CENTER OF LEGAL COMPETENCE

Verein zur Förderung
der rechtlichen
Ostkompetenz Österreichs

Wohllebengasse 6
A-1040 Wien
Tel.: +43-1-503 73 35
Fax: +43-1-503 73 36
E-mail: office@clc.or.at

Housing Policy
in Central European Countries in Transition

Czech Republic, Hungary, Poland, and Slovakia

Hans-Joachim Dübel

December 2003

Housing Policy in Central European Countries in Transition

Content:

A Housing Sector in Transition

1 Housing Provision

As of 1990, the housing sector in Central European transition countries was characterized by a high quantitative endowment with dwellings. Statistical data, while showing some dispersion, indicated only 25% less units per 1,000 inhabitants than on average in the EU countries. During socialism this result had been obtained under great efforts, including diverting resources from other sectors of the economy. In their thrust towards greater quantities, planners had accepted a comprehensive standardization of construction methods, and sometimes low standards of construction quality.

As the 1990s brought about very low levels of new construction activity, and vacancies have increased steadily, still more than a decade into the transition a notion of a quantitatively sufficient provision with housing units in the region prevails. From this, inference is often made that housing demand must be structurally low due to saturation. This impression is misleading, however, for a number of reasons:

Backlog in household formation. In spite of a mostly weak demographic environment, housing demand is supported in the region by strong household growth, both currently as well as during the remainder of the current decade and likely beyond. Particularly Poland and Slovakia are characterized by large households, at the far upper end of the European scale; household size can be expected to drop along with rising income levels and changing household preferences, as these adjust to average EU levels. For comparison: the average size of households in the EU between 1980 and 2000 fell geometrically by approximately 8–10% per decade.

Reduction of cohabitation. Latent housing demand resulting from the living of several households in forced joint tenure – often younger households living together or with their parents – is generally underestimated as a housing demand factor. The extent of such cohabitation in the reviewed countries is higher as the overall endowment with housing units is lower; it is strongest in Poland and Slovakia, and weakest in the Czech Republic and Slovakia. Considering the impact of increased migration, sagging new construction activity and the absence of rent reforms – which could lead to free space in the existing stock – cohabitation has been on the increase or at least remained stagnant, in almost all transition countries, during the 1990s.

Regional concentration. In the surveyed countries, housing demand is undergoing a transformation: it is increasingly regionally concentrated and related to new quality demands. Consequently, statistical housing deficits or surpluses are increasingly unevenly distributed in an interregional perspective. Because of inaccuracies of migration and housing statistics these deficits are not always clearly traceable from a statistical point of view. However, anecdotal evidence suggests that they are particularly problematic in Poland and Slovakia, whose Eastern regions in both cases feature a coincidence of structural economic problems and housing sector disequilibria.[2] In the Czech Republic, Slovakia and Hungary there is strong migration activity into the main urban centres.

Stock losses. The quantitative impact of permanent losses of housing stock in the region – through uninhabitable condition or insufficient quality standard – is significant. Due to the lack of public support, the necessary demolitions of the majority of these units are realized only gradually. However, during the 1990s even the small demolition activity already approached a scale of approximately a quarter of new construction. Considering available data on vacancies – in the region in total approximately 2.1 million housing units, or 9% of housing stock – a sharp increase in demolitions can be expected until the end of the current decade.

2 New Construction Activity

Reviews of the housing sectors in transition countries tend to lament over the recession in new construction activity in the 1990s. This tendency overlooks that the sector benefited from a vast qualitative change, in particular in the investor structure, away from government to private and partly non-profit investors.

Various attempts made in the 1990s to stem the decline in new construction by reviving the old role of the state as investor resulted in little quantities being produced and often had to be aborted due to high subsidy costs. The main burden of new construction therefore fell on the private sector – in particular in the areas of single-family and upscale rental housing construction – and on more recently developed public-private partnership finance models such as the Polish system of social housing construction (“*Towarzystwo Budownictwa Społecznego*“ – TBS) created in 1997.

The evaluation of activity also needs to consider that during the first decade of transition income, construction and funding cost trends preempted an improvement in the affordability of new housing units. In addition, opportunity costs for potential buyers in this market segment tend to be extremely high, since most sitting tenants are protected by rent control in their existing apartments. It might sound cynical, but in reality is not: only with the accelerating decay of many rental apartment buildings, which – whether privately or publicly owned – due to rent controls are overwhelmingly insufficiently maintained,, the cost-benefit relation of new construction is improving from the perspective of potential buyers.

2 Paradoxically, housing vacancy ratios in Slovakia are at national lows both in the eastern part of the country and in the booming region around Bratislava. The reason is the extremely weak provision with housing in the east: the number of housing units in the Košice district per 1,000 inhabitants is 25 % lower than in Bratislava. This turns the housing sector into an additional push factor of migration, from east to west.

Table 1: Population, Housing Stock, and Factors Contributing to Housing Construction in Central Europe Countries in Transition, 1990–2010

Country	Inhabi-tants	Inhabited Stock	Household Growth and Reduced Cohabitation		Demolitions and Vacancy Increases	
	* 1.000	per 1.000 Inhabitants	per 1.000 Inhabitants, per annum		per 1.000 Inhabitants, per annum	
	2000	2000	1991–2000	2001–2010 (1)	1991–2000	2001–2010 (1)
Poland	38,650	307	2.13	2.25	0.19	1.63
Slovakia	5,379	348	0.88	1.93	1.13	1.31
Czech Republic (2)	10,230	374	1.19	1.45	1.02	1.48
Hungary (2)	10,246	403	0.33	0.91	2.32	2.07

Country	Construction of New Housing Units		
	per 1.000 Inhabitants, per annum		
	1991–2000	2001/2	2001–2010 (1)
Poland	2.31	2.63	3.88
Slovakia	2.02	2.25	3.24
Czech Republic (2)	2.21	2.54	2.93
Hungary (2)	2.64	2.91	2.99

Source: Author’s computations based on official housing sector statistics and proprietary housing market model.
Notes: (1) Forecast. (2) Data for 1991/2001 instead of 1990/2000.

Table 1 summarizes the empirical survey results obtained by the author with respect to the aforementioned housing demand factors. To improve comparability between countries, housing stock and flow values are related to the number of inhabitants. Two ten-year periods are subdivided, the 1990s and the current decade; for the latter, a forecast is made based on 2001/2002 trends.

Considering the elapsed decade of the 1990s, Table 1 reveals striking differences in overall housing market growth. Growth is here calibrated by the change in the number of inhabited housing units, which is identical by definition to the sum of changes in household growth and changes in the level of cohabitation of households. At the bottom of the league is Hungary, whose population between 1990 and 2001 declined by over 3 % – a magnitude that could not be compensated by the country’s positive household formation trend. Hungary reached moderately positive growth territory of overall demand only because of a strong decline in household cohabitation, which was made possible by high levels of new construction. In Slovakia, in contrast, a strong household growth trend coupled with a 2.5 % population *increase* resulted primarily in a rise in the level of cohabitation, rather than more housing production, certainly as a result of the overall weaker economic development, e.g. compared to Hungary. In the Czech Republic – in economic dynamics similar to Hungary, but facing a less pronounced population decline of only 0.7 % during the decade – both household growth remained strong and cohabitation became slightly reduced. The strongest increase in housing demand was recorded in Poland, where population grew – only second in the region to Slovakia – by 1.2% during the 1990s. Compared to Slovakia, the household formation backlog here met more favourable conditions – in particular moderate land and housing prices – that turned latent into realized demand for housing construction.

