CHAPTER 2

Thinking About Housing Subsidies

In most countries, policy discussions for the housing sector usually simply assume that housing subsidies are necessary for some portions of the housing market, with the the precise reasons for subsidizing housing left vaguely defined. This vagueness inevitably weakens the effective design of the subsidy programs, because it is unclear what the ultimate goals of the program are. To help avoid this outcome, this chapter looks at several rationales for governments to subsidize housing and how they can be used to frame a housing subsidy policy.

Once it is decided that certain housing problems require government intervention, there are many policy and programmatic choices to be made. For example, can some problems be solved by improvements in the regulatory environment or the creation of new institutions? Which require a subsidy and, if subsidies are considered, what combination of subsidy approaches are the most effective for different market segments? Decisions have to be made on whether to subsidize the demand or the supply side of the housing sector, whether to focus subsidies in particular locations or to specific types of households nationwide, how to optimize and complement actions of national and local government, and which group of the population should be subsidized to reach the desired outcomes. This chapter looks briefly at some of those critical choices for housing subsidy policies in general. The subsequent chapters focus on subsidies related more specifically to the financing of housing.

Experience in many countries has shown that the design and evaluation of housing subsidy programs benefits from the use of clear economic and public accounting criteria. This chapter also discusses such criteria-- efficiency, administrative simplicity, equity, transparency, effects on housing markets, impacts on housing and labor market mobility, the presence of adjustment and exit strategies -- and how the use of these criteria might improve the outcomes of subsidy policies.

The long-term process of housing subsidy policy development and implementation is, however, far from linear. It is influenced by conflicting political priorities and requires a concerted effort to align actions by many different parts of government, both housing and non-housing entities. Such process requires as much thought as the design of policy and programmatic actions themselves. The chapter begins, therefore, with a brief discussion of the process of subsidy policy development.

2.1 The Process of Subsidy Policy Development

A major reason that efficient, effective and transparent subsidy schemes are quite rare is that housing subsidy policies and programmatic actions[1] are often developed primarily on the basis of short-term political considerations rather than in the context of a longer-term policy framework. This problem afflicts housing policies in the most sophisticated economies as well as the least and is an issue even in countries with substantial resources devoted to housing policy formulation. Of course, this problem is present not only in housing policy, nor is it necessarily due to lack of good faith. There is often a large gap between political perceptions of housing problems and their causes (by the electorate and the elected) and analytical reality. But it may also be due to catering to ancillary agendas of various interest groups.

One way of avoiding poor policy outcomes is to initiate periodically a process of systematic analysis of the most pressing housing issues and the development of a clear vision and set of goals for the future of the housing sector. If this is done at a high enough political level, it may ensure that regulatory measures and individual subsidy programs initiated by different parts of the legislature or administration fit that framework or at least do not seriously compromise the core national housing policy goals. Such a process may also assist in bringing together the often discrepant housing goals and actions of local and federal governments, and public and private sector agents.

Technical diagnostic analyses and scenario development can greatly facilitate this process. The policy analyst's tasks in this political context are to:

- (i) Refine the analysis of the country's housing problems and the reasons or causes of the problems for different housing market segments.
- (ii) Clarify why some of these problems should be addressed by the public sector.
- (iii) Determine which of the reasons for the poor housing conditions can be solved by regulatory change or institutional reforms and which problems require subsidy actions.
- (iv) Create a deeper understanding of how much households in different geographic, demographic and income groups can and are willing to contribute themselves to upgrade their housing situation through cash savings, sweat equity, income or debt finance and propose subsidy incentives that government might consider to facilitate and/or complement households' own efforts in different segments of the housing market to fulfill its specific housing goals.
- (v) Analyze existing and alternative subsidy programs with respect to the efficiency, equity, transparency and effectiveness of possible interventions and comparing the relative benefits for similar beneficiary groups across programs.

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[1] Housing policy embraces important decisions that set a course of action for different actors to follow and which therefore establishes the framework for subsequent decisions. Programs on the other hand have to do with the specific ways of implementing policy. Often collectively these programmatic decisions become policy rather than derive therefrom. Policy may derive from non-actions as well.

This chapter will briefly frame each of those tasks in turn.

The development of a subsidy policy is, of course, shaped by the fact that public resources are scarce and that fiscal policies will set limits to the use of certain types of housing subsidies such as government guarantees. In that connection, it is important for policy-makers to set a time-frame of subsidy interventions. Resource limitations will also imply that not everybody in society with a housing problem can be helped and that careful choices have to be made as to whom will be helped first and how the subsidy expenditures can be most leveraged. A preliminary assessment at this stage of the cost of existing and preferred subsidy solutions will help the process of formulating and refining the objectives of subsidy strategies and adjust expectations as to what can be achieved and in what period.

Such a policy development process needs to be inclusive and enlarge the scope of the discussion in order to reach sound decisions. It will involve the consideration of a huge number of factors and the participation of all major actors in the housing sector. It is important that the private sector and local communities be involved in this process of inquiry and definition of objectives for the housing sector. This part of the process of the development of a housing (subsidy) policy is really the most difficult. Often it requires a special commission or high-level task force that coordinates the different inputs to channel the discourse into useable objectives and strategies and oversees the long-term implementation of the strategic plan for the housing sector. Several countries (and local governments) have gone through such a high-level "framing" process and eventually followed the implications of such work over time to a considerable degree.[2] However, even in countries that have put major resources in this process of subsidy policy development, it has proven difficult to reform existing subsidy programs that are contradictory to the established policy goals and the implementation of intended programs proved in all cases to be more difficult than anticipated.

2.2 Diagnosing Housing Problems

Most emerging market and transition economies experience serious housing problems. Such problems range from a pure shortage of housing, to the need for less costly housing,

[2] Four such efforts that are prominent are (1) Chile in the late 1970s (a comprehensive housing and financial sector analysis lead to financial sector reforms and the design of the upfront cash grant program), (2) South Africa in the early 1990s (an inclusive and extended policy development process culminated in the design of a comprehensive and transparent subsidy policy, including upfront subsidies for ownership and rental options, institutional support systems and financial sector incentives), (3) Germany in the 1970s (an in-depth housing sector analysis facilitated the design of the one-time cash assistance program for homeownership), and (4) the United States' Experimental Housing Allowances Program of the 1970s (this long-term study showed that, all else equal, demand –side subsidies were more efficient than selected supply-side programs and lead to the adoption of the (limited) housing voucher program). However, these same countries pursue other subsidy policies that can not be so recommended, and the implementation of intended programs proved in all cases to be more difficult than anticipated. Lithuania recently completed a systematic analysis of housing issues and policies with the assistance of a grant from the World Bank. Others that have embarked on this path are Mexico, Brazil and Egypt.

better quality housing, or thermally more-efficient housing. However, the perceptions of housing conditions and what constitutes a housing problem are often quite different among different social groups and within and outside government and so are perceptions of the causes of the housing problem. It is common for governments to define the "housing problem" in the most general terms, such as the total number of households who do not live in "standard" housing (often specified as a typical house owned by a middle income household or in square meters) or who will not to be able to "afford" such a standard house within a given planning period. This approach creates a measure of the problem that is attention-grabbing but both unrealistic relative to feasible solutions and uninformative about how to formulate practical interventions.

