THE PUZZLE OF HOUSING PRIVATIZATION IN EASTERN EUROPE

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EXECUTIVE SUMMARY

Housing Privatization: An Overview of the Issues

While most attention is focused on the restructuring of the industrial and commercial sectors of Eastern European economies, the evolution of the housing sector towards a market basis is also important to the process of economic reform. The state rental sector typically accounts for 15 to 20 percent of the overall housing stock and over half of housing units in some cities. It consumes large state subsidies while suffering from deferred maintenance and inefficient management.

One option for reforming the state rental sector is to sell as many units as possible to their current tenants. Among other benefits, privatization permits the reduction of public spending for the construction, operation, and maintenance of these state-owned housing units. However, the seemingly simple solution of privatizing the state-owned housing stock founders on several issues:

- The present distribution of housing units is the result of bureaucratic allocation, not market forces;
- Many tenants would be unwilling to purchase their units even at very deep price discounts;
- In the medium term, the rental sector would be virtually eliminated;
- Sale of units at deep discount would prevent the state from recovering some of the investment it has made in the housing sector can allow the state to finance other priority items related to restructuring.

For reform to be successful two objectives will have to be pursued: (1) selling units at or near market prices to tenants or other households willing to purchase them; and (2) integrating the remaining state-owned rentals with the nascent but expanding private rental market. At the same time, it will be necessary to protect low-income tenants from the full impacts of higher rents and to improve the quality of housing services provided by state rentals.

Pieces of the Puzzle

There are six policy actions necessary for achieving these objectives:

Phased Rent Increases. Raising rents on state rental housing to a level equivalent to that of privately-owned rentals in a free market is mandatory for integration of the two sectors. The development of a market-oriented housing sector implies that the private rental housing market offers adequate returns to investors and that households face the true cost of their housing in return for the greater freedom in their choice of housing. But increasing rents is equally important for the sale of state rentals at reasonable (market or near-market) prices—the higher the rent, the higher the value of the unit and its selling price.

Dealing with Implicit Property Rights. In state rental housing in Eastern Europe, where tenants rights are very strong, there is little incentive for occupant households to move to homeownership. Reforming the law on tenant and landlord rights will be necessary to make rental housing an attractive investment option for private capital. Often, these tenant rights—in some cases, so strong that the distinction between owning and renting is often blurred—have literally been purchased through some payment at the time of initial occupancy. These rights are effectively property rights and they cannot be ignored in attempting to reform the rental sector. One possible solution is for the state to buy out these rights, converting the tenure of occupants to pure tenancy without any implicit ownership rights, before proceeding with privatization.

Market-Rate Housing Finance. Without adequate finance, effective demand for housing will be limited, as households rely on inefficient alternative strategies beyond typical mortgage financing. The state may then attempt to resolve the problem through the supply side by lowering unit sale prices or offering financing with below-market interest rates. This approach is likely to direct subsidies to those who do not need them and promote the sale of the best quality units while leaving the poorest in state ownership. Ideally the financing should be available on terms dictated by the market. This equivalency raises the level of resources flowing to the state and cuts out any bias occupants might have to purchase their rental unit rather than seeking another unit. Establishing a system of market-oriented housing finance requires overcoming three key problems: (1) development of banking institutions operating under market principles; (2) introduction of appropriate lending and savings instruments; and (3) strengthening foreclosure procedures.

Property Appraisals and Other Real Estate Services. In principle, establishing a system of property appraisal and ancillary real estate services should not be difficult, but the lack of established markets undermines the usefulness of many standard real estate service techniques. At present, for example, it is difficult to assemble data on "comparable properties" easily, mainly because of the relatively low volume of private transactions in some countries and the lack of a institutional structure to share and make public information on the sales that do take place. For purchasers to be able to protect themselves from being charged too high a price, information on selling prices of units must be made available through the growth of private real estate service companies operating in a competitive market.

Housing Allowances. Housing allowances provide consumer subsidies only to poor households and are tenant- rather than project-based, i.e., the recipient can take the subsidy with him when he moves, rather than having the subsidy tied to a unit. All income eligible households—those living in state and private rentals—could participate. Thus, state rental units would lose their "privileged" status as subsidized housing and would be required to compete with private rentals to attract tenants—a strong motivation for maintaining housing quality and service levels when the state and private rental sectors are fully integrated. The results of a simulation of a housing allowance program in Hungary show that the majority of current tenants would be income eligible to receive an allowance payment but the rent increases (from all tenants) would be sufficient to finance the allowance payments and leave significant funds to finance improved operation and maintenance of these units.

Private Management of State-Owned Housing. Because rents will increased many-fold during the transition, tenants will demand genuine improvement in services in return. There is much scope for cost reduction in the management of state-owned housing. Introducing competition into the market for property management services can achieve these cost savings, either by spurring greater efficiency on the part of the state management companies or by replacing the state management companies with private management firms. Also, because of the limited scope for renters to express effective demand (by moving out of poorly-run buildings), there is a need for renters to be able to change management companies more readily than is the case in the countries of Western Europe and North America.

Implementing the Reforms

Implementation Strategy. Successful implementation requires that the *entire program* to be announced together so that every family understands the structure of the new system and what its effects will be. On the other hand, not all of the administrative apparatus needs to be in place when the program in unveiled. The availability of housing finance and a system for producing quick and fair appraisals are needed first. When rents are increased, housing allowances should be in position, as should a system for buying out existing tenant ownership claims. Lastly, as rental revenues rise, the shift to private management of the remaining rental properties should be established.

