbank among others. Also some of the regional Sberbanks are active; these include those located in Moscow, Nizhny Novgorod, Saratov, Samara, and some other cities.

3. The U.S.-Russian Investment Fund's loan becomes active when the Agency secures its license. The fund is also stimulating several banks to make mortgage loans by providing them with a line of credit to finance these loans. The funds are provided at interest rates somewhat below market levels. The fund requires banks to use the loan origination guidelines of the Agency for Mortgage Lending. The fund has repeatedly announced plans for a large program of mortgage financing.

4. Under the small-scale Moscow mortgage program, loans are originated on the following terms: a 10-year repayment term; 10 percent fixed interest rate (supposed to be subsidized by the municipality); and the loan amount not exceeding 70 percent of the value of the mortgaged unit.

5. For more details see Struyk and Kosareva (1999).

6. Special housing savings schemes that integrate construction finance and mortgage lending have also been designed. First, the bank identifies clients wishing to acquire housing through share participation in the construction of a specific building (as a rule, at the final construction stage) and concludes an agreement with the contractor for phased construction payments, stipulating fixed deadlines and cost estimates. Then clients of the bank make monthly deposits during the construction period (usually about a year), with the amount calculated on the basis of the cost estimate in such a way that by the time construction is completed, the client will have paid half of the unit price. For the balance, the bank issues a one-year loan against the collateral of the constructed apartment.

7. In 1993 Sberbank signed a new agreement with the finance ministry that brought the interest rate in line with the Central Bank discount rate. Later the interest rate on new and overdue loans issued after April 1993 changed along with the Central Bank rate (by the end of 1993, the interest rate equaled 210 percent).

8. Struyk and Kosareva (1992).

9. The program is outlined in Ministry of Construction of the Russian Federation (processed). Eventually this plan will be incorporated into a government resolution.

10. Data detailing the split between construction and downpayment subsidies for retired officers for each year were not available.

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This is a very thorough and readable analysis of the housing finance situation in the CEE. More than a policy paper, it provides a combination of historical perspective and current, on-the-ground intelligence that will be useful to both practitioners and researchers in housing finance in the region.

DEBRA L. ERB, PRESIDENT
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This text makes a major contribution to our understanding of housing finance in transition economies—providing both detailed data which are not available elsewhere and coherent analysis of how governments frame the environment in which housing finance markets develop.

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