As a first step, governments may design a set of scorecards that they can use to help them make explicit what they do and do not know about housing conditions in different market segments and what they are assuming about the causes of housing problems. The urban and housing indicators approach of the World Bank and UN-Habitat may be a good starting point for such analysis of housing conditions, but may require a deeper analysis of the reasons for the perceived supply and demand constraints in different market segments.[3] There could be a checklist of adequacy of title and registration systems, costs and steps of the permitting process for land development, local regulation standards, etc., that would be useful for local governments to complete. Another one could focus on the effectiveness of the housing finance sector and the reasons for inefficiencies and existence of major underserved market segments that could be completed by the Central Bank, the Ministry of Finance and private lenders. Yet another would plot all existing subsidy programs and their current beneficiary groups against groups of the population identified as having major housing problems.

Such straightforward exercises would create, within a short period of time, the general basis for initial housing policy analysis because pertinent housing issues will be out in the open and can be discussed at various levels of government and among government and private sector agents in the housing market.

It is not the task of this book to explore all the alternative formulations of what is an authentic housing problem. The list below includes some common examples, but each country has particular circumstances, and often has a different perception as to what is or is not a problem.

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[3] Such set of indicators focused on policy effectiveness is currently being formulated by an advisory group for HABITAT FOR HUMANITIES and other institutions to collect and to be made available in the public domain.

Examples of What Are Commonly Perceived as Housing Problems

1. A considerable proportion of households live in informal or impermanent housing (which may or may not imply poor quality).
2. Many households have less-than-acceptable access to housing-related amenities, such as water or sewer, paved roads, heat, lighting, etcetera.
3. There is a general shortage of housing due to wars or economic crisis.
4. Construction activity is "too low" in general or in specific sectors (e.g., rental, low cost housing).
5. The prices of houses are high relative to what "should" be the case.
6. Cost burdens are too high due to high prices or rents in specific market segments.
7. A large proportion of households are unable or unwilling to access sufficient credit for the construction or purchase of acceptable housing.

Such detailed diagnostic analysis will further provide insight in the deeper *causes* of the perceived housing problems for different housing market segments. Identifying these reasons will be controversial and different parties in the policy making process will perceive the problems and their causes differently, but factual analysis can narrow that gap.

Frequent Causes of Housing Problems

1. Building or subdivision standards and the costs of getting permits are too high relative to incomes and prevent new formal sector housing to be constructed for all required market segments.
2. Property claims or rights are unclear or are not registered or enforced, which is a disincentive for investment in housing.
3. Rents in relevant housing market segments are controlled by government or tenant regulations make it difficult to enforce contracts, which cause low levels of investment in rental housing.
4. Housing finance is too costly or scarce because of macro-economic conditions or because of specific market or policy imperfections in the housing finance system.
5. Credit policies, while rational, exclude many who would potentially be good credit risks either for mortgage credit or micro-credit.
6. Incomes of some are too low to pay for minimally acceptable housing even with appropriate regulation and, in effect, redistribution is desired in the specific form of housing.
7. Existing housing subsidy programs are poorly targeted and/or increase housing inequities.

The technical analysis has to provide a detailed understanding of income or other consumer limitations and of the specific regulatory or market inefficiencies that are at the root of the housing problems in different market segments, e.g., which supply issues cause the prices of new houses to be "too" high and for what income segments or what specific risks, costs or structural problems in the mortgage or micro-finance markets cause rates to be "too" high or finance not to be extended to particular sectors of the market.

The outcome of this initial analysis would ideally be the identification of specific market segments for different types of housing and housing finance products and their frontiers, i.e., the margin beyond which specific demand and supply constraints limit expansion of and access to these markets. The following are the usual broad market segments and the area s where expansion of opportunities is most likely.

1. *Upper income housing market* segment (typically above the 65^{th} or 75^{th} percentile of the income distribution) where households can obtain diverse housing products provided through the formal housing and housing finance market. The *frontier* of this market segment may be related to issues of limited availability of land or finance for housing caused by macro-economic conditions or market inefficiencies.

2. *Middle and lower-middle income market segment* (typically upwards from the 40^{th} or 50^{th} percentile of the income distribution) where households' incomes are adequate to obtain formal moderate income housing yet most live in unauthorized or substandard formal housing. The *frontier* for expanding the formal housing market for this segment and improve housing quality is not so much constrained by low incomes, although that is certainly part of it, but by lack of access to finance because of informal employment, lack of wealth or neighborhood risk factors, or inefficiencies and incompleteness of housing finance markets. In some countries, housing finance linked subsidy programs allow households at the top of this income bracket to obtain formal sector new housing. But regulatory constraints on the real side and controls on rental markets often form barriers to expansion of formal housing for the unassisted part of this market segment and upward mobility out of unauthorized or substandard formal housing is limited.

3. *Low-income market segment* (below the 40^{th} or 50^{th} percentile of the income distribution and/or informally or self-employed households) where households live in sub-standard housing or substandard neighborhoods with limited access to services. Formal housing markets seldom deliver new housing for this segment and are unlikely to do so for the medium term. Housing subsidies are often limited to selected upgrading programs. The *frontier* for expansion of formal, healthy quality low-income housing is often two-dimensional; i) the frontier for improvement of existing housing conditions is confined by lack of infrastructure, formally registered property rights, while lack of access to micro-credit limits investment; ii) the frontier for new low-income housing is constrained mostly by a combination of regulatory issues, non-functioning land markets and low incomes, and lack of access to appropriate financial instruments.

The relative proportion of households in each category will differ in each country, and so will the specific causes of the housing problems. Successful approaches to expand the current frontiers of each of those housing market segments are likely to cause an upward filtering of households into better quality formal housing. Such mobility will also make it more manageable for governments to directly address the poor housing conditions of households living in squatter areas and slum dwellings, which may be a large proportion of the urban population particularly in countries with high urban in-migration rates.

2.3 When are Housing Problems Societal Problems?

2.3.1 Subsidy Policy Objectives

The debate over the efficacy of government interventions in the housing sector is too often clouded by confusion over their objectives. Simply defining housing problems and identifying possible causes and solutions is not a sufficient basis for agreement as to rational policies for governments to intervene in the housing market and allocate limited government funds for housing subsidies. In addition, there needs to be clarity about the public purpose of government intervention and the value of achieving various housing goals to society at large.

In particular, policy analysts need to make clear *why a country should subsidize housing,* i.e., *why tax contributions by society at large should be allocated to housing problems of some,* rather than leave it up to individuals to define their housing problems and solve them as best they can. In other words -- when are the housing problems of individuals *societal problems*? Moreover, if it is concluded that the country's housing markets work well, and that the country's low-income is really the problem, why not use the same resources instead to subsidize income directly or food costs, or education, healthcare or transport, rather than housing? Only if these questions are answered, can the ultimate goals of a subsidy scheme be understood. There are two different ways of approaching this question.

Housing as a merit good. Some may argue that society in general benefits if most people live in better housing than they would choose without government subsidies. This argument considers housing to be a "merit good" that society as a whole values more highly than do individuals alone (Musgrave (1959)). There is, however, no specific evidence that subsidizing housing all by itself and for no other reason than improving the general standard of housing is an effective strategy, certainly not in the context of emerging market economies.[4] Such arguments for subsidies in the broader housing context are valid mostly for the ubiquitous provision of minimum levels of services such as water, sanitation and electricity.