The Pace of Privatization. The speed at which the privatization process should proceed remains an open question. The most likely case will see privatization will move forward selectively, with local authorities trying to steer a middle course between raising required funds for their investment and operational needs (which implies trying to sell the best quality units) and minimizing their operating costs (which implies getting rid of the low-quality units which are the most expensive to operate). Successfully navigating this transitional phase will require careful analysis by the local government of the composition of its social housing stock and conditions in the market for housing purchase.

Other Policy Actions to Support a Competitive Private Housing Sector. Other reforms needed to promote a market-oriented housing sector include changes in legal structures, the construction and building materials markets, and the regulatory system governing land and property development.

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HOUSING PRIVATIZATION: AN OVERVIEW OF THE ISSUES

The transformation of several of the economies of Eastern Europe from their central-plan, command systems to the market-oriented economic model is now well underway. While most press headlines go to the restructuring and privatization of large state-owned enterprises, the evolution of the housing sector towards a market basis is very important to the process of economic reform as well. In Eastern Europe subsidies to this sector, when comprehensively measured, often amounted to 6 or 7 percent of GDP under the old regimes. Moreover, the mispricing of rental units, the inefficient production of state construction companies, and the heavy subsidies to homeowners have combined to make housing both scarce (especially in relation to demand at the artificially low prices) and expensive in terms of its value in the open market (Telgarsky and Struyk, 1990).

The state rental sector typically accounts for 15 to 20 percent of the overall housing stock and over half of housing units in some major cities. Hallmarks of this stock include:

- Low rents, often accounting for less than 5 percent of occupants' income;
- Large on-budget subsidies for construction and maintenance (and massive implicit subsidies in the form of below-market rents);
- Substantial deferred maintenance;
- Allocation of units by bureaucratic regulations;
- Possession of implicit property rights by tenants;
- Inefficient management.

Through mid-1991, no Eastern European country had taken more than the first steps in the process of reforming the state rental sector. Some steps have been taken, however: private rentals have again been permitted (although landlords often are still constrained in their ability to freely set rents and lease terms with sitting tenants); in some countries (Hungary and Bulgaria) a significant share of the stock is being sold to tenants at deep discounts;[1] and in others (Czechoslovakia, Hungary, and Poland) the ownership of state rentals has been transferred to local governments. In contrast, the owner-occupied sector in these countries has generally shifted with greater alacrity to market principles; but important efficiency gains are still to be realized through improving information on sales prices, reducing impediments to private housing production, and increasing the availability of housing finance through the introduction of market interest rates and more suitable mortgage instruments.

Benefits and Problems of Privatization

In shifting the housing sector further to market-oriented principles, realigning the state rental sector is consistently posing the greatest challenge to the architects of reform. As noted above, one option already being adopted on a limited basis is to sell as many units as possible to their current tenants. This approach seems to offer a variety of benefits, the most significant of which is the reduction of public spending for the construction, operation, and maintenance of these state-owned housing units. Other common advantages attributed to the privatization of housing include:

- Dampening of inflation through the absorption of excess cash balances ("monetary overhang");
- Stimulating savings through the increased availability of housing as an investment asset which is attractive to households;
- Increasing labor mobility as the market in private housing is deepened and the opportunity to buy and sell housing becomes more widely available;
- Improving the condition of the housing stock by passing the responsibility for repair and maintenance to households (who will have greater incentives to keep their units in good repair than the state);
- Transferring wealth from the state sector to selected households (to the extent that the sales price of the housing units is discounted from their market value).

[1] Sullivan (1991) reports that about 20 percent of state rentals in Budapest have been sold since 1988.

However, the seemingly simple solution of privatizing the state-owned housing stock founders on several issues.[2] First, the present distribution of housing units is the result of bureaucratic allocation, not market forces. Selling the units to their tenants at deep discounts represents large subsidies which may not go to households most in need of support and thus represents an inefficient use of scarce public resources.

Second, assuming a methodology can be applied to accurately calculate the market price for the sale of state rental units—not a simple task when the private market for housing, which would be the logical benchmark, is still relatively undeveloped and information from private housing sales remains largely unaccessible—past experience indicates many tenants would be unwilling to purchase their units even at very deep price discounts. Deferred maintenance and below-market rents in state rental units imply that purchasers will face significantly higher housing costs when they become responsible for maintaining their units and no longer benefit from the implicit subsidies of artificially low rents.[3] If sale of units to their occupants on a wholesale basis is at best problematic for the reasons outlined, an even more remote option is the sale of entire buildings or projects to investors in the near term.

Third, if a program of privatization were successful, it would mean the virtual elimination of the rental sector over the medium term. In most Eastern European countries private rentals have only become legal since 1989-1990 and many barriers to the development of a full-fledged private rental market still remain in place. Czechoslovakia provides an example of the problems faced by private landlords. In existing private buildings and in those properties being returned to their original owners, landlords are severely constrained: rents remain controlled, fixed-term

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2 See Katsura and Struyk (1990) for a more detailed discussion of these reasons and a description of the housing privatization efforts in China, Hungary, and the United Kingdom.

3 Henward (1991) notes that because of substantial deferred maintenance and repairs, tenants in state-owned housing are reluctant to purchase their units even when offered discounts of up to 85 percent and highly subsidized financing.

leases cannot be imposed on sitting tenants (who may pass on their right of occupancy to their heirs), and evictions are almost impossible because of lengthy legal procedures and the requirement to provide substitute housing. Thus, the current stock of private rentals is likely to shrink as landlords withdraw their units or abandon their buildings. New private rentals, though not confronting these constraints, face a small market because of their high rents—a result of a shortage of finance, land, and efficient construction methods. Correcting these problems will take some time; too-rapid privatization could create significant housing problems until suitable conditions for private rentals are put in place.