The driving factor of the forecast for the current decade until 2010 is the assumption that, as a result of the catching-up process of income and housing preferences to the EU counterparts, average household size and cohabitation levels will adjust, too. While this process is highly unlikely to be concluded as soon as 2010, it is assumed to accelerate during this period vis-à-vis the past decade. Household formation is assumed to become strongest in Poland and Slovakia, where housing demand remains supported by the demographic trend and now affordability catches up. In the Czech Republic and Hungary housing demand will also be rising, however in both cases less dynamically because of the weaker demographic trend and the more advanced household formation situation. A possible scenario of increased immigration into either country – for example from Romania or Slovakia to Hungary, or from Ukraine and Slovakia to the Czech Republic – would obviously stimulate demand.

As important for the analysis as the global demand situation is the closing of the previously discussed qualitative and regional "mismatch" gaps. The 1990s have seen here dramatic and historically unprecedented developments. In Hungary, for example, vacancies rose to a staggering 13 % of the housing stock, fuelled through internal migration from rural areas to the cities – especially metropolitan Budapest. Combining the currently recorded high level of completions with the weak household growth dynamics of the country, the only conclusion is that the trend in vacancies will proceed unchallenged. The supply-side decline will exceed demand growth as a factor driving construction for the remainder of the decade. In the other reviewed countries, vacancy increases during the 1990s were significant as well, as Table 1 shows. In the Polish case, a statistical effect distorts the analysis: in response to the formulation of housing subsidies, the country in 2001 recorded an overhang of 700.000 formally uncompleted housing units, which however had been in use already by their inhabitants. As a result, the expected rise in the numbers of vacant units will materialize here only with a time lag.

Summarizing these results, they suggest a noticeable increase in housing construction in the region for the remainder of this decade, by approximately 60 % over the past decade. This means that long-term average rates of new construction of approximately 3 per 1,000 inhabitants will again be reached. On top of the house will be Poland and Slovakia, followed by the Czech Republic and Hungary. Single-family construction will likely remain the main sub-sector driving growth; new construction of multi-family homes will likely be strongest in Poland and Slovakia, the countries with the largest general housing demand backlogs, as well as in the course of increasing urbanization in the regions main centres, Warsaw, Prague, Brno, Budapest and Bratislava.

3 Modernization Activity

Housing authorities in the region regularly publish technical estimates of modernization ‚needs', however, without accompanying realistic demand estimate reflecting an assessment of both ability and willingness-to-pay by the targeted users. Table 2 displays crude assessments of both vacancies and stock featuring quality deficits on the basis of available surveys and individual expert opinions. Because of statistical gaps in the monitoring of the housing markets, this data needs to be considered with great caution; in the author's view, however, it reflects the broad proportions.

Table 2: Assessment of Vacancies and Quality Deficits in Central European Countries in Transition, around 2002

Country	Housing Stock	Vacancies (1)	Ratio	Post-war Units with Deficits (2)	Ratio	Units with Severe Deficits (3)	Ratio
Poland	13,000	1,000	8 %	3,000	23 %	1.300	10 %
Slovakia	1,885	220	12 %	n.a.	n.a.	500	27 %
Czech Republic	4,366	350	8 %	1,200	27 %	500	11 %
Hungary	4,077	540	13 %	600	15 %	400	10 %

Source: National housing statistics, individual surveys and expert opinions. Author's assessment. Notes: (1) Estimate based on official housing statistics; only permanently inhabited housing units; (2) Large panel construction and low-quality construction of the immediate post-war era with low economic lifetime, various sources. (3) Estimate of HypoVereinsbank Polska for Poland, of P.S.S. *Stavebná Sporitel'ňa* for Slovakia. Author's estimates for Hungary and Czech Republic.

The already sensibly high overall vacancy rate in the region is currently still mitigated by the high demand dynamics of the Polish market. In the remaining countries, moving chains have led to drastic increases. As a result of low rents and deficient construction quality, multi-family houses are most affected by the modernization and maintenance backlog. Particularly affected are the construction vintages of the immediate post-war era, in particular in Poland, as well as the subsequent generation of industrially pre-fabricated large panel buildings. These two groups encompass between 15 and 30 % of all housing units, with the caveat that quality deficit estimates concerning them are disperse among the surveyed countries. In addition – primarily among pre-war housing units, but also within the previously discussed two groups of post-war units – there is a high ratio of de-facto uninhabitable, but still inhabited, housing units. This ratio can be estimated to reach approximately 10 % of the national housing stocks.

Particularly problematic is the linkage between housing quality levels and ownership structure. In Hungary, more than 52 % of the rental housing units that remained in communal ownership are situated in the very lowest quality bracket of five, equally sized groups. At the same time, for rental units that were previously communal and later privatized that share is only 28 %. Given the low overall modernization activity, this allows for the conclusion that it was mostly high quality housing stock that was privatized, and low quality stock consequently remained with local governments. The situation is similar in the remaining surveyed countries.

A statistical coverage of modernization activity on central government level is currently only practiced in the Czech Republic. According to the publication, approximately 10,000 housing units are modernized per year, which corresponds to roughly half of new construction activity in the country.

The partially intensive modernization activities sponsored by national housing funds in Poland, the Czech Republic and Slovakia (see below), and the related Hungarian programs for the multi-family stock provide for additional anecdotal evidence. In Poland, several 10,000 housing units must have been modernized with public funds since the initiation of programs in the mid-1990s. In both Czech Republic and Hungary the figures should be approximately 10,000, in Slovakia below. In any event, considering the available quality indicators above, modernization activity in the region is far too low and probably does not even compensate for stock losses resulting from ongoing deficient maintenance.

It should be noted that the contract savings schemes *(Bausparen)* developed in the Czech Republic and Slovakia play a certain role for the modernization of single-family houses. Combining data from both countries, in the past decade approximately 500,000–600,000 contract savings agreements were closed, resulting according to the author's estimates in approximately 100,000–150,000, primarily smaller, modernizations[3].

B The Contribution of Bank and Capital Market Financing

1 Institutional Development

Prior to the political turn of the tide of 1989, bank finance was of limited importance for the funding of housing investments by individuals in the region. The most active systems were Hungary, with a tradition of credit financed homeownership, and Poland, which promoted construction by housing co-operatives with finance. In all four countries, the respective public savings banks dominated savings collection and lending.

During transition, these banks, and the governments that supported them, became burdened by under-performing mortgage assets which

3 Data covering the number of investment projects financed by the contract savings institutions is not available. The share of modernization loans in portfolio is approximately 40 %. In addition, double counting needs to be considered as households usually sign more than one agreement. See *Dübel* (2003).

resulted from a combination of low and long-term fixed interest rates and sudden increases in short-term funding costs.[4]

At the beginning of the 1990s, under the leitmotiv of encouraging competition to the savings bank monopolists and thus foster banking sector decentralization, new privately managed housing finance specialists were licensed. The Czech Republic and Slovakia, in 1992 and 1993, promulgated laws on contract savings institutions, followed by the Czech mortgage bond act in 1995. In the case of mortgage bonds, links to traditions in the pre-war era were revived. The result was that specialized mortgage banks were created only in Poland and Hungary. In the Czech Republic and Slovakia, in contrast, following the historic Austrian model, universal banks were enabled to acquire a special license to issue mortgage bonds, against higher capital requirements.