Subsidizing housing to achieve specific societal goals. We believe that the question of why housing should be subsidized can best be understood by perceiving better housing as a means to achieve higher level societal goals. We distinguish four such goals that are

[4] Such perception of housing subsidies has led countries, especially developed countries, to adopt schemes that subsidize housing consumption broadly, for example through tax deductions related to mortgage payments or general interest rate subsidies. Such subsidies benefit the middle and upper-middle income groups mostly and it is unclear what rationale is being applied for such allocation of public funds, other than reasons of electoral posturing.

usually involved, explicitly or implicitly, in the political discussions about subsidy intervention in the housing sector. These are the following:[5]

(i) Improving public health
(ii) Improving justice and fairness
(iii) Improving market efficiency
(iv) Stimulating economic growth

The first two of these reasons for subsidy intervention relate to housing conditions directly and focus on promoting welfare in society through the housing sector. The third reason focuses on expanding housing opportunities by pricing and allocating costs and risks in the housing and housing finance sector more optimally, e.g., through subsidizing the provision of inputs that are underprovided by private markets and addressing externalities created by market operations. The fourth is associated with the macroeconomic management of aggregate demand in the economy.

There may, of course, be more than one reason to create a particular housing subsidy, e.g., programs intended to address public health issues may be motivated by improving social justice and stability in society as well; programs to address market failures are often guided by equity concerns and programs addressing the outcomes of wealth inequality in housing markets can be pursued on the grounds of improving economic efficiency in mortgage markets. In addition, policymakers will need to define specific objectives that are sub-parts of a larger goal. For example, measures to improve market efficiency may focus particularly on the market for home-ownership and even more specifically on overcoming constraints faced by first-time home-owners to buy a house.

In practice, it is the political system in a society that determines governmental interventions, and political discourse is often less than precise (or even coherent) about the goals of specific interventions. However, clarity about the ultimate reasons for subsidies will be crucial to develop a coherent set of subsidy programs within the context of a strategic housing plan and to guide the political process in creating the appropriate supportive laws and budget allocations. The following sections briefly examine these different reasons for housing subsidies.

2.3.2 Improving Public Health

The first housing subsidies arose in Western European countries as a consequence of the horrible living conditions that emerged in urban areas during the industrial revolution. The most compelling reason to subsidize housing still is (or was at one time) to make sure that poor living conditions of the lower income groups do not cause outbreaks of disease or pose physical or social hazards to the population at large. The impetus to provide such assistance is not necessarily inspired by compassion but by public health considerations. In countries where large segments of the population, particularly in urban

[5] Part of this section is based on Hoek-Smit and Grigsby (2002). These goals are intentionally broad. A longer list, such as provided by Weicher (1974), may include 15-20 reasons (a different one for each expert that he asked), but he also groups them into 4 similar categories. The goal here is not to list all potential rationales, but to ground the process in some clear arguments for societal intervention.

areas, live in substandard housing and in neighborhoods lacking adequate services and on risky sites, these problems are easily the highest priority for housing subsidies.[6] In more affluent societies, where substandard housing is no longer an important issue, the focus of "public health" motivated programs is mostly on neighborhood stabilization – crime prevention, better social services, improving neighborhood infrastructure.

In emerging market economies, housing oriented public health goals are addressed mostly through large scale public investment in infrastructure, not housing *per se*, e.g., through the extension of clean water supply, sanitation and other basic services to all underserved neighborhoods. Some countries have also provided public housing or supported social housing for public health reasons.[7] Public health-oriented housing programs may also include social equity components such as financial support for paying utility bills, assistance to owner households to bring their housing up to standard, or support to community-based consumer or micro-finance lending to provide incentives for gradual upgrading of homes.

2.3.3 Improving Fairness and Justice

A second general objective of housing subsidies is to improve the income or wealth distribution in society through housing, animated by a concern about *social justice or equity* in the distribution of economic resources among members of society. The need for redistribution through housing subsidies may be justified by unacceptable outcomes in the housing market in general, or may be triggered by calamitous events such as natural disasters or wars that affect a large proportion of households in society.

For example, slum and squatter improvement programs are often designed to alleviate extreme poverty as a matter of social justice. Many countries have national housing agencies and special housing funds that subsidize housing to civil servants or “workers” to compensate for low wages. The fact that poor quality housing is such a visible manifestation of poverty makes housing an attractive target for those in society who pursue social justice goals. Improvements in housing consumption can be observed by taxpayers and voters much more directly than most other aspects of the welfare of poorer people.

Another related social justice reason to subsidize housing is to prevent potentially *destabilizing social effects of poor housing and neighborhood conditions*. Political fears that these poor living conditions will lead to social problems are certainly an important motivation for housing subsidies as well. Indeed, slum upgrading and other low-income housing programs are often approved in the aftermath of political unrest.

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[6] However, such programs are not always a *political* priority. It may be that the problem is considered too great to address and not affecting the population at large, or that social stratification, of which housing is but one aspect, is an accepted fact of life.

[7] Social rental housing, which is supported by government but delivered by NGOs or semi-public institutions, is differentiated from public housing, which is funded and operated by government directly. The latter is usually targeted to the lowest income strata, while social housing typically targets a broader range of income groups and seldom reaches the very poor.

In general, programs designed to increase political and social stability are more often focused on owner-occupied housing and neighborhood improvement than on providing access to better rental housing.[8] Indeed, many programs are focused specifically on increasing homeownership *per se*, rather than necessarily housing conditions. This policy preference is based on the belief that home-ownership gives households a greater stake in their community and buttresses civil involvement and social adhesion, although research is not conclusive on this issue.

Housing subsidies are sometimes used to *redress the sources of societal inequality* (often referred to as *"unfairness"*) when housing or neighborhood conditions affect people's opportunity to improve their chances of success in life, or procedures to obtain property rights or loans are inequitable. This may involve improving neighborhood facilities and social services, or giving some of the poor the opportunity to move into better housing and neighborhoods or closer to job-opportunities. In particular, providing better access to property rights and housing finance can permit more households to become homeowners in the formal sector and build up their wealth through housing.

[8] This policy choice is influenced by the national housing system in the country. In many Western and Northern European countries broad-based social rental housing programs have been the preferred response to address social inequities.

Box 2.2 Adjusting Subsidy Goals in South Africa

In South Africa, the post-apartheid housing policy addressed past *social injustices* in the urban and housing sector through redistributive programs that would increase freehold home-ownership for low-income households. Depending on the income level, households could receive a free house or get a better house by taking a loan. The subsidy program produced over 1.5 million houses between 1994 and 2005, with almost all beneficiaries receiving a totally free house, making no contribution or using any credit.

This approach was effective in making these beneficiaries feel attended too (social justice), but it did not always produce stable communities or permanently higher housing consumption, since some were not able to maintain the house and could not recover the cost of that gift in the resale market when they needed to move for employment reasons. Also, the housing program was not integrated with housing finance and community infrastructure sufficiently. If creating opportunities for the poor (fairness) through building housing wealth, access to finance and quality neighborhoods, rather than redistribution through home giveaways, had been the predominant goals, another combination of programs might have been given priority, e.g., developing the low-income housing finance system, linking subsidies towards savings or other owner contributions, or delivering community services in geographically integrated neighborhoods. Goals for the second generation of programs are shifting in that direction, now that the initial severe inequality has been somewhat alleviated. Existing programs are adjusted to meet these new goals.

Housing finance subsidies are commonly used to address such social justice and fairness concerns, for example, through upfront grants, housing allowances, interest rate subsidies, subsidies to pay for utilities, or assistance to access housing finance and savings opportunities or even the direct provision of such finance functions.