Finally, governments in Eastern Europe face tremendous costs in carrying out their programs of economic reform. Recovering some of the investment it has made in the housing sector can allow the state to finance other priority items related to restructuring the economy (such as infrastructure investment, retraining of labor, and providing an adequate social safety net during the transformation period). The stock of state rental housing is a very valuable asset. In Hungary, it is estimated that the value of the stock was greater than the total amount of assets in the financial system in 1990 (World Bank, 1991). Local governments which are now being made responsible for managing the state-owned stock lack their own resources and could tap the value of the units they now own to finance rehabilitation and upgrading of low-quality units (which are unlikely to be attractive to purchasers at even very low prices) and other investment projects for which they are now responsible. This source of resources will be very valuable in the transition period while local governments are establishing their systems of taxation and finance. At present, most local governments must rely on transfers from the central government for the majority of their revenues.

Objectives for Successful Housing Privatization

This paper argues that the reform of the state rental housing sector will be highly complex. For reform to be successful two objectives will have to be pursued simultaneously, and a series of programs and enabling circumstances will have to be in place before sales of the stock are initiated. The two objectives are:

(1) Selling units at or near market prices to tenants or other households willing to purchase them;

(2) Integrating the remaining state-owned rentals with the nascent but expanding private rental market by raising rents, with the possibility of eventually selling projects to private investors.

While pursuing these objectives it will be necessary to protect low-income tenants from the full impacts of higher rents and to improve the quality of housing services provided by state rentals so that tenants are motivated to pay the higher rents and the units can compete with those in the private sector and be attractive to possible investors.

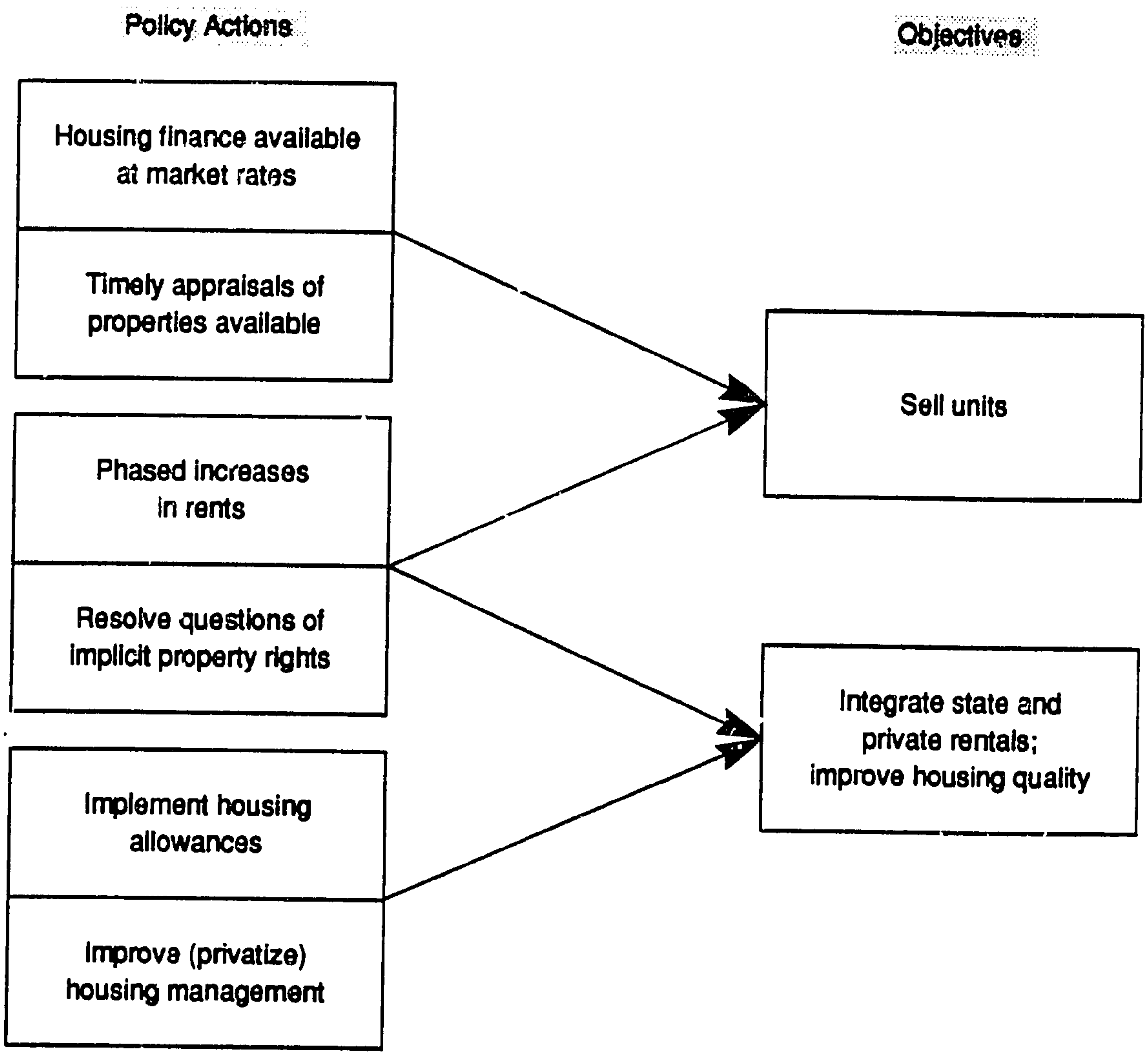
Achieving these objectives efficiently requires moving on several fronts before launching a program to sell units. To date no Eastern European country's reform plans have approached what is needed in terms of extensiveness and sophistication to permit a privatization program which can meet the many goals outlined above. Unfortunately, the shift of ownership of state rental housing to the local level makes it even less likely that such a comprehensive program being adopted.