The completion of the banking sector privatization process in the region is generally expected to be achieved by 2004/05. In Poland and Hungary state-owned banks – PKO BP in Poland, FHB and Postabanka in Hungary – continue to hold high market shares in housing finance. In the Czech Republic and in Slovakia, privatization of the respective savings banks *Česka Spořitelna* and *Slovenska Sporitel'ňa* had only been concluded in 2001.

In parallel to the process of withdrawal of the state from banking, the Czech Republic, Slovakia and Poland around 1995 started the creation of national housing funds that were initially primarily funded from privatization proceeds. In the first two countries, the funds became managed by new public housing agencies. These have launched programs both for the rental and owner-occupied housing sectors. The Polish Fund, in turn, is administered by the general development bank BGK and focuses exclusively on promoting the rental sector.[5] Eventual follow-up plans in Hungary after the privatization of state-owned FHB, which was scheduled for the end of 2003, are still unclear. In order to support the restructuring or liquidation of under-performing old mortgage portfolio, both Czech Republic and Slovakia have created bad banks.

Table 3 summarizes the current institutional development status in the region.

4 *Struyk* (1996) discusses the various strategies developed by governments in the region to deal with these assets.

5 The Czech government plans to dissolve the new housing agency again, and to transfer the administration of the fund to the Bohemian-Moravian Guarantee and Development Bank, which is already in charge with the servicing of public housing programs.

Table 3: Main Institutions of Housing Finance in
Central European Countries in Transition, around 2002

Country	Universal Banks	… of which: public	…of which: issuing mortgage bonds	Mortgage Banks	Contractual Savings Institutions	Housing Funds
Poland	X	X		X		X
Slovakia	X		X		X	X
Czech Republic	X		X		X	X
Hungary	X	X		X	X	

Source: Research undertaken by the author.

Even with the full completion of banking sector privatization, the institutional development process in housing finance will be far from being concluded. A consolidation of the banking sector should occur in the course of the expected market entry of European and American global player banks; so far, cross-border investment in the region has been dominated by European banks with regional relevance and interest. New specialized service providers will enter the mortgage sector, as they do in Western Europe, including mortgage servicers, insurers as well as conduits and service providers for capital market instruments such as *mortgage-backed securities*. In Poland, the politically controversial creation of a monopoly refinancing institution – following the example of the U.S. institution *Fannie Mae* – cannot be ruled out.

2 Market Development

Despite the developed institutions and a public support framework that was partly already established shortly after their creation, the 1990s were characterized by a sluggish development of the mortgage market. Almost at the end of the decade, in 1998, the total outstanding housing loans in the surveyed countries still stood under 2% of the regional gross domestic product. A number of reasons can be cited for this result.

Throughout the 1990s, the macroeconomic environment remained characterized by high and volatile nominal and real interest rates, even after the initial adjustment inflation push had tapered off. It took until 2002/03 to see real interest rates drop to the region of affordable levels, of between 3 and 5 %. The exception is the Czech Republic with a nominal discount rate of just 1 %, and negative real interest rates.

The development of real incomes so far has been subdued. Incomes showed high volatility and started a slow catching-up process only after the mid-1990s, despite partly already high GDP growth rates. As inflation has declined finally in the current decade, real incomes have started to grow more steadily.

The cost of new housing construction are frequently very high, both in absolute levels as well as in relation to income. Particularly problematic are supplies with main and feeder infrastructure (water, sewerage, streets), which in many jurisdictions must be financed by project developers or individual investors.

Finally, banks until about the year 2000 did not focus internally on housing finance as a promising business line. As the incumbent savings banks were only gradually privatized, the margins in housing finance remained unprofitable for new entrants. The exception were contract savings institutions *(Bausparkassen),* which themselves benefited from strong public support and were competitive with the savings banks. Universal banks focused on corporate finance, and the newly established mortgage banks or mortgage bond issuers on commercial real estate lending. The retail modernization finance market became the domain of contract savings institutions. In many areas of housing finance, considerable legal problems needed to be solved that partly continue to exist today.

Housing finance was provided in the initial transition phase mainly through own resources of the end-users and partly through external financial resources provided by developers. As a result, even in traditionally homeownership-friendly Hungary, the share of owner-occupied housing with debt incurred in 2002 only stood at 10 to 20 %. In the Member States of the EU the ratio is 70 % to 80 %, in the U.S. even 95 %.

Table 4: Outstanding Housing Loans and Mortgage Bonds in % of GDP in Central European Countries in Transition, 1998 – 2002

Country	Retail Housing Loans (1)			Mortgage Bonds
	1998	2000	2002	mid-2003
Poland	1.6	2.2	2.8	0.1
Slovakia	1.9	4.5	5.9	0.7
Czech Republic	1.7	3.1	5.5	1.7
Hungary	1.3	2.4	6.6	2.9

Source: Central Banks, Association of German Mortgage Banks. Computations undertaken by the author. Notes: (1) Loans to private households.

Table 4 reveals that housing loans quickly gain scale in the region, in particular since 2000. The reasons can be seen in a combination of beneficial interest rate developments and stabilized incomes – nominal interest rates halved within three years in the Czech Republic and Slovakia and dropped by two thirds in Poland. Also, numerous banks in the region decided around 2001/02 to refocus their general business strategy on the consumer credit market. Finally, the public support schemes to be discussed below play a significant role, in particular in the Hungarian case, in which the interest burden for borrowers is reduced substantially.

Caution should be applied when comparing the growth process in the region with the catching-up growth of the mortgage markets in Spain and Portugal to average EU levels, despite the pressing analogy. First, the loan volumes recorded currently still lag far behind those of both countries at the beginning of the process at the end of the 1980s, which stood at approximately 15 % (Spain) and 10 % (Portugal) of GDP, respectively. Second, the permanent affordability of mortgage lending has still not been tested in the region; under current growth rates, credit risk might rise and produce problematic cost levels and even temporary crisis. Third, as will be discussed below, there is both a fiscal and structural policy need to reduce existing excess subsidization in the mortgage sector, which has supported growth in some countries. This implies for these to choose between the alternatives of a hard vs. a soft landing. Fourth and finally, the transition into the European Monetary Union and the integration into the European capital market will pose challenges to the markets that are both new in dimension and not yet fully visible.

C The Contribution of Housing Policy

1 Institutional Development

Given the institutional weaknesses of housing policy in the surveyed countries, which is still ongoing, the formulation of coherent national housing policies during transition was impossible. Even the separation of policy formulation and policy implementation, under socialism in the single hand of public planning bureaus or the respective designated financial institutions, has not yet been fully completed.

Poland, the Czech Republic and Slovakia today maintain housing policy departments in ministries with broader responsibilities, for infrastructure, regional development or construction. In addition, many important decisions are made in the finance ministries – with respect to the development and support of housing finance, as well as all questions of taxation relevant for housing. Only in Poland there seem to be indications that the finance ministry has conceded a policy formulation responsibility in these areas to the housing office.