2.3.4 Improving Market Efficiency

In Chapter 1 the argument was made that, in general, private markets are more efficient in producing and allocating housing resources than governments. The quantity of housing and credit provided in efficient markets is determined by balancing demand and supply factors. This means that, in cases where the value of a house or credit services to buyers is less than the (true) cost to provide it, producers and lenders will not continue construction and lending for that market segment.

In the above sections it was noted that housing outcomes produced by markets, even rather efficient ones, are often not acceptable for society as a whole because of *social equity considerations* and *negative consumption externalities related to public health and social stability*, and that governments often subsidize housing and housing finance for those reasons.

But there is another reason for government subsidy intervention into housing markets one related to the fact that private housing markets can be *imperfect and incomplete* for a variety of reasons, including poor macroeconomic conditions, missing regulatory infrastructure, informational asymmetries, high transaction costs, high fixed costs, inability of investors to capture all benefits and extreme wealth inequality.. In principle (but not always in practice), it may be useful for government to intervene in housing markets not just through regulation but also by using subsidy incentives and/or the creation of institutions to reduce or remove some of those barriers to greater housing market efficiency and align private incentives with economic and social efficiency (Mankiw, 2004). For example, subsidies may be used to address inefficiencies related to costliness of information gathering for use in credit scoring or development of mortgage default insurance or securitization markets. There may be feedback effects that can not be captured by the private sector, such as the lowering of default losses in poorer neighborhoods due to better liquidity of real estate in turn due to improved access to credit. Large start-up costs and uncertainty of returns may block development of institutions and services that may be sustainable later without subsidy, such as liquidity windows or mortgage insurance.

However, in order to develop successful government interventions in the housing market*, the exact reasons for market inefficiencies must be understood* (Calomiris, 1994; Mayo, 1999). Designing new subsidy incentives with the objective to improve market efficiency is complex precisely because it is just as easy for such interventions to create negative future effects on markets. [9] Their design, adjustment and/or phasing out has therefore to be done with great care. *It is often the case that reforms of past government subsidies are the highest priority to increase market efficiency*. This topic will be analyzed more extensively in subsequent chapters.

2.3.5 Stimulating Economic Growth

Some countries have used the housing sector to jumpstart the economy during a recession or depression. Housing creates employment not only in the housing construction industry but in industries that provide building materials and furnishings for the house. The assumption behind using subsidized housing production as an economic stimulator is that this employment and spending multiplier effect can mean that housing subsidies will stimulate the economy relatively more than other forms of government spending. In addition, investments in housing in general build up a country's capital stock.

Using housing subsidies to stimulate economic growth directly can, at best, be a secondary objective for many emerging market economies. First, government budgets are so strained that only limited allocations for the housing sector can be made. Second, housing finance and housing production systems in most emerging economies are marred by inefficiencies and inequities, and housing subsidy programs should foremost focus on the process of improving the efficiency of markets and improving public health conditions rather than on pouring large amounts of funds into an inefficient sector. Third, this approach requires that detailed information is available on the macro-economy, the

[9] For example, Calomiris, 1994, explicitly includes subsidy measures to address market failures related to the negative impact of wealth inequities, information asymmetry etc. Other authors maintain that subsidies cannot improve market efficiency because of unavoidable deadweight loss they imbue (the inefficiency that a subsidy creates as people allocate resources according to the subsidy incentives rather than the true costs and benefits of the goods and services they buy and sell).

housing market and the housing finance sector to guide the establishment and the timing of specific interventions. The data and skills to do that are usually absent.[10]

2.4 Subsidies and other Types of Government Intervention

What is a subsidy? So far we have spoken loosely about the concept of a subsidy and have mentioned it jointly with other forms of government interventions in markets. Such government actions include: (i) building the basic legal, regulatory and institutional infrastructure for markets to function well, , (ii) modifying regulatory or legal policy to shift market activity in certain ways to reach social or economic goals, and (iii) expending financial resources (both through budgetary allocation and fiscal policies) or taking risks to support desired behavior or address specific market failures (e.g., externalities). Some would count all three state interventions as subsidies (with the possible exception of providing the legal and regulatory system), while others would include only the latter two, and the first category would be treated as normal "public goods" that governments need to provide. In any case, for purposes of this book, the focus is only on the latter two as being in the realm of tools of housing policy.

Distinguishing subsidies from other government policy interventions or expenditures is, however, not always as clear cut as it would appear because of the hidden nature of some subsidies, particularly in the housing finance sector. Some institutional interventions, such as, for example, the creation of a government mortgage insurance program ostensibly run on full market principles, may imbed deep subsidies either because administration costs are not accounted for or by ignoring the presence of catastrophic risk being borne by the government.

Defining subsidies

Subsidies are often perceived as giving or receiving something for free. That notion is misleading. From a broad perspective **"a subsidy is an incentive provided by government to enable and persuade a certain class of producers or consumers to do something they would not otherwise do, by lowering the opportunity cost or otherwise increasing the potential benefit of doing so"** (adapted from the US Congress (1969)).

Since housing is both a consumption good and an investment good, an inclusive definition of opportunity cost needs to be used. For a household, lender or developer these costs are the yield or benefit that could have been received if the money had been used for other purposes or at a later time.

The opportunity cost to government of providing housing subsidies needs to be considered within the same framework. The opportunity costs for government means that a smaller part of the budget (or fiscal revenue) will be available for other programs, often for the same group of persons.

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Also, different authors define subsidies differently. For example, Mayo (1999) uses a broad definition of a (housing) subsidy that includes most public good provisions in the housing sector (e.g., public land registration systems), while according to our perspective such institutions are a normal public service that complete markets for information within the housing sector in general and would not be considered a subsidy. However, when a government establishes a liquidity facility to increase the efficiency of *certain segments* of the mortgage market or to make the *mortgage market more attractive relative to other segments of the financial system* such action is more compatible with a subsidy type intervention, since it incentivices one financial sector or market segment over others. Such ambiguities are mostly relevant only in the context of housing subsidies to the supply-side of the housing market and will be discussed in subsequent chapters.

Lastly, we distinguish housing subsidies from general transfer payments such as welfare payments and social security which are government payments not made in exchange for a good or service. From a macro-economic perspective transfer payments are tax rebates just as housing subsidies to households. However, whereas housing subsidies intend to change the housing consumption of beneficiaries, transfer payments leave it up to the individuals to spend the money in ways they see fit. The question on whether to subsidize housing or income directly is a complex one, but depends mostly on whether housing markets work efficiently for the relevant housing segments. In most emerging market economies this is not the case (see section 2.2).

Subsidies or Regulatory and Legal Policy. Because subsidies can be costly and distorting, they should be a policy of last resort, after, or in conjunction, with other policy steps which are low cost. Much has been written about the enabling policies required for housing markets to work well (Mayo, 1983; Angel 2001).

Some critical measures to improve the housing sector may not be related to housing directly but may involve macro-economic or fiscal measures to improve the stability of the financial system or the overall income distribution. There may be a need for policies to improve the business climate in certain areas or to adjust labor laws to encourage more people to obtain formal sector employment, which all may have a positive impact on housing investments. But other problems require housing or housing finance sector policies either to support the demand side or the supply side of the market.