This paper outlines the elements of a comprehensive and coherent strategy for transforming the state rental units either into homeownership or into essentially private rentals, while being fair to sitting tenants who typically have substantial implicit property rights. The next section enumerates the various elements of the reform package and discusses how they fit together. The final section presents some conclusions on how to implement the reform package.

PIECES OF THE PUZZLE

As illustrated in Figure 1 (see next page), there are six policy actions necessary for achieving the dual objectives of selling state-owned units to private owners and integrating state and private rentals (i.e., putting the state and private rental markets on an even competitive footing). Two of these actions—phased increases in rents and dealing with implicit property rights—are common to realizing both objectives. It is this overlap in policy actions that makes it essential to pursue both objectives

Figure 1
Privatization of State Rental Housing



simultaneously. Of the remaining four actions two are required for selling units and two for integrating the rental sector.

Reforms to Achieve Both Sales of Units and Integration of the Rental Sector

Phased Rent Increases. Raising rents on state rental housing units over time to a level equivalent to that commanded by privately-owned rentals in a free market is mandatory for integration of the private and public rental sectors. Using free-market rents as a target is important because the development of a market-oriented housing sector implies that the private rental housing market offers adequate returns to investors and that households face the true cost of their housing in return for the greater freedom to choose they type of housing they desire.[4] Not allowing rents in the housing sector to be set freely has several negative consequences:

- Below-market rents do not allow investors in housing to earn a competitive return—potential producers of housing channel resources to other assets;
- Units from the existing stock of rental housing are lost at an accelerated rate as the owners cannot afford to maintain their buildings or abandon them entirely;
- Tenants do not face the true cost of their housing consumption and will tend to be "overhoused" (i.e., occupy housing which is larger or of higher quality than they would if they faced the true cost of such a choice).

Having identified the negative consequences associated with keeping rents below their free-market level, what benefits result from allowing them to rise? First, it allows the private rental sector to continue to expand under the spur of the high rates of return. Private rental housing represents the "safety valve" for excess demand in the housing system until the shift in housing production to the private sector is complete and the supply of housing is brought into balance with demand.

Second, making households face the true cost of their housing choices is likely to result in a much more efficient allocation of units. For example, households of one or two persons which currently occupy large units will face much stronger incentives to move to a unit of two or three rooms in order to reduce their housing costs. This movement will free up the larger unit for growing families which are currently living in cramped conditions. While it is clear that Poland faces a large, absolute shortage of housing units, it is far from clear that such a situation exists in other Eastern

4 Rent control on all residential properties is currently in effect in Czechoslovakia; in Hungary and Poland, the private rental market is free of controls, but still accounts for only a small share of the total rental housing stock.

European countries such as Hungary and Czechoslovakia. Thus, achieving a more efficient distribution of units among households may potentially obviate the need to undertake increased production of housing units and allow investment in the sector to focus more on raising the quality of the existing stock.

But increasing rents is equally important for the sale of state rentals at reasonable (market or near-market) prices. Put simply, the value of a unit to a sitting tenant (and other possible purchasers) depends on the unit's net rent. The higher the rent, the higher the value and selling price. It is crucial to announce the full program of rent increases that will be phased in over the transition period at the beginning of the period so that terminal rents will be used by potential purchasers in computing a unit's value.

In Hungary, the effect of low rents on the sale of state-owned units has been very clear. The Hungarian government has a standing offer to sell individual units to their occupants at discounts ranging from 85 to 60 percent of current market value. Despite generous financing terms—downpayments as low as 10 percent and the balance payable through an installment loan with an implicit interest rate of 3 percent annually—that provide a strong incentive to purchase, only about 20 percent of the state-owned rental stock has been sold—most of it in 1991 as fears of rent hikes have increased. It is still much cheaper for the household to remain as a tenant with low rents and no responsibility for maintenance and repairs.

It may be true that some transitional limits on rents are required during the period of large price adjustments associated with the economic restructuring process.[5] However, it should be the aim of policymakers to move as quickly as possible toward market rents as the results of economic restructuring raise household incomes. (For those households whose incomes do not keep up with the

[5] For example, in the months following price liberalization in Poland in 1990 and in Czechoslovakia in 1991, it was not uncommon for households to be spending as much as 60 percent of their income on food. In such circumstances it is obviously not feasible to require households to also immediately increase the share of income devoted to housing costs from 10 to 30 percent.

increases in rents, support from the state, in the form of housing allowances, is appropriate; this issue is discussed below.) A gradual increase in rents over a three- to five-year period seems wise in order to provide time for the various adjustments described above to take place.

Dealing with Implicit Property Rights. The attractiveness of owning rather than renting a unit also depends on the degree of security sitting tenants enjoy. In situations where tenants rights are very strong and landlords have little opportunity to replace existing tenants with those willing to pay a higher rent, there is little incentive for households which already have obtained rental accommodation to move to homeownership. These circumstances describe Eastern European countries, where renters of state-owned flats have enjoyed extraordinary protection.

In Czechoslovakia, for example, sitting tenants usually occupy their flats without a fixed-term lease and are implicitly considered to have a perpetual occupancy right to the unit which they can pass to their heirs. In addition, in the limited circumstances when tenants can be evicted—for instance, for failure to pay rent or for no longer being an employee of the enterprise which is providing housing—the legal procedures required to actually remove the tenant can take years to carry out. The most difficult problem for the landlord is the requirement that "comparable" substitute housing must be found for the displaced tenant.