In Hungary, even as late as 2003 there is no defined housing policy formulation capacity within government, with the consequence that the former regulator and housing finance monopolist, OTP Bank, continues to exercise great influence over housing policy formulation. In Poland, the yet-to-be privatized savings bank PKO BP, the leading mortgage lender of the country, and the development bank BGK, are both directly involved in policy development. In the Czech Republic and Slovakia, state agencies assume in part the policy formulation task.

The institutional development problem is exacerbated by the idiosyncrasies of the public budgeting process. Support instruments such as premiums paid for contract savings for housing, or tax support for mortgage lending, as entitlement programs generate permanent budgetary drains; however, due to the cameralistic approach to budgeting, they are not or only insufficiently quantified with respect to their future, sometimes even current – in case of unbudgeted tax support, budget impact. Moreover, these instruments are beyond the control of the housing policy departments, which gives rise to large imbalances in the relative support volumes within broadly defined housing policy budgets.

Finally, in the surveyed countries the ex-post evaluation of housing policy programs still stands at various stages of infancy. Construction sector research institutes founded in socialist times continue to suffer from an excessive focus on the civil engineering aspects of housing, which often results in lofty ‘needs’ assessments for the sector. Universities and other academic institutions, in turn, have partly generated remarkable new research activities in the sector. New foundations of think tanks linked to academia, which could be suited to undertake independent evaluations of housing programs, face substantial economic difficulties. The bulk of funding stems from ad-hoc deals with international sponsors; in the 1990s first and foremost the large regional urban and housing sector program sponsored by *USAID.* The result is discontinuity of the analytical capacity.

As a consequence of insufficient institutional capacity, the national discussion of housing policy in too many circumstances degenerates to conflict about selective policy issues, fuelled by turf wars between the different responsible government entities.

2 Housing Policy Concepts

After 1989, the countries in the region had to address two very different housing policy tasks: to support of the redevelopment of a banking system capable to efficiently serve consumers and investors in the real estate market („Support to Finance“), and to pump-prime the sagging investment in the housing sector at a time of rapidly changing consumer preferences, increasing migration and social segregation („Support to Investment“). In addition to these tasks, significant resources had to be devoted to finish ongoing large-scale construction projects and subsidize under-performing old mortgage portfolios.

Existing policy documents of the different housing policy departments give little guidance as to what was the basic policy concept during transition. Some are dominated by unrealistic plans to revive public housing production. Looking back at the de-facto policies pursued, rather than the published documents, a number of basic policy lines are distinguishable.

Support to Finance: Institutional building in the financial sector and promotion of the financial market were clearly a political priority which was implemented rather homogeneously. Fiscal support reached high volumes in the entire region, and followed the basic principle of indirect support of investment by providing incentives to the private sector to supply finance, in particular in the area of owner-occupied housing. In Poland and in Hungary the aspect of stabilization of the public banks was of additional, high relevance. The support instruments of choice were tax preferences for borrowers and savers, as well as interest rate subsidies.

Support to Investment: In Hungary and Slovakia the institutional change in the housing sector focused on large scale tenant privatization and the creation of condominium associations. In Poland and the Czech Republic this process enrolled only in slow motion, old institutions such as co-operatives and public housing investors remained strong. In all reviewed countries, an almost complete communalization of public housing stock holdings, or a transfer to publicly owned corporations with the purpose of later privatization took place. New non-profit investor forms succeeded only slowly, despite the relatively swift creation of a legal basis.

Single-family home construction by their owner-investors grew dynamically.

Housing allowance programs were introduced very early during transition, however, mostly without accompanying thorough rent reforms which they could have supported. The pump-priming of new housing investments in the rental sector was mostly implemented through direct lending of national housing funds and grants provided to both private and communal developers.

Table 5 summarizes the main focuses of housing policies in the Central European countries in transition in a stylized fashion.

Table 5: Main Focus of Housing Policy in
Central European Countries in Transition, around 2002

Country	Main Policy Areas			
	Homeowner-ship	Multi-family Housing	Finance	Investment
Poland		X		X
Slovakia	X		X	
Czech Republic	X		X	
Hungary	X		X	

Country	Main Policy Instruments (1)			
	Lending (2)	Grants	Tax Support	Guarantees
Poland	X		X	
Slovakia	X	X		
Czech Republic	X	X	X	
Hungary	X	X	X	

Source: Author's assessment. Notes: (1) Multiple choice possible.
(2) of public housing funds or publicly-owned banks.

3 Homeownership Policies

a Support to Finance

As attempts were made to replace the instrument of direct public lending to the housing sector, in three of the four countries, early steps were taken to fiscally support mortgage lending and contract savings for housing. What follows is a description of the subsidy mix, ordered by its intensity from low to high:

Poland was the outlier in the region as owner-occupied housing was supported until the end of 2001 primarily through direct construction grants, which bore no direct relation to financial structure. In parallel, in 1995 a proprietary contract savings program was established, which however has not accepted new applications since 2001. Since January 1, 2002, mortgage loans have become subsidized through a partial interest deductibility. The relief is so small, however, that the typical house buyer's debt service burden is reduced only at a rate significantly below his average tax rate. A public interest rate support program planned already in 2001 has been realized in the meantime only at a small scale as it is taken over by the declining market interest rates. Mortgage bond funding , as elsewhere in the region, does not enjoy tax advantages.

Slovakia in 1998 simultaneously introduced an income tax exemption for mortgage bond investors and direct interest rate subsidies for mortgage borrowers. In return, no deductibility of mortgage interest from the income tax base was conceded. In Slovakia, too, contract savings for housing were strongly promoted; since about 1998, premium levels have been cut back progressively.

In 1996, the Czech Republic together with the mortgage bond legislation introduced an income tax exemption for investors; in addition, mortgage interest paid by borrowers became tax-deductible. An interest-rate buy-down program for the retail market was introduced in 1997 and expired at the end of 2001, as market rates dropped below the normative affordable rate set in the program, of 7 %. Contract savings for housing was strongly subsidized since the introduction of the system in 1992.

In the region, Hungary developed the broadest fiscal support scenario for the mortgage sector. Interest income from mortgage bonds is tax-exempt for investors – as other fixed interest income in Hungary is, too. High interest rate subsidies are paid since 2000 for mortgage loans the funding of which is arranged through the mortgage bank system. To this end, additional subsidy incentives have been created for universal banks to sell their assets to mortgage bond issuers. Finally, borrowing households benefit from a tax credit system allowing the deduction of 40% of their debt service payment from the taxes owed, up to a maximum limit.

Table 6 summarizes the impact that these policies have had on the affordability of mortgage loans, for a parameter constellation of mid-2003. It should be considered that loan-to-value ratios (LTV) applied in retail mortgage finance in the region are still as low as 40–50 %; here, for simplification and in anticipation of market practices in Western Europe standards, a value of 60% is assumed. Moreover, house-price-to-income relations differ just slightly as only metropolitan areas are considered. Certain upper limits may be applicable to subsidy schemes, which might change the results of the computation under certain circumstances.

In Hungary, due to the high subsidies borrowers can count on securing the lowest debt service burden in the region, which compensates for higher house prices and market interest rates. At the other end of the scale, Polish borrowers – with the lowest fiscal support level in the region – essentially rely on the continuation of the interest rate reduction process to improve affordability. The relative subsidy environment apparently correlates with the differing growth rates of the national mortgage markets in Table 4.