In this connection, it is important to emphasize the negative effects of *inappropriate government regulations and institutions* on market outcomes. For example, unnecessarily strict building, planning and subdivision standards, poor property rights and registration systems, excessive government involvement in the urban land or housing finance sectors and other policy or regulatory bottlenecks may frustrate the efforts of the market to serve all portions of the population. Indeed, in many lower income countries, the great majority of newly formed households cannot afford or access the lowest priced house in the *formal* housing market because of unaffordable standards and other supply side constraints. As a consequence, only a small proportion of the requirement for new housing can be fulfilled through the construction of standard houses and the subsequent filtering up[11] of lower-income households into the vacated houses. The only choice open to most newly formed households under such conditions is to double up with other households, or, if the government implicitly permits it, to build or rent a house in the unauthorized sector.

The highest priority for government action under these circumstances is to remove or adjust such institutional and regulatory bottlenecks before any subsidies are considered that compensate for poor market outcomes. However, most such policies on the "real" side are in the political realm of local government and it may require central government subsidy incentives for local governments to undertake the necessary enabling policies (see also Mayo, 1999).

Using subsidies as a measure of last resort not only makes sense in terms of efficient use of resources, but also means that whatever subsidies are applied to housing and finance markets will most effectively be translated into more and better housing.

2.5 Key Choices in Designing Housing Subsidies

2.5.1 Framing subsidy approaches

Once a realistic assessment has been made of which housing problems or market blockages can be solved by regulatory and institutional changes and in what time-frame, and what gaps in the existing subsidy package exist, a set of specific issues can be identified that requires reforms of existing subsidies or the design of additional subsidies over time. However, the specification of subsidy actions and programs can be a rather daunting task. Countries often look towards international "fashions" or "best practices" to simplify this process. However, subsidy schemes from other countries are unlikely to suit the specific housing problems, local market situations and national preferences of the borrowing country.

This section examines some first level subsidy policy choices most policy-makers have to make. In particular, we will discuss how to decide whether to subsidize demand for or supply of housing; whether to focus on households or specific locations; whether only new housing or all types of housing should be subsidized and whether all or a select few of qualifying households. The more detailed level subsidy reform and design decisions – e.g., whether to subsidize ownership or rental housing, which specific household groups to target, details of supply-side incentives and their links with other subsidies, will be dealt with in the next chapters.

2.5.2 Demand-Side or Supply-Side Subsidies?

In the not too distant past, nearly all housing subsidies were supply-side subsidies. Private markets were considered unable to respond appropriately to the demands of

[11] The concept of filtering is used to describe the process by which successively lower income households move gradually into better quality existing housing when supply of new housing allows those with relatively higher incomes to move into standard new housing.

certain sections of the population, and direct or indirect government intervention in the construction and finance functions was thought to be required. Gradually, however, evidence of the inefficiency of supply-side subsidies (e.g., gross misuse of funds, inefficient production by the public sector, unnecessarily deep subsidies and poor targeting, negative impact on market development) accumulated. In countries where the differential between incomes and housing costs had decreased, urban growth had slowed and markets were reasonably effective, housing policy experts considered it more efficient to subsidize household demand directly and have private firms deliver housing in response to such demand incentives.[12] Many industrialized countries moved to demand side subsidies in the 1970s and even some Latin American countries (see the case of Chile in Chapter 9). However, supply side interventions and subsidies may remain needed in some markets because of constraints in supply markets that the private sector cannot yet address. After clarifying the difference between demand and supply-side subsidies, we discuss the relative merits of each type.

Demand side subsidies focus on stimulating the willingness and the ability of households to pay for better housing or housing of a particular type. Demand subsidies are favored when the objective is to improve fairness and justice through the housing system. Increasing the demand for housing can be achieved through housing allowances or housing vouchers for rental or owner-occupied housing, through up-front grants, interest rate subsidies or tax-benefits (to buyers) that lower the effective recurring cost of housing payments. Demand-side subsidies can be delivered to beneficiaries directly or through suppliers of housing or housing finance, without actually subsidizing the supply side.

Because households, even poor ones, usually have strong individual preferences regarding the type of tenure, type and location of home, lender, etc., demand-side subsidies are considered more efficient at improving a household's satisfaction with their housing situation than supply-side subsidies, which are instead linked to specific houses or loans.[13]

Supply-side programs can reduce the cost to the consumer of housing or housing finance directly through the following approaches:

(i) Information and research.
(ii) Tax provisions that benefit non-profit or private developers, the provision of below-market funds for housing loans, sharing credit risk, compensating for high transaction costs.
(iii) Direct subsidized government funding or lending.
(iv) Below-market provision of serviced land and infrastructure; or government construction and management of subsidized housing for rental or owner-occupancy.
(v) Price controls.

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[12] A large scale research experiment was carried out in the 1970s in the USA to test the relative efficiency of different types of supply- and demand side subsidies –The Experimental Housing Allowance Project.

[13] On the other hand, if the "appearance" of housing is more important to public policy than the beneficiary's satisfaction, as is often the case, supply side subsidies may be more effective at meeting this goal, e.g., by creating a certain uniform appearance to the subsidized houses (see section 2.2.1).

As noted, supply subsidies create a smaller range of choices for households than do demand subsidies. Another major drawback to supply-side subsidies is that they often undercut the normal market output when government takes on functions that could be done more efficiently by the private sector. Governments are especially inefficient in delivering or managing housing credit directly and when they do, they often prevent private sector expansion of the housing finance system. For these reasons, many countries have shifted away from supply-side subsidies tied to finance systems and have chosen to use up-front grants or other demand subsidies to the individual household.

However, in practice, the use of demand-side subsidies is not always feasible or efficient, i.e., supply side markets do not properly respond to market signals or to regulatory or policy incentives to deliver certain types of housing or housing finance. True demand side subsidies will only work if there is either an existing supply of rental or ownership housing for the targeted income group or housing suppliers and lenders can and will respond to the increase in demand by the subsidized group, i.e. when markets are elastic. Where markets do not work for low/moderate-income households, or program conditions make it difficult for suppliers to respond to an increase in the demand for moderate/ low-income housing, these programs fail to deliver the expected outcomes. In many emerging market economies, where land and finance systems are seriously constrained, so-called “demand-side” subsidies in the form of upfront capital grants are instead channeled through, and captured by, lenders or developers, turning the subsidy into a supply-side subsidy effectively (see Chapter 9).

The decision to select demand or supply subsidies for specific market segments has to be based on an understanding of how much households in each market segments can and are willing to contribute themselves from sweat equity, cash savings, income or debt finance. Access, availability, and willingness to use housing finance, whether mortgage-based or non-collateralized credit, have a critical impact on how much different categories of households can pay for housing. As important is how economic and housing mobility among income classes would actually take place as a consequence of various interventions (i.e., how long people remain poor and exposed to poor housing conditions, and how much upward filtering can be expected). On the supply side it is important to consider whether housing and housing finance markets for specific types of products are expanding in desired directions already and in what time–frame they will reach currently underserved households. For each targeted market segment the specific constraints need to be mapped that hinder the frontiers of the different housing and housing finance markets to expand (see section 2.2).

2.5.3 Location-Specific or Household/System-Specific Subsidies?

Another choice policymakers have to make is whether to concentrate subsidies, whether to supply or demand, in specific locations or provide subsidies to specific categories of households, irrespective of where they live. The decision has much to do with the precise objectives the subsidy program is to address.

For example, if the goal of the program is to ameliorate public health or improve existing poor housing conditions, a neighborhood-by-neighborhood slum or squatter improvement approach is likely to be the best choice. However, when improved access to housing markets or improvements in housing finance systems are the goal, national scale interventions may be needed.