However, current Czechoslovak reform plans will allow sitting tenants to continue to enjoy a perpetual lease which may be passed to their heirs in both state-owned and private rentals. Only leases for new tenants will be allowed to specify fixed terms (i.e., sitting tenants cannot have fixed-term leases imposed by their landlords). With sitting tenants having little incentive to move from their current units (and so give up their protected status), the large majority of the rental stock will remain unintegrated with the emerging market-oriented rental housing sector. This situation has two effects. First, a lower rate of residential mobility is established than would obtain in a market-oriented system which more evenly balanced tenant and landlord right. The lower level of turnover provides less opportunity for households which tend to have the greatest needs for rental housing, such as young families. Second, this lack of protection of landlord property rights implies that there will be little interest by investors in dwelling units which are already occupied by protected tenants—effectively cutting off a large segment of the housing stock from private resources which could fund repairs and rehabilitation.

Reforming the law on tenant and landlord rights will be necessary in order to make rental housing an attractive investment option for private capital. Since the tenants have simply been exercising their rights under the law—as opposed to having bought the right from the landlord—the withdrawal of some tenant protection does not amount to confiscation without compensation of a right or asset which the tenant purchased.

Often, however, these protection have literally been purchased by the tenants through some payment at the time of initial occupancy. Thus, these tenant protection are not legal rights given to all tenants, but are property rights which individual households have obtained through a contractual agreement between the landlord and the household. The occupancy rights conferred by the payment of "key money" or similar charges include the ability to transfer occupancy of the unit to one's heirs and nearly absolute freedom from eviction, as long as rental payments are made. Moreover, in some countries it has been possible for tenants to sell their units in the "gray market" as well as to the housing agency when they move.

In Hungary, for example, tenants have been required to make a key money payment to the government at the time of the initial occupancy of the state-owned rental unit. The occupancy right implied by the key money payment was officially recognized by local governments in 1981. Local councils even purchase back the occupancy right (paying between 3 and 10 times the initial payment, depending on the quality and condition of the unit) in order to have households vacate their unit so that it may be allocated to another household, rather than have the initial tenant privately sell the right to another household. Despite local authorities' attempt to buy back the occupancy right, the majority of households which leave their units sell the right to another household. It is estimated that 30 percent of the tenants in state-owned housing purchased their occupancy right on the gray market.[6]

In cases such as Hungary, occupancy rights are so strong that the distinction between owning and renting is often blurred. These rights are effectively property rights and they cannot be ignored in attempting to reform the rental sector. A proposal put forth for Hungary attempts to address the problem. The Government offers identical awards to those who purchase their units as well as those who elect to remain as renters (Hegedus et al., 1990). In this particular case those electing to purchase would pay 20 percent less than the market value of their unit, and renters would receive a payment equivalent to 20 percent of the value of their units in cash or bonds. After this step renters can continue to occupy their units as long as they pay the going rent (specified in a lease), but they cannot sell the unit or give it to other family members. How to price these property rights is ultimately a political decision, presumably dependent part on the effective strength of the rights under the old regime.

While rewarding sitting tenants for their current property rights is a necessary step, it will not be sufficient. The laws governing tenants' rights must be amended. This is likely to be politically difficult and will have to be done at the national level. In Czechoslovakia, for example, the Civil Code must be revised—a task doubly difficult because of the contrary views of the Czech and Slovak Republics. In Hungary, there is debate over whether the key objectives can be achieved by rescinding Government Decrees issued over the past 30 years to amend the Code or whether this basic law will have to be revised.[7]

Other Reforms for Selling Units

The announcement of the schedule for increasing rents and the program for handling property rights sets the major ground rules for purchase of state rental units. However, two other actions are necessary for an efficient sale of units: first,

6 See Hegedus et al. (1990).

7 See Heller (1991) for a discussion of the Hungarian case. On Czechoslovakia, see Hetzel (1991).

financing to support the purchase must be in place; and second, timely and accurate appraisals of units being sold must be available.

Market-Rate Housing Finance. Without adequate finance, effective demand for housing will be limited, as households will have to rely on alternative strategies beyond typical mortgage financing for purchasing a unit. Such an approach to housing finance can have several outcomes:

- Would-be purchasers are limited to housing with prices equal to or less than the amount the household has saved and can borrow from friends and relatives. Households without access to outside sources of capital will be forced to save for several years in order to purchase a unit.

- Many households simply cannot afford to purchase any unit unless the seller can provide financing. Since the sellers will themselves often need financing to obtain their new housing unit, this approach will only provide a solution for a marginal number of households.

- Households are forced to purchase small or poor quality units or build a small starter unit which they may then improve and expand over time as they are able to save adequate funds. It may take several years before a household finally obtains a housing unit which adequately meets their needs.

- Households that wish to become owner-occupiers remain in the rental sector (especially if they enjoy low rents and a highly-protected status as tenants in state-owned housing), reducing turnover and limiting the development of the rental housing market.

Inevitably, all such informal financing is inefficient—households which could take on and service the debt required to purchase a housing unit are unable to do so in a large number of instances. A potential result of such an outcome is for the state to attempt to resolve the problem through the supply side by lowering sale prices on state-owned housing to levels affordable without financing or by offering sales by the state and local government on an installment basis at below-market interest rates—as is now the case in Hungary.

As noted above, where the distribution of state-owned housing is the result of bureaucratic rather than market forces, the sale of units to existing tenants represents additional subsidies to households which previously have been heavily subsidized, but which may not be the household most in need. In addition, the combination of subsidized rents and the potential maintenance and repair costs to new owners of units in poor repair, it is likely that only the best-quality units would be purchased, leaving the state with the units with the highest operating costs and which require the greatest investment in order to make them saleable. Discounts offered because of the lack of financing reduce the amount of resources which can be generated from the sale of these higher-quality units and makes the financing of needed rehabilitation of lower-quality units an even more difficult task for the state.

Ideally the financing should be available on terms dictated by the market; equally important, the terms and conditions for those purchasing a state rental unit (except for the purchase price discount) should be the same as those for households purchasing units in the open market. This equivalency not only raises the level of resources flowing to the state, but also cuts out any bias occupants might have (and the subsidy that causes this bias) to purchase their rental unit rather than seeking another unit.