Table 6: Prices, Interest Rates and resulting Debt Service for a simple Single-Family Home in Central European Countries in Transition

Country	Multiple of Income		Interest Rate Level		
	House Price	Loan Volume	Mortgage Bond	Market Rate	Rate after Subsidy
Poland	5.5	3.9	n.a.	8.1 %	6.4 %
Slovakia	6.0	4.2	5.1%	7.5%	5.5%
Czech Republic	6.0	4.2	4.5%	6.0%	4.5%
Hungary	7.0	4.9	8.0%	10.5%	3.0%

Country	First Year Debt Service	
	Bullet Loan	Amortizing
Poland	24.6 %	28.5 %
Slovakia	22.5 %	26.7 %
Czech Republic	18.9 %	23.1 %
Hungary	14.7 %	19.6 %

Source: Survey among real estate brokers and banks in the region, author's assessment and computations.
Notes: (1) calculation assumes 60% loan-to-value ratio.

It is worthwhile to recapitulate the practice of individual support instruments, which feature important differences in formulation and implementation as well as lessons to be learned for future policy formulation.

Interest Rate Support

The interest rate subsidy programs developed in the region resulted from a combination of obstinately high nominal interest rates and rising political impatience over the weak development of the mortgage markets. Loan instruments that might have been suitable for the high inflation environment that characterized the region were largely missing.[6] An additional strong motivation was the swell of foreign-exchange denominated loans that put some domestic lenders – those with limited funding capacity in foreign-exchange denominations – under pressure, for example, PKO BP in Poland.

6 In the case of amortizing or bullet mortgage loans, high inflation levels generate the so-called ‚tilt'-effect of high real repayments that overburden the borrower. Assuming a constant real house price, applying a full nominal interest rate means that the borrower implicitly repays each year a part of the real value of the house, to the extent that inflation is a component of the nominal interest rate. This problem can be addressed with loan instruments that capitalize the inflation component of the nominal interest rate into the outstanding loan principal. Early during transition, such capitalization schemes were frequently used, for example so-called dual-indexed mortgages in Poland.

A comparison of the differences in program formulation is instructive. Only Hungary has linked interest rate subsidies directly with the funding of loans through mortgage bonds, and in addition subsidizes the margin of mortgage banks, who issue the mortgage bonds. In Slovakia and the Czech Republic, while interest rate subsidies are not linked to mortgage bond financing of the loan, eligible banks with a mortgage lending license are urged by the central banks to use this funding instrument.

Table 7: Concepts of Interest Rate Buy-Down Programs for Retail Housing Loans in Central European Countries in Transition, since 2000

Country	Limits	Buy-down Subsidy Ceiling	Current Level of Buy-down
Poland	Only new buildings		
Slovakia		6 %	2.5 %
Czech Republic	Only new buildings	4 %	0 %
Hungary	Linked to mortgage bond funding	10 %	5–6 %

Country	Borrower Interest Rate Ceiling	Duration of Buy-down	Notes
Poland	8 % (2002), 6.5 % (2003), falling	To be repaid at maturity	Program hardly used
Slovakia	Interest Rate Corridor (5–5,5 %)	Final maturity	
Czech Republic	7%	Maturity	Program expired in 2002
Hungary	5 % (new buildings) 6 % (stock)	Maturity	Rates partly as low as 2-3%

Source: Survey undertaken by the Author.

With respect to the maximum interest rate deemed as affordable to retail borrowers, different social policy views held by national policy makers are apparent. As Hungary and Slovakia aimed for the lowest interest burden on their borrower population, interest rate subsidies there continue to be given in 2003, despite the strong interest rate decline of the past three years. In the Czech Republic, in turn, interest rate subsidies expired in 2002; only an ancillary program targeting young households is continued.

Both the Czech Republic and Slovakia took precautionary measures against the upward budget risk, by defining tight subsidy ceilings, which in Slovakia in addition can be adjusted flexibly in the annual budget law. The ceiling – and thus budget risk – is much higher in Hungary; in addition, in 2002 a faulty formulation of the subsidy formula resulted in high buy-down subsidies granted even as market interest rates had dropped precipitously – many borrowers of 2002 ended in closing loans at after-subsidy interest rates of 2 to 3 %. These errors translate into both high current and future claims on the Hungarian state budget.

The Polish government, finally, formulated its interest rate support scheme as a loan program, albeit free of interest charges. Borrowers have to repay the interest rate buy-down support they receive and accumulate towards the end of the loan maturity, under the scenario that market rates fall for a sufficiently long period under the maximum affordable rate. From program start at the end of 2002 until mid-2003, according to observers only 50–60 loans were given by the implementing development bank BGK. The reason was that market rates had strongly declined during the period, and the difference between maximum affordable program rates and market rates had become negligible, or even negative, despite frequent adjustments of program conditions.

As a result of the different program formulations, budget costs vary strongly by country. Hungary pursues the costliest program, with 2003 budget costs in excess of 0.2 % of GDP. For the Slovak program, budget provisions for 2003 are only a fraction, 0.04 % of GDP; however, actual costs might be higher due to strong market growth. The costs of the Czech program in its last year, 2002, were even less.

The conclusion to be drawn is that – with the exception of Hungary – the support of the mortgage markets through interest rate subsidies has been rather symbolic. In general, interest rate support is only suitable for short-term disinflation processes with sufficient visibility of interest rate developments. Because of the hard-to-manage budget risks, they should in no case be formulated as permanent subsidies, and ceilings should be adjusted to circumstance. Particularly problematic, since wasteful from an affordability perspective, is the fixing of maximum interest or debt service burdens over the entire duration of a loan. This holds because income growth simultaneously takes place, if not in real terms than usually at least with inflation, and therefore an erosion of the income burden generated by nominally fixed annuities will take place, which the subsidy just further exacerbates as the loan seasons. Interest rate subsidies therefore should be limited in advance to a maximum period of five to ten years – the most critical for borrower affordability – depending on inflation levels. Alternative, less wasteful support schemes would be interest rate caps for variable-rate loans, and foreign-exchange caps for foreign-exchange denominated loans, both at sufficiently high exercise levels.

Income Tax Support to Borrowers

Deductibility of mortgage interest payments from the tax base, or from taxes owed ('tax credit'),[7] were introduced in the 1990s in the Czech Republic and Hungary to provide general support to the mortgage market. Poland joined this group in 2002, as housing policy makers lamented over a mortgage loan market in the doldrums. Ironically, these steps were taken

7 In the case of deductibility of mortgage interest rates („Mortgage Interest Deductibility") the interest cost incurred are subtracted from the pre-tax income (= tax base). As a result, the tax subsidy equals the interest payment multiplied with the applicable average tax rate, which might vary with income. In the case of a tax credit, the mortgage interest paid is directly deducted from the tax liability owed, subject to applicable limits. This results in a constant implicit average tax rate. As a result absolute tax subsidies are distributed more evenly in the case of tax credits than in the case of tax deductibility.

at a time when – under the influence of the macro-economic convergence process – the tax support instrument in important EU countries either was wholly dismantled (U.K.), overhauled and cut back (Sweden) or replaced with a grant system (Germany).