Location specific subsidies can have a positive impact on housing values that encourage investments in an area. They can also leverage community inputs. The possible drawback of location specific subsidies is that these tend to be capitalized into real estate values. For example, if tied to a specific housing development, the developers can charge more (Hilber and Mayer, 2000). When applied to specific existing neighborhoods, the rise in prices may be accompanied by changes in the local residents (especially if much of the housing is rental) or "gentrification", which is sometimes considered a negative from a broader equity perspective.

Location is important in other ways as well. Subsidized low income new housing is frequently provided in locations where land is cheap, but where people are far away from work and other amenities. Such locations will not create housing wealth for beneficiaries, and it is not uncommon to see many properties being abandoned by the beneficiaries or left vacant, e.g., in Chile, South Africa, The Philippines, Egypt.

2.5.4 New housing or all housing?

A design element of a different nature is whether to focus subsidies on new housing production or on the improvement and resale of existing housing. This choice depends on urban growth trends in different regions, the condition and turnover rate of the existing stock, projected income trends and income distributions, and the likely filtering of housing stock.

For example, the housing policies and subsidies of Hong Kong and Singapore emphasized the fast production of relatively cheap housing units in the 1950s and 1960s to house an exploding and poor migrant population. Gradually, when squatter areas were mostly eradicated and incomes rose, subsidy policies emphasized the improvement of the quality of the stock and home-ownership through housing finance. European housing policies shifted from addressing acute post-war shortages in housing to the current focus on efficiently financing a stable and more affluent population of smaller household size and dealing with a stock of older subsidized housing that needs to be renovated.

However, when urban growth rates are predicted to remain high but real incomes are likely to increase slowly, as in many African countries[14], subsidy policies need to take account of these trends and focus, for example, on financing the development of new serviced plots, and stimulating incremental house construction by home-owners, while at the same time subsidizing the upgrading of existing informal neighborhoods until incomes and regulatory reforms permit more of new construction to be in the formal sector.

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[14] See Fay and Opal (2000) who describe Sub-Saharan urbanization without economic growth.

There is a bias by politicians towards subsidizing new housing, since expansion of new production can be pointed to as visible evidence of subsidy programs, and it can be claimed to provide macroeconomic as well as social benefits. However, if low-income housing *resale markets* are not supported by subsidies or are not eligible for finance subsidies, home-owners can only sell their house for the smaller amount potential buyers can obtain in cash or through consumer credit. The role of the resale market to create asset value in the house for owners (and lenders) is a critical consideration for any subsidy policy.

2.5.5 Entitlements or Rationing?

Another important policy question related to individual household subsidies is whether all households qualifying for the subsidy should be entitled to receive it and over what time period? The simple answer to this question is that the housing budget of emerging market economies (and increasingly of OECD countries) can seldom carry universal housing subsidy programs and thus very few programs are structured as an "entitlement." The more complex answer is that, even if budget allocations were plentiful, it would depend on the ultimate objective of the subsidy program.

For example, when the purpose is to redistribute income through subsidies, an entitlement program may be appropriate. When the objective is to gradually get the private sector to make down-market loans, it may be undesirable or unnecessary to give all qualifying households a subsidy in order to reach that goal.

In either case, the next question is --if not every qualified household is to receive a housing subsidy, who is to be preferred? The poorest? Those who will be helped the most by the assistance? Those for whom assistance will do the most for the housing system as a whole? The most deserving (e.g. the working poor or those who have saved the most)? Groups with special problems (e.g. the elderly or handicapped)? Or should housing assistance be distributed through a lottery?

The answer to these questions is, of course, closely related to the ultimate objective of the subsidy program. For example, for programs focused on expanding the housing finance sector, the qualifying households would be limited to borrowers acceptable to the industry and who would not have been able to receive a loan without the subsidy incentive. This could suggest a focus on lower middle-income households employed in the formal sector, with a phasing out of the subsidy at higher income levels.

2.5.6 Rental or Ownership Subsidies?

Most countries stimulate homeownership[15] for a variety of reasons -- households build up equity and wealth in their homes and home-ownership may stimulate households to save (although the current ease of refinancing ones mortgage in advanced economies often stimulates dis-saving). In addition, the majority of households prefer to be home-owners since in most societies owning provides security and enhances ones social status.

[15] There are exceptions, however. Several European countries (e.g.,The Netherlands and Germany) have very generous rental subsidies, a remnant of the post-war reconstruction efforts, and have a high percentage of the population reside in subsidized rental housing.

It is, however, important to have a balance between ownership and rental housing. First, not all households have high or stable enough incomes or can access credit to buy a home. Second, in countries where property rights are unclear and registration systems are inefficient, formal home-ownership strategies are limited. But most importantly, rental housing is needed to allow mobility of the population, for example students and laborers who need to respond to changing employment opportunities, and young unmarried professionals and older people who often do not want to have the burden of ownership.

In many countries the formal private rental market does not work simply because rent control, the tenant protection laws or the tax regime make it unprofitable to invest in rental housing. In other countries tax or other subsidies make ownership housing more advantageous. Ideally, regulatory and subsidy policy should be tenure neutral, so markets can respond to household demand and preferences.

2.6 Some Criteria for Subsidy Design and Evaluation

The design of specific subsidy mechanisms requires artfulness, intuition and science. Anticipating how different beneficiaries will respond to a subsidy and how deep the subsidy needs to be to get the desired response, how market agents will adjust their behavior, how government entities will be able to allocate the subsidies, what the cost will be not just in the first year after its initiation but in future years: these and many other considerations have to be taken into account. Hard data may not be available to answer most of such questions. Each context will be different and borrowing subsidy programs from other countries or even applying them unchanged across cities within one country will generally not give the desired results. So what is a policy analyst to do?

Science is not completely irrelevant in this process and the use of some core and well established economic and public accounting principles and criteria, even if applied conceptually only or with simple measurements, can improve subsidy design and reform greatly. The case studies discussed in the second part of the book provide some examples of this latter type of subsidy analysis (see also LeBlanc, 2004). The following subsidy assessment criteria will be discussed in this section:

(i) Efficiency
(ii) Equity
(iii) Transparency
(iv) Degree and types of housing market impacts
(v) Impacts on housing and labor market mobility
(vi) The presence of adjustment and exit strategies

While all of these principles are important, tradeoffs have to be made among them as will be discussed below.

2.6.1 Efficiency

Efficiency is about maximizing outputs for a given measure of inputs, i.e., using subsidy resources in such a way that net benefits to both recipients of subsidies and society are maximized relative to opportunity costs (see Box in section 2.4). The benefits should be defined in ways that reflect what the subsidy intends to accomplish.

Measurements of efficiency of housing programs are complex, specifically when these include the analysis of welfare effects not just on consumers (beneficiaries) but on producers in the housing market[16] or the relative welfare effects of alternative government spending options. For this discussion it suffices to outline different and complementary, but sometimes contradictory, measures of efficiency --productive, transfer and allocative efficiency.

- *Productive efficiency asks whether the cost of the subsidy can be reduced without affecting the outcome of the subsidy, for example, by using the private sector rather than government in implementation.* The costs include the stated (on-budget) cost and any indirect costs, as well as the administrative cost to produce and monitor the housing intervention. The indirect costs of a subsidy can be very substantial and include welfare losses due to distortions introduced in the housing or housing finance markets, and the economic costs of pushing up tax rates to pay for any major housing subsidy. Other costs often overlooked include (1) the exposure of government to system risks when subsidies include government guarantees to the housing finance sector and (2) the true market value of government resources, such as public land used to provide the subsidy.