Establishing a system of market-oriented housing finance requires overcoming three key problems faced by reforming Eastern European economies:

- Development of efficient banking institutions operating under market principles;
- Introduction of appropriate lending and savings instruments which deal with the inflationary problems associated with economic restructuring;
- Strengthening foreclosure procedures.

Banking systems in Eastern Europe are only now making the transition from reliance on public resources to private funds for their lending activities—a change which requires more careful evaluation of borrowers and their requests. In the case of housing finance, the change is further hindered by the previous monopolistic structure where housing finance was channelled through a specialized bank (usually the state savings bank). This bank often acted merely as a credit allocation agent for the state, disbursing highly subsidized credits, and was not required to make any assessments about the riskiness of its loans. Steps are being taken in most Eastern European countries to move the savings banks onto a commercial footing by removing the subsidy-distribution function from their operations and moving new housing lending towards market terms.[8]

A second problem to be overcome is how to structure long-term lending in an inflationary environment. The initial response in most Eastern European countries has been to deepen subsidies to maintain the financial affordability of housing loans. However, in the cases of Poland and Hungary, the experience with this approach has proven to be extremely costly to the government budget. As a result, these countries are now planning to implement appropriate lending instruments—in the case of Poland, dual index mortgages (DIMs); in Hungary, probably a form of graduated payment mortgage—that help maintain affordability for the borrower while ensuring adequate returns for the lender.[9]

Finally, attracting newly-established private banks—which can bring needed technical underwriting skills and competition into the housing finance market—will require additional reforms beyond raising interest rates to market levels. Enforceable collateral guarantees and foreclosure procedures, which are still lacking in most Eastern European countries, are also needed to provide security to lenders.[10]

If the reforms to the housing finance system described above can be achieved,

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8 Poland, Hungary, Bulgaria, and Yugoslavia have all raised the interest rates on their new housing lending and are in the process of restructuring their primary housing finance institutions.

9 Other Eastern European countries, such as Czechoslovakia and Romania, have been slower to make changes in their systems of housing finance. Their ability to maintain their current highly-subsidized systems, however, is based on the relatively small portfolios of housing loans within the financial system. As the demand for housing finance increases, it seems likely that reform will be necessary if adequate levels of finance are to be made available without severe pressure being placed on the state budget.

10 Heller's (1991) discussion of these problems in Hungary gives a good overview of the general problems and some pointers on how they might be mitigated. The most serious difficulty is the right of the borrower to remain in the unit unless substitute housing is provided.

it is still likely that some form of support will be needed for lower-income households to be able to purchase a home. If access to homeownership is a desired social goal, then Eastern European governments should aim to provide the required subsidies in a manner which is explicit, controllable, and able to be well-targeted to those households most in need of support; means-tested capital grants for home purchase financed out of the national budget are an example of such a support program.

Property Appraisals and Other Real Estate Services. In principle, establishing a system of property appraisal and ancillary real estate services should not be difficult, since the markets for owner-occupied single family units and apartments are now developing in nearly all Eastern European countries. However, in several countries prices in real estate transactions have not been determined by market forces for many years. For example, sales prices for buildings and land in Czechoslovakia have been fixed since 1964 by a national law (which is currently being revised). However, location and other key characteristics were not considered in the price-setting formula. Similarly, land prices in Bulgaria was set by a national tariff during 1973-1987 (Telgarsky and Struyk, 1990). Thus, there is little familiarity with market-oriented methods of pricing and appraising properties.

There are several approaches to solving the problem of developing price information on buildings and property, but the legacy of the planned economy undermines the usefulness of some of these techniques. Cost-based methods will not yield suitable results when historical prices do not really reflect true costs and current prices are distorted by the dislocations associated with economic restructuring. Similarly, income-based methods are rendered less useful because of the disequilibrium in the rental market, with free-market rents pushed up because of the scarcity of available rental housing while sitting tenants continue to enjoy low, regulated rents. Thus, the most useful approach seems to be one which utilizes the information provided by similar transactions in the developing private real estate market—the price signals from these sales not only reflect current market conditions, but also expectations about future market conditions, such as capital appreciation.

At present, however, it is difficult to assemble data on "comparable properties" easily, mainly because of the relatively low volume of private transactions in some countries and the lack of a institutional structure to share and make public information on the sales that do take place. Only in Hungary and Poland have associations of real estate professionals been organized; in other Eastern European countries, real estate brokerage and services are still handled mainly by lawyers and other entrepreneurs as a part-time sideline to their other business. Thus, except for the largest real estate service firms, agents can often only provide their clients with their own limited knowledge of the market.[11]

This dearth of accessible information can lead to inequitable treatment of similar purchasers. For purchasers to be able to protect themselves from being charged too high a price, information on selling prices of units must be made readily available through the development of private real estate service companies operating in a competitive market.

Other Reforms for Integrating Public and Private Rental Markets

Those remaining renters of state-owned units will face sharp increases in rents. In Hungary it is estimated that in the fall of 1990 rents on private units were 10 to 12 times greater than the rents administratively set for state rentals. Of course, this is not the gap which will have to be covered by increasing rents on state units: the supply of private units is also increasing and the effective demand of the majority of occupants of state rentals is well below these levels (i.e., market rents are far too high to be paid); both factors will drive market rents downward as rents on state units are gradually raised to meet them.[12]

In conjunction with raising rents two policy actions are essential. The first is the introduction of housing allowances to protect low income renters from having to spend a overly large share of their incomes to remain in rental housing. The second

[11] Plans to establish regulations governing real estate professionals and set up institutions to provide market information (such as multiple listing services) are being discussed in Poland and Hungary.