One of the main drivers behind the reform steps decided by the latter group of EU countries was the distributional incidence problem associated with a tax support instrument, as high income borrowers receive the largest absolute and relative benefits. The same argument holds true for transition countries, as the example of Hungary developed in Table 8 demonstrates. Between the lowest and the highest income bracket, average tax credits given in 2002 more than tripled. This still has to consider the fact that the tax credit instrument carries less distributional distortion compared to the more popular instrument of deduction of interest payments from the tax base (mortgage interest deductibility), which is practiced in both the Czech Republic and Poland.

Table 8: Distribution of Income Tax Payers and of Income Tax Credits for Mortgage Debt Service in Hungary, 2002

Income Tax Classes *1.000 HUF	Distribution of Tax Payers	Distribution of Tax Credits	Average Tax Credit, *1.000 HUF
Under 300	14.4 %	1.0 %	42
300-600	23.2 %	9.1 %	63
600-1000	23.9 %	13.5 %	68
1000-1500	16.6 %	17.7 %	84
1500 – 2000	8.8 %	14.3 %	93
2000-4000	9.8 %	26.2 %	110
4000 and more	3.2 %	18.1 %	150
Total	100.0 %	100.0 %	92

Source: Metropolitan Research Institute Budapest.

Worth consideration on the positive side is the property of the tax support instrument to stimulate the mortgage market with relatively little bureaucratic effort, and at the same time low political visibility. This needs to be contrasted with the effects of falling interest rates as a result of prudent macro-economic policies, which are both far larger and more evenly distributed. This argument was used by the reforming EU countries in the 1990s, and obviously became endorsed by the Slovak policy makers. Moreover there is danger of snowballing fiscal costs in a country with strong mortgage market growth, a latent danger in particular in the Polish market which is subject to strong housing demand dynamics. As the budget problems in the surveyed countries grow, revisions of tax support policies must be expected to be made in the coming years.

In transition to a reformed homeownership support model, a limitation of tax support to interest payments (in the Hungarian model of tax credit for debt service), the imposition of ceilings on total eligible interest payments or loan volumes, and the introduction of ‘negative’ tax support for borrowers in the low-income tax brackets would be advisable.

Support for Contract Savings for Housing

Three of the four surveyed countries introduced new contract savings for housing schemes after 1990: the Czech Republic and Slovakia (1993), as well as Hungary (1997). Poland decided in 1995 to introduce a proprietary system, *Kasa Mieszkaniowe* (KM). After ceasing to write new contracts in 2001, old contracts are still grandfathered by the government until maturity with premium payments.

Dübel (2003) reviews the experiences made in the first ten years of the new systems in Slovakia and the Czech Republic. The benefits in both countries can be seen in a large number of small loans extended to finance housing modernizations and smaller housing-related transactions, e.g. the purchase of land and existing dwellings.

In contrast, a senior-subordinate financing mechanism involving mortgage loans and contract savings loans, as is the practice in Germany where contract savings loans fulfil primarily an access to finance function, does not take place, limiting the system's effectiveness for more costly new construction. The reasons are legal and institutional problems in arranging the financial mechanism. Given the low interest rate levels of competing mortgage loans, a co-financing perspective is unlikely to take off any time soon.

Problematic are also the high subsidy volumes that contract savings for housing fetches in both countries, a result of nominal savings yields for the contracts targeted in the range of 10 % and higher. In the Czech Republic, the contract savings premium budget in 2003 took over 50 % of the total housing policy budget, over 0.5 % of GDP. In Slovakia, in contrast, expenditures were cut back since the late 1990s and are now almost at half the Czech figure. An important difference between implementation strategies is that Slovakia, by retaining the primacy of the annual budget law over the enabling law for the system, was able to adjust the premium level in small steps as general interest rates were falling.

Table 9: Premium Budget for Contract Savings for Housing in Central European Countries in Transition, 1998-2002

Country	Premiums for Contract Savings for Housing in % of GDP		
	1998	2000	2002
Poland	0.22 %	0.19 %	0.13 %
Slovakia	0.42 %	0.29 %	0.27 %
Czech Republic	0.28 %	0.39 %	0.49 %
Hungary	0.03 %	0.04 %	0.04 %

Source: National housing policy budgets. Author's computations.

A third problem is the low level of investment of deposits into loans in the Czech Republic, which has prompted the contract savings institutions to invest their excess liquidity in – income tax exempt – mortgage bonds, and therefore has contributed to an undershooting of interest rates on the mortgage market (see Table 6 for a comparison of interest rates).

From the perspective of all three countries maintaining the system, the cost-benefit relation could be aided by promoting the greater use of contract savings for housing loans as an access product to the mortgage market, rather than establishing a parallel housing finance system that is doomed to fail. Pre-savings could help to solve the access problems of many young households to finance in the region. These suffer from the strict lending constraints of the implemented mortgage bank systems and of the practices of universal banks. The premium levels for the contracts should moreover be adjusted to the level of subsidies benefiting mortgage finance in general, and – jointly with these – fall as interest rates drop. A model for the specification of a premium formula that fulfils this requirement has been developed in Austria. Finally, it is questionable whether – assuming consistently low interest rate levels – the traditional model of fixed interest rates on both savings and loan sides of the balance sheet has a future. Austrian contract savings institutions are pioneering a more flexible business model that operates with interest rate caps on variable-rate loans, rather than fixed interest rate levels.

Income Tax Support for Mortgage Bond Investors

A fundamental question when introducing the mortgage bond system was to secure the competitiveness of the instrument relative to the predominant funding technique for mortgage loans, which relies on short-term deposits. Various aspects are relevant for the comparison: inter alia relative taxation, including minimum reserves, implicit or explicit public guarantees that might exist for deposits, and the problem of adequate capital adequacy policy with respect to interest rate risk. Moreover, because of the high credit risks incurred in corporate finance, commercial banks in transition countries tend to be over-liquid, which leads to declining deposit relative to bond interest rates.

In both the Czech Republic and Slovakia, policy makers chose the avenue of income tax exemption of mortgage bonds with their introduction – in both cases without a sunsetting and contrasting with the income tax liability of interest obtained from government debt. In Hungary mortgage bonds were in contrast equally treated with government bonds as not taxed. Only Poland subjected mortgage bond investors to pay income tax.

Tax preferences for mortgage bond holders are a legitimate support instrument, which is certainly preferable to unconditional government guarantees that are in addition in transition countries often of doubtful quality. However, the practice pursued in the three countries is questionable from various perspectives: first, the absence of a sunsetting in both Czech Republic and Slovakia raises the question of a permanent competitive distortion in favour of the banks issuing mortgage bonds. Second, an overshooting of both mortgage and housing markets is already noticeable in both countries, as interest rates drop; while the subsidy declines with the interest rate level, it accelerates the cost of fund decline in a situation that could be critical for market stability. Third, international investors are under most practical circumstances excluded from receiving the tax advantages, with the result that less foreign capital is attracted than optimally for the mortgage bond market, and more domestic capital is distracted from the government bond market resulting in a rate increase for government bonds. This is currently a serious problem in the

Hungarian bond market, due to the snowballing of different subsidies. Fourth, the non-taxation of mortgage bond interest seems to contradict the spirit, if not the words, of a current agreement of EU finance ministers to introduce a minimum taxation of interest in order to minimize tax-induced capital flight. Fifth, and finally, no market failure can be detected that would justify the need to apply the tax instrument indiscriminately. Even Germany, in its critical urban post-war situation of the 1950's, applied the instrument only selectively and eliminated it after two years.[8]

b Support to Investment

Construction Grants and Tax Credits for Single-family Homes

Direct construction cost grants have a long-standing tradition in transition countries. Hungary introduced the instrument in single-family housing already in 1971. Until 1994 the program was called social policy grant, later simply housing grant. The social policy component has remained intact, since the size of the subsidy depends on the number of children in the investor's family. Since the grant is not differentiated by regional house prices and is thus particularly large relative to house prices in rural areas, the efficiency of the instrument is often put in doubt. In the remaining countries in the region, construction grants are primarily used in the area of communal housing construction (see discussion below).