  Equally, the *administrative burden* to implement subsidy programs can be considerable. Such costs are in some instances higher than the subsidy itself, in particular if new organizations have to be set up. The need for and burden of rationing and prioritization can be reduced by designing subsidies in such a way that non-qualifying households would be discouraged to apply, or by introducing point systems that can be easily administered. Also, when subsidy incentives are designed in such a way that they align participants' and private sector partners' behavior with public objectives, the need for monitoring and rule enforcement is reduced. Subsidy programs that require a small catalytic function by government, but that are further implemented by private or non-profit firms, are often administratively most efficient.

  Although costing out of subsidies and their implementation costs can be difficult for housing finance subsidies, it is critical to understand the scale of government outlays and risk exposure (see below under "transparency") for any comparison of alternative housing subsidy programs.

- *Transfer efficiency measures the effects of the subsidy on the actual production and consumption of houses*. There are three specific issues involved in transfer efficiency which have been widely applied to the evaluation of housing subsidies.

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[16] See Horne (1973) on financial subsidies.

(i) *To what degree does the housing subsidy program replace investments or expenditures the recipient would make anyway without the subsidy*? To the extent that a subsidy simply substitutes state money for personal or private sector money, with no change in behavior, there is no benefit (at least related to housing) for the cost. This is sometimes called *"buying out the base"*, referring to the base case of no subsidy. An efficient subsidy in this sense would not just increase the net income of the recipient but actually change the behavior in the direction sought by the program. Closely related is the question of whether the subsidy is focused on *"households on the margin,"* who just need a small push to affect their behavior.

"Buying out the base" is particularly problematic in broad-based housing finance subsidies such as interest rate subsidy programs, general subsidies related to savings programs for housing, and mortgage interest tax deductions. In all three cases, many recipients show no or only a small change in their consumption of housing (e.g., a general subsidy to first-time buyers when 80% of the group would have bought a house anyway).. Careful design and targeting and regular adjustment of the subsidies to new market conditions can avoid the worst of these problems.

(ii) *To what degree does the subsidy leverage additional household resources for housing?* In other words, how much supplemental investment in housing is unleashed by the subsidy? Upgrading programs that improve the security of tenure, core-house programs relying on household contributions, or programs that expand access to credit, typically have a high leveraging effect.

(iii) *How large is the gap between the cost of the subsidy and the beneficiary valuation of impact on their housing situation?* Most subsidy programs result in benefits that are valued less by the recipient of the subsidy than the (opportunity) cost to government if it were expressed in a cash amount. Although the presence of societal benefits are presumed to warrant such subsidies irrespective of the individual's valuation[17], this gap must be factored in when assessing overall efficiency. This gap is intrinsic in any program which grants benefits "in kind" rather than cash unless it serves to change consumer preferences.

Research has shown that giving consumers an allowance or grant to find better ownership or rental housing, will, all else equal, translate into a

[17] Designing the subsidy to increase beneficiary valuation, while desirable, is not always politically feasible or in line with the objective of the subsidy. Part of the overall package of benefits from a subsidy scheme arises from the reaction of the general public to the visible improvement of the living conditions of the beneficiaries, which may imply constraints on the type of housing package that beneficiaries receive. For example, while providing beneficiaries with a simple core house or a walk-up in an accessible location may be preferred by beneficiary households, the political priority may dictate a finished house on cheaper, but less suitable, land.

higher value being placed by the consumer on the improvement in their housing condition than through other types of subsidies (but see section 2.5.2 where limitations of demand side subsidies are discussed). Moreover, many programs could be improved by increasing the housing choices for households and allowing subsidies to be used not just for prescribed new ownership houses but for resale of houses and private rental housing as well. Lastly, requiring an owner equity contribution for home-ownership programs will generally improve the reported valuation of the subsidy by the beneficiary.

- *Allocative efficiency measures the total opportunity cost of the subsidy relative to the total benefits to society.* The benefits to society include the intended public health outcomes, redistributional improvements, gains in market improvements or extension, and economic outputs or increase in national savings. The measurement of allocative efficiency is complex and a political issue for most national subsidy programs, and is not frequently calculated because of that. In general, the most allocatively efficient housing subsidies in emerging economies are those designed to address more "basic needs" and property-right related subsidies, particularly when combined with a savings (or other beneficiary input) and credit program. These have relatively low opportunity costs and high individual and social benefits.

2.6.2 Equity

The equity principle relates to the fairness of the distribution of benefits of the subsidy program or the entire subsidy package. The main equity concern in subsidy design is that outcomes within and across programs not worsen income or housing inequalities in society. There are two types of measures of equity:

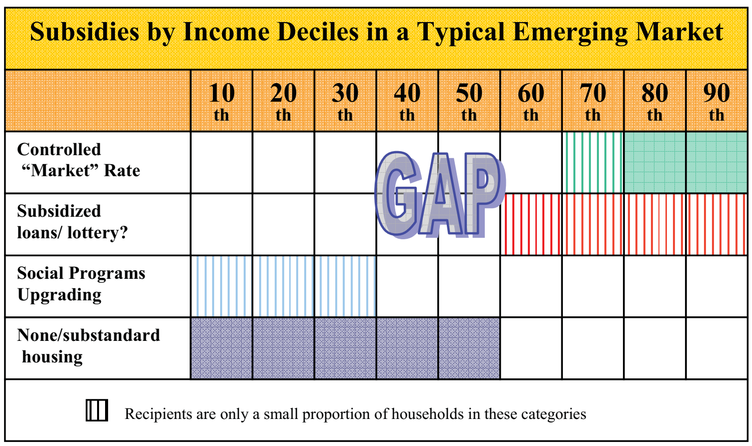
- *"Horizontal equity"* refers to the treatment of households or people within the same income or wealth strata and measures the proportion of those who receive a subsidy relative to all qualified households. In practice, horizontal inequity is nearly always unavoidable because of limited resources (unless the scheme is an entitlement). Designing the subsidy to be closely targeted and using as small a subsidy as possible to get the desired effect helps increase the number of people who can be assisted, thereby reducing the horizontal inequity of the program. Not only does an excessively large per household subsidy reduce the number of people who can access it, it also widens the inequality in the treatment of similar people in general. Broad access is particularly important in housing programs designed to address public health problems or extreme housing inequality in society.

- *"Vertical equity"* refers to the relative treatment of people across different income or wealth strata. Vertical inequities can be exacerbated by subsidies so large that the housing quality of beneficiaries ends up substantially above what can be afforded by households with incomes only slightly higher than the limit for eligibility. As a response to this "cliff-effect" (so-called because a small difference in household situation, say in income, can cause a major shift in outcomes), a disproportional number of households declare incomes or house prices just below each cut-off point.

A system that gradually decreases the subsidy with higher incomes will moderate this effect, but may increase the total number of qualifying households and raise its costs.

Vertical inequity can also be worsened if subsidies primarily benefit the upper-middle class. It is not unusual for the major housing subsidy programs in a country to focus solely on those who can afford formal home-ownership and a formal mortgage loan, which in most emerging economies is the top 30 percent or higher in income. This neglects most housing problems for households below the median income or those with mostly informal or irregular incomes, who may not benefit of any subsidies or only relatively minor ones. (see Fig. 1).