[12] See Hegedus et al. (1990), Chapter 4.

policy action should address improving the management the state-owned rental stock.

Housing Allowances. The use of housing allowances allows the reform of the state rental sector to proceed on the middle course between the two administratively-oriented solutions which are often advanced to resolve the current problems of state-owned housing:

- Wholesale privatization of state rental units at deep discounts, which remove the immediate problem of the costs state rentals impose on the budget in the short term, but does not address the needs of poor households who cannot afford to purchase their unit or rent a unit in the free market;

- The retention of the units as special, highly subsidized, rent-controlled units, which continues the current pattern of high costs to the public sector with little control over occupancy of the unit once the unit is assigned to the initial tenant.

Both of these approaches have the disadvantages of imposing significant costs on the public sector budget by providing expensive subsidies that are difficult to target on the households most in need.

Housing allowances provide consumer subsidies only to poor households, which is in sharp contrast with rent controls under which all households benefit, regardless of income. Moreover, allowances are tenant- rather than project-based, i.e., the recipient can take the subsidy with him when he moves, rather than having the subsidy tied to a unit. All income eligible households—those living in state and private rentals—could participate. Thus, state rental units would lose their "privileged" status as subsidized housing and would be required to compete with private rentals to attract tenants—a strong motivation for maintaining housing quality and service levels when the state and private rental sectors are fully integrated.

Analysis has been done of introducing a housing allowance program in Hungary under which at the end of the phase-in period participants would pay between 15 and 20 percent of their income for rents (exclusive of utilities) and with subsidies calculated as the difference between the market-determined rent of a good quality unit of the size appropriate for the household and its mandated contribution (Hegedus et al., 1990).[13] Subsidies for renters living in units larger than the program standard for a family of its size are computed based on the standard unit—thereby creating a strong incentive to move to a smaller unit. The results show that the majority of current tenants would be income eligible to receive an allowance payment but the rent increases (from all tenants) would be sufficient to finance the allowance payments and leave significant funds to finance improved operation and maintenance of these units.

Private Management of State-Owned Housing. Because rents are likely to increase by several hundred percent during the transition, tenants will demand genuine improvement in services in exchange for the higher rents. It is, however, an open question whether the monopolistic and openly disparaged state-owned management companies, such as the IKVs in Hungary, will meet this challenge, even with a sharp rise in the financial resources available for maintenance and operations. For example, in Czechoslovakia, comparisons of per unit management costs between self-managed cooperative housing and state-owned housing managed by the OPBHs (the state management companies) showed that management costs in the cooperative were about half those in the state-owned housing (Taylor, 1991). Clearly, there is much scope for cost reduction in the management of state-owned housing. Introducing competition into the market for property management services can achieve these cost savings, either by spurring greater efficiency on the part of the state management companies or by replacing the state management companies with private management firms.

The introduction of competition among housing suppliers is especially critical

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13 The subsidy payment to a participant household in these simulations was calculated using the "housing gap" formula of the housing voucher program administered by the US Department of Housing and Urban Development. This formula was chosen—rather than, for example, the German or Dutch models—because of its comparative simplicity. This clarity transmits the desired incentives for household behavior to be readily understood by program participants.

for another reason—because of the limited scope for renters to express effective demand. In particular, in situations of significant housing shortage, the possibility for dissatisfied renters to "vote with their feet" by relocating to another unit is highly constrained (for example, Mayo and Stein, 1988); in Warsaw, as an extreme, moving is nearly impossible.[14] Hence, there is a need for renters to be able to change management companies more readily than is the case in the countries of Western Europe and North America. Eventually, as more private rental housing is developed, competition will be generated by households being able to move to better managed buildings.

Struyk et al. (1991) outline four elements for the comprehensive reform of the management of state rental housing:

(1) Management contracts for each building or project (large enough to make the management activity economically efficient) would be competitively awarded by local government.

(2) Prospective management companies would have to present their plans (based on a fixed management fee and estimated operating budget) to tenants who would then vote for the package of management company, services, and fees they desired.

(3) In the early years, winning firms would be awarded renewable one-year contracts (subject to tenant re-selection); later, as the most capable firms were identified, longer-term contracts could be awarded.

(4) Management contracts should be phased in over a several-year period, beginning with demonstration projects and an information campaign to attract potential service providers (including existing state management companies) and provide them with training on efficient management and financial control techniques.

This approach has the added benefit of opening business opportunities to small entrepreneurs. Property management companies require little capital

14 More typical is the situation in Slupsk, a city of 100,000 persons northwest of Warsaw with a mixed economy based on manufacturing, transport, and agriculture. On average, only 100 of the 12,300 state rental units become available each year for new tenants (Bernard and Maffin, 1990).

equipment for routine operations and local governments could work with commercial banks to help newly-formed companies gain access to credit. Recent experience in District 2 of Prague shows that there does seem to be a pool of entrepreneurs willing to enter this market. After abolishing the state management company for the district, the district council received 24 responses to its request for proposals to provide management services for its social housing stock. Of course, not all of the responding firms had adequate organizational and financial management skills, but these are deficiencies which can be addressed through training and careful monitoring of the performance of the management companies.

IMPLEMENTING THE REFORMS

Having outlined the areas where changes are needed in order to carry out the privatization of the state rental stock in a fashion that contributes the development of the housing sector, many questions still remain: How should these reforms be implemented, simultaneously or in a specific sequence? At how fast a pace should privatization proceed? What other reforms, though not necessary to carry out housing privatization, can help smooth the process and promote the development of a market-oriented housing sector? These questions are examined below.