An instrument similar to the Hungarian scheme was introduced in Poland in 1992, immediately after the discontinuation of the costly interest rate subsidies for new co-operative housing. Each taxpayer became entitled to deduct construction costs – up to a price ceiling applied to a 70 square meter housing unit – from his taxable income. The ceiling was indexed with the average construction costs as recorded by the housing office, to account for inflation. The distributional incidence of the instrument was so biased that in 1997 a uniform applicable tax rate equivalent to the marginal rate in the lowest Polish tax bracket, of 19%, was introduced and in addition the instrument became transformed into a tax credit. It thus became de facto a constant grant. The instrument ultimately failed even in this simplified variant, because of abuse by beneficiaries: tax credits could be applied for every year of construction elapsed prior to the completion of the unit, which – given high inflation rates and the indexation of the applicable construction costs – induced beneficiaries to delay the invoicing of the construction costs that signalled formal completion. The instrument was abolished in response to these

8 Legal basis was the First Promotional Act for the Capital Market of 1952, which introduced tax exemption of interest for so-called Social Pfandbriefe („Sozialpfandbriefe"), defined as bonds the proceeds of which were to be invested by at least 90 % into social housing construction. The law expired already by the end of 1954. In the meantime, the capital market had gained sufficient strength, allowing the sale of Pfandbriefe subjected to ordinary taxation with chances of success (see *Bellinger/Kerl* [1995]). One of the main arguments made then against the tax exemption was that it would lead to an undesirable split of the German capital market (see *Schönmann* [1993]).

practices and in favour of mortgage interest deductibility by the end of 2001.

Everything considered, the implementation problems described do not establish a major counter-argument against direct public support of construction costs. This subsidy works as equity substitute, which fills the financing gap that the low loan-to-value ratios practiced under the mortgage bond financing mechanism leaves, and at the same time avoids the problems of interest rate buy-downs, which subsidize bank spreads. In Germany a grant targeted to first-time buyers is disbursed in equal instalments by the tax office over eight years *(Eigenheimzulage),* the instrument is a compromise between lump-sum equity replacement and interest-buy down scheme. There is also a strong family size component of the grant. A serious argument against the instrument is possible house price effects, which could especially arise in market situations with inelastic supply, e.g. as land ready for construction is rationed. This description, however, does not generally apply to the regional housing markets well – perhaps with the exception of the main urban centres. A regional differentiation of the grant level, as practiced in France under the equity support program *„Prêt à taux zéro“*[9], could within limits improve program performance.

Equity Support for Young Borrowers

A less developed element of housing policy in the region so far are support schemes targeting young borrowers. These groups are usually not reached by finance subsidies, as they generally lack access to finance. To create an access channel is particularly relevant if standard loan-to-value ratios of mortgage lending are low, which may be an economic necessity in the presence of high inflation or simply a residual of historic bank regulations – in particular in the case of mortgage banks.

While contract savings for housing by design could be suitable to fulfil the function of enhancing the equity basis, for the reasons described above, they currently do not fulfil this function in the region. Correspondingly, both in the Czech Republic and Slovakia where contract savings institutions exist, national housing funds complement the private mortgage supply with public subordinate („second“) mortgages to young households; in the Czech Republic in addition young first time buyers in the secondary housing market receive interest rate subsidies. Neither Hungary nor Poland practice support schemes tailored to the finance problems of young households – to the contrary, the tax credit for debt service in the former, and the tax deduction of interest payment in the latter, put income-poor young households at a competitive disadvantage.

Should it prove impossible to co-ordinate contract savings for housing schemes for a co-financing arrangement with mortgage loans, the introduction of targeted public loan guaranty programs, or – at a lower intensity level – regulation conducive to support private mortgage insurance, should be considered as an alternative. Also, tax support instruments could – in

9 PTO is given as a subordinate, non-interest bearing loan with a grace period of ten years.

principle – be reformulated with a perspective of strengthening the equity base of young households.

VAT, Property Transfer and Property Tax Support

Exemptions from or reductions of value-added tax charges levied on housing services in the region should be seen against the background of high tax levels. These exceed typical EU levels, with the exception of France and Belgium. In Hungary, for example, the purchase of a new condominium apartment at a price of € 40.000 comes along with a property transfer tax bill of € 1.760 (4.4 %). Reimbursing value-added tax paid on the construction turnover, in contrast, is limited to 25% or € 1.540, whichever is lower, resulting in a substantial net tax burden for the buyer.

More generous are VAT regulations in Poland, the Czech Republic and Slovakia, where rates are partly strongly reduced for housing construction and acquisition purposes (see Table 10). In the Czech Republic and Slovakia, in addition, the purchase of a new flat or house is exempt from property transfer tax within certain time limits. With the accession to the EU in May 2004, however, all split VAT rates are supposed to fall, resulting in uniform higher rates. It is unclear at the moment, whether and how this price shock could be compensated through other fiscal measures. Slovakia, for example, reduced the unified VAT rate after the removal of the split from 23 % to 19 %.

Table 10: Overview of the most important Tax Rates in Central European Countries in Transition, mid- 2003

Country	Personal Income Tax		Corporate Income Tax	Value-added Tax	
	Min	Max		Construction (1)	Regular
Poland	19 %	40 %	24 %	7 %	22 %
Slovakia	10 %	38 %	25 %	10%	23 %
Czech Republic	15 %	32 %	31 %	5 %	22 %
Hungary	20 %	40 %	18 %	25 %	25 %

Country	Property Transfer Tax		
	Min	Max	Applicable to new buildings?
Poland	2 %	2 %	Yes
Slovakia	4 %	20 %	No
Czech Republic	5 %	5 %	No
Hungary	2 %	6 %	Yes

Source: Survey undertaken by the Author.
Note: (1) applicable to new housing construction.

Property taxes are an additional area in which the Czech Republic and Slovakia apply long-term exemptions for new buildings and first-time buyers, respectively, of up to ten years. The property tax exemptions practiced in Hungary still in the early 1990s, then directly tied to loans being provided by the monopolist OTP, have been abolished.

High turnover and value-added taxes exercise a direct cost increase effect on new housing units sold on the market and thus have a recessive impact on new construction. In so far, stimulations for new construction through VAT reductions or reimbursements can be seen to have considerable production effects, and moreover should have progressive income incidence. Lower VAT rates also open room for local governments to levy property taxes or charges for infrastructure connections. Important is also the minimization of bias between transactions with new and existing buildings: in the latter case, transaction taxes, the tax rates of which are generally lower, often replace value-added and capital gains taxes.

A holistic analysis of the burden placed on transactions with new and existing housing stock through the interaction of different taxes does not seem to exist in any of the four surveyed countries. In particular, it would seem that the distribution of tax revenue and public service provision in the housing sector is unilaterally biased against local governments. The detour of central government block grants designated to support the residential infrastructure investments of local governments seems to be impractical, given central government budget stress situations and frequent institutional problems arising in intergovernmental fiscal relations.