Figure 1 Gap Analysis



Vertical and horizontal equity need, therefore, to be considered not just within each specific program but across different programs. Targeting of beneficiaries also needs to be sensitive to possible gender, racial, or religious biases, which may be exacerbated through finance-linked subsidies because of conscious or unconscious discrimination by lenders.

2.6.3 Transparency of Costs and Beneficiary Selection

The political process will yield good subsidy design only if the actual costs and benefits of subsidies are known publicly. It is therefore important *to define the cost of a subsidy explicitly and, preferably, show its cost in the annual budget*. If costs cannot be shown on the regular budget, as in the case of fiscal subsidies (e.g., tax benefits, tax funds used for housing) or government guarantees for mortgage lending, the budget office of the government needs to make the costs and risks of the subsidy explicit each year. [18] Such

[18] IMF and the EU have published transparency rules related to government subsidies. These are as yet not widely implemented or enforced, however.

calculations would include creating estimates of foregone tax revenues[19]; recognizing the risks of non-repayment of loans from special funds and the liability this poses for the actuarial soundness of these funds; and estimating different risk scenarios including catastrophic or systemic risk for government guarantee programs.[20]

A good example of very large yet obscure costs is lending by public institutions at below-market fixed interest rates with funding drawn from special funds. Such subsidized institutions are common in many Latin American, Asian and some Nordic countries. The size of the subsidy in this case depends on uncertain future market interest rates and unanticipated credit losses because of political risks with respect to loan recovery enforcement. On the funding side there often is an equal lack of transparency. In case of special tax-funded institutions, the taxes are withdrawn from employees' wages to fund these special programs and are seldom included in an analysis of alternative ways to use tax income since they are considered "non-government" funds.

Other, more subtle, examples of hidden costs include government guarantees for default or cash-flow risk that do not charge for coverage of systemic risks in the economy or property markets or the costs of restrictions imposed on the efficiency of financial markets. Even if such costs can not be made transparent in the state budget process, they must be accounted for in any serious analysis of the efficiency and sustainability of housing subsidy schemes.

The other component of transparency refers to *the selection of beneficiaries, which needs to be done according to objective and published criteria*. It is important to make bidding and other administrative procedures clear. The efficiency losses of non-transparent administrative systems or simply corruption are considerable in many countries, but are rarely well documented.

2.6.4 Degree and Types of Market Impacts

All housing subsidies alter markets to some degree in the process of changing incentives. Sometimes the subsidies are designed to explicitly improve the operation of housing markets while other times equity or other goals are paramount. But even subsidy programs focused on equity concerns need to be designed with a view to the market context in which they operate. In practice this means that, where possible, subsidy programs would adhere to the following precepts:

(i) Use market principles such as competition in their design and leave some risks with private entities or households;
(ii) Use market mechanisms such as auctions rather than non-transparent government allocation systems for subsidy funds;
(iii) Use existing, reputable market or NGO actors rather than government entities to implement programs; and

[19] Such calculations are more complex than compiling the total tax deductions, since the tax program itself may affect the consumers' decision to become home-owners and may induce households to take out larger loans (see Sinai and Gyourko, 2004).
[20] For example, implicit government guarantees to the housing finance sector in Brazil have cost the government as much as 6% percent of GDP.

(iv) Avoid setting up separate circuits of publicly owned businesses that will make it difficult for private actors to enter that part of the market in future (or if there is no choice include an exit strategy to allow private entities to take over the specific function in future).

These issues will be discussed at some length in Chapter 4 for housing finance subsidies.

2.6.5 Housing and Labor Mobility

When subsidies are tied to housing units and households cannot transfer the subsidy benefit to another unit or capture the subsidy through resale, housing subsidies can have a negative effect on the mobility of labor to places where it is needed and prevent upward filtering of households through the housing stock. This is a particular problem with public or non-profit rental housing subsidies and rent control policies, but is also a constraint in subsidized ownership housing that may not be transferred for a specific period of time.[21] To the extent possible, subsidies need to avoid limiting the future locational and housing choice of beneficiaries.

2.6.6 Program Monitoring, Adjustment and Exit Strategies

As the GDP, income distributions and demographic profiles of countries change, and as housing markets develop and the financial and mortgage sector deepens, housing subsidy policies need to change. Indeed, few conditions that require housing subsidies are permanent or cumulative and many are of a transitory nature. Yet, most subsidy programs lack a plan that calls for their regular evaluation and adjustment over time. Programs frequently remain in place long after they fulfilled their objectives or are shown to be ineffective.

Having an adjustment or exit strategy is particularly relevant for subsidies funded by international development agencies, most of which have a fixed funding period. Yet project design seldom includes plans for the gradual take-over of the subsidy commitment or function.

2.7 Summary

The general approach to subsidy choice, design or reform discussed in this chapter emphasizes the importance of an initial analysis of the housing problems and the different causes of these problems in order to frame the goals and specific objectives for government intervention. It suggests that it will be extremely beneficial to first consider market and regulatory solutions to fulfill government housing goals and engage in the reform of existing subsidies that no longer help to fulfill those goals before new subsidies are considered. It further discusses some of the general principles that can be applied to an analysis of subsidy programs and the entire subsidy package.

[21] For example, in many Site-and-Services or low-income turn-key programs, subsidized housing cannot be transferred for a period of five to eight years, leading to undesirable informal transfers that cannot use mortgage finance and, hence, depress prices in these neighborhoods. At the same time, if the targeted households convert the subsidy to cash, the purpose of the subsidy is defeated. Aligning subsidy incentives and target groups carefully can reduce such problems.

Two related criteria stand out as particularly critical in designing housing finance subsidies: the need to cost out alternatives in relation to their benefits (as measured by net impacts, not program usage), and the importance of making all current and future costs explicit (i.e., transparent). Hidden and uncertain future costs have been the hallmark of housing subsidies delivered through the financial system, making it impossible to evaluate their outcomes relative to their cost. Even more importantly, it has exposed governments to high and unexpected expenses. Such cost analysis across programs may also identify major gaps and inequities in the subsidy package and show that in many countries subsidies increase housing and income inequities since lower income groups receive relatively small benefits. These subjects will be further discussed in the next chapters.

It is important to mention here that this process requires data on market conditions and subsidy usage and net impact, and that the appropriate economic and financial analysis is applied. However, the capacity of governments to do such analyses is often limited. It is much easier to speak of evaluating efficiency, transparency, equity, demand versus supply side subsidies, and so on, than to apply those principles in practice. The reality is that countries routinely pursue major subsidy schemes in response to political pressures with almost no such analysis in advance nor capacity or desire to evaluate how well the scheme is working after several years of experience.

The result is frequently gross inefficiency and inequities in the development and execution of housing subsidy schemes. As is indicated in later chapters, many subsidy schemes have either been much more costly than necessary or only minimally effective in reaching their stated goals. If even one percent of the cost of the scheme had been devoted to analyzing how different programs would work out, or how they in fact worked out, and how different programs might complement each other to cover different policy objectives, their efficiency and effectiveness could have been substantially improved.

The difficulty of conducting this type of analysis is exacerbated by the fact that in many countries the responsibility for housing subsidy programs is scattered across ministries and agencies. For example, housing finance-linked subsidies are often a major, if not the most important, subsidy mechanism, yet the responsibility for their design and evaluation is often outside the realm of core housing ministries (e.g., instead with tax agencies, finance ministries or even the Central Bank). They are, for that reason, often poorly integrated into the overall housing policy. High level political commitment is necessary to bring all the relevant parties together for such systematic assessment of the entire subsidy policy and provide the necessary resources over time.