Implementation Strategy

In considering how to implement the set of proposals described above, the first point is for the *entire program* to be announced together so that every family understands the structure of the new system and what its effects will be. At the time of announcement, the major policy decisions for all six actions must have been taken. Indeed, they are interdependent and form the substance of the announcement.

On the other hand, not all of the administrative apparatus needs to be in place when the program in unveiled. The two policy reforms that should be ready are the availability of housing finance and a system for producing quick and fair appraisals for units whose occupants may want to purchase. When rents are increased, housing allowances—at least a simple system for the first year when not many households will likely participate because the rent increases will be modest—should be in position. It is also at this point that the exact method and timing for making payments to tenants who elect *not* to purchase their units should be implemented (the discounting of purchase prices is straightforward and is simply a policy decision). Lastly, as rental revenues rise, the shift to private management of the remaining rental properties should be established. Even with some staggering of the policy reforms, these action constitute an enormous challenge to even well-functioning government administration.

The Pace of Privatization

The discussion above has concentrated mainly on the steps which need to be taken in order to successfully carry out a program of privatization. However, the speed at which the privatization process should proceed remains an open question. The pace of privatization is a key factor in reforming the state rental sector. Selling the units too quickly risks depressing the revenues which can be obtained by the state and thus may fail to recover—in real terms—the value of investments for which society as a whole has paid. Too slow a pace (particularly in combination with a failure to move rents to free market levels) can place an insupportable burden on local authorities responsible for the state-owned stock and deprive them of revenues badly needed to upgrade inadequate and poor quality units.

Unfortunately, there does not appear to be a simple "right" answer to the question of how fast privatization should proceed. What seems clear is that the pace of privatization is likely to be faster if either of two sets of conditions obtain:

(1) Cases where the reforms outlined above are not put into effect and their future implementation appears improbable.

(2) Cases where rapid reforms are realized and authorities and households can freely make a choice between owning and renting.

In the first case, authorities responsible for state-owned housing are likely to push the pace of privatization because of the desire to be free of the burden of losses imposed by unreformed social housing: rents do not cover operating costs; local authorities lack the funds to carry out needed repairs and rehabilitation; tenants cannot be moved to more appropriate units in order to create a better fit between households and the stock. In short, if housing conditions do not change much from the *status quo* under the planned economy, but local authorities now must finance its heavy costs, they are likely to look for the quickest solution—giving away their problem. As noted at the beginning of this paper, selling of social housing with deep discounts presents serious problems, but these may not weigh so much on the local authorities' decision as the pressing problem of a current funding shortfall. Such a choice could easily occur—in early 1990, several districts in Budapest instructed the state company managing state rental units in the districts to sell *all* the units (Sullivan, 1991).

In the second case, the problems outlined in this paper are moving toward quick resolution and households and local authorities are making decisions freely based on market-oriented criteria. Households become owner-occupiers because of its economic and security advantages (compared to market-based rentals) and local authorities offer units for sale to meet their own revenue and housing strategy goals.

In the grey area in between these two cases, it is likely that privatization will move forward selectively, with local authorities trying to steer a middle course between raising required funds for their investment and operational needs (which implies trying to sell the best quality units) and minimizing their operating costs (which implies getting rid of the low-quality units which are the most expensive to operate). Successfully navigating this transitional phase will require careful analysis by the local government of the composition of its social housing stock—so that it is well-aware of what it has to offer in the market—and conditions in the market for housing purchase—what the likely outcomes of its privatization efforts will be. Whether local governments have these skills is an open question, but the experience to date in Hungary and Czechoslovakia suggests that they generally lack these abilities.

Other Policy Actions to Support a Competitive Private Housing Sector

Other reforms which are needed beyond those specified above to promote a market-oriented housing sector include changes in legal structures, the construction and building materials markets, and the regulatory system governing land and property development.

Legal Issues. Governments should seek to develop a legal framework that gives adequate protection to the rights of both sides in housing relations—lenders and borrowers; landlords and tenants. Development of the private market for housing requires that parties in the housing market can freely enter into contracts regarding the sale and leasing of housing. Specifically, for this system of contracts to be effective requires enforceable foreclosure and eviction procedures. The purchase of a state-owned unit is much more attractive to households if they are certain that they will be able to exercise a full range of property rights and maximize their return from their housing investment.

Construction and Building Materials Markets. At present, the role of state-owned enterprises (SOEs) as producers in the housing sector is being cut, with the major differences between Eastern European countries being the speed at which production is shifting towards private contractors and self-help. It remains to be seen if the SOEs can reform themselves to become efficient and responsive enough to consumers in a competitive market. During the transition, it is important that government work to establish a "level playing field" for construction firms in both the public and private sectors. It is still often the case that SOEs still receive preferential treatment—either because of previously negotiated deals, their political importance as employers, or their familiarity with decision-makers—in terms of access to land, financing, and other inputs. These advantages perpetuate the inefficient operation of the SOE and reduce the chances of success for new private firms trying to break into the market. A strong population of competing firms in the housing sector is an important factor for reducing costs and increasing efficiency in the sector.

Regulatory Framework in Support of Private Activity. Finally, governments can also promote a market-oriented housing sector by establishing a regulatory system that acts as a facilitator of private activity rather than an inhibitor. Local governments need to look not only at the sale of state-owned housing as a means of meeting demand for home ownership, but also at the provision of building sites out of the stock of developable state-owned land for households that wish to build new units. (It may well be the case, as described by a Czechoslovak deputy mayor, that the best use of some state-owned housing would be its demolition and use of the land as new building sites.) In support of efficient private development, streamlined procedures and clearly defined regulations and standards for title transfer, land development, and construction can help boost the supply of affordable housing. More slack in the supply of housing gives governments greater freedom to make choices about how best to use the state-owned stock as it eliminates the need to be constantly addressing the problems caused by housing shortages.

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