Table 11: Summary of Main Instruments of Housing Policy in Central European Countries in Transition, as of mid- 2003

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

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

Source: Research undertaken by the Author.
Note: X: currently practiced, (X) aborted, (1) Tax credit.

Table 11 summarizes the main results of the cross-country comparison of the afore discussed instruments of homeownership policies. Clearly, the scale of support is characterized by extremes, with Poland featuring the lowest and Hungary the highest subsidy intensity. The Czech Republic and Slovakia maintain homeownership programs that are comparable in many features; mortgage interest deductibility in the Czech Republic is essentially replaced by direct interest rate subsidies in Slovakia.

4 Multi-family Housing Policies

Support schemes for finance and investment in multi-family housing can have both rental tenants and co-operative or condominium owners as a target group. The dichotomy chosen here is that the schemes to be discussed do not target the status of homeownership, e.g. by promoting the acquisition of an owner-occupied flat or house. After the turbulent developments in the 1990s, multi-family units in the region are today owned by a multitude of different investors: local governments, non-profit investors of different provenance, different variants of co-operatives, and condominium associations and their respective members.

In this paper, only a brief description of the two most important program types – a) the modernization of multi-family housing stock in all ownership forms, and b) the new construction of multi-family units by public or non-profit investors – is undertaken. For a deeper analysis of the problems of the rental housing sector, including details of housing allowance programs, for Poland, Slovakia and the Czech Republic the reader is referred to *Lux* (2001).

Considering the range of support instruments applied by governments in the region, the focus is on direct investment grants and public loans extended via the newly established national housing funds.

Modernization Programs for Multi-family Housing

The programs reviewed aim to respond to the perception of a public responsibility for the multi-family housing stock, which today is mostly owned by condominium associations and co-operatives but is still subject to large rehabilitation and modernization needs. A frequent program focus are the problems of rehabilitating the prefabricated large-panel housing blocks built during the 1970s and 80s. Given that private or communal co-investors are targeted, the instruments used are similar in character to those used for homeownership support.

In Poland, even after the reform of 2001 private investors are allowed to apply tax credits for modernization investment costs incurred. 19% of the costs can be forwarded against the tax liability, up to certain ceilings. However, the access to modernization loans is often difficult for private households. Under the development bank BGK, the Polish national housing fund since 1995 supports the modernization of rental housing units, in particular those owned by the local governments – *Gminas* – and of other social housing associations, with long-term loans carrying an interest rate subsidy and long grace periods. A public fund with similar instruments was created in 1999 in order to support investment into the energy efficiency of housing.

In Slovakia, there is no tax support comparable to the Polish scheme; however a market for retail modernization loans has developed. The two largest lenders in this segment are the State Housing Fund and the contract savings institutions, which maintain a certain competitive relationship. The Housing Fund offers soft loan programs for modernizations, for which both natural and legal persons can apply. In addition, condominium associations and co-operatives can obtain loan guarantees by the Slovak Guarantee and Development Bank to support access to bank loans. Many private owners in multi-family housing stock take up contract savings loans in order to improve the energy efficiency and other smaller modernization measures (baths, installations); the contract savings institutions after a legal change in 2000 also offer the contract savings product to legal persons, which are aimed at funding larger modernizations in the multi-family stock.

In the Czech Republic, modernization programs operate with similar instruments like in Slovakia, with the difference that loan interest rates are in addition deductible from the income tax base. A speciality are local government run modernization funds which inter alia sponsor loans to private owners in multi-family stock against a minimum co-financing share. Local governments are moreover still relevant owners, and are in this function supported by the central government through grants (esp. for the prefabricated housing stock) and soft direct modernization loans. As in Slovakia, contract savings institutions dominate the modernization loan market for retail clients; loans to legal persons, however, are not yet being provided.

Table 12: Approximately Distribution of Owner-occupiers and Renters in the Housing Stock of Central European Countries in Transition, around 2003

Country	Owner-occupiers			Renter
	Total	Single-family Homes	Condominium Apartments	Total
Poland	77 %	57 %	20 %	24 % (1)
Slovakia	67 %	52 %	15 %	32 % (2)
Czech Republic	42 %	40 %	2 %	58 % (2)
Hungary	92 %	75 %	17 %	8 %

Source: Author’s estimates from national statistics.
Notes: (1) Members in private co-operatives are assigned to owner-occupiers.
(2) Including members of all co-operatives.

The Hungarian central government extends cost grants for modernization investments in condominium and co-operative multi-family housing. The typical requirement is that either condominium association or co-operative has accumulated the co-financing equity for at least four years. An important element of the so-called *Szécheny* plan of 2000 is the program for energy efficient rehabilitation of the pre-fabricated large panel housing stock, which is implemented under the sole responsibility of the local governments regardless of the ownership structure of the buildings. Local governments can apply to the central government for grants up to a third of total rehabilitation and modernization costs. Access to contract savings loans and the high general subsidy level for mortgage loans, finally, support modernization investments undertaken by condominiums and individual owners. When undertaking rehabilitations, modernizations and extensions, individuals can benefit as usual from both housing construction grants and tax credits for mortgage debt service.

The relatively comprehensive and detailed public program scenario in the region attempts to solve two key problems in the multi-family housing sector: first, the impact of ‚micro'-privatization to tenants, which – because of the unsolved co-ordination problems between a high number of co-owners – has led to significantly less investment in the housing stock than originally expected and in many areas even triggered an additional maintenance backlog; second, even in the cases where clearly defined owner or inter-owner agreements exist, in the presence of controlled rents and low general willingness-to-pay for housing that gives rise to a significant equity financing gap for investment.[10] To fight on both fronts, public policy makes the attempt to lock both 'owners' and 'tenants' into a co-financing strategy jointly with the public sector. The general strategy is to solve at least a part of the modernization task with the support of those either most able, or most willing, to pay.

However, it is clear that a program approach alone cannot solve the larger problem of rehabilitation and modernization of the multi-family stock in the region. Because important investments have been delayed for too long, in large parts of the stock a wedge between rising investment costs needed to secure minimum quality and falling average ability-to-pay of tenants or owners has emerged. As the decay goes on, households with higher ability-to-pay move to other housing solutions, not least because the booming mortgage market offers them better housing alternatives at an affordable cost level. Many buildings in the multi-family stock are therefore impossible to rehabilitate and modernize economically, whatever the wishful thinking of local and central government policy makers may be. A model process that has elapsed in quick motion in that regard can be contemplated in the former German Democratic Republic: here, many communal housing associations and co-operatives today are facing bankruptcy, despite massive support by the federal government through public subsidized loans, because the investment costs incurred were too high relative to realistic revenue capacity, which in many areas is characterized by rent decline and increasing vacancies.

Tough political decisions are needed, if not either permanent and rising subsidies, or alternatively an accelerating decay with negative reper-

10 As a rule, residential rental revenues in multi-family housing stock in the region cover only a fraction of the operating costs of the buildings. In Hungary, for example, communal housing corporations obtain two thirds of their rental revenues from commercial leases in basements. Total revenues are moreover almost completely absorbed by operating costs, with the result that investment budgets need to be derived from privatization windfalls, external grants and – if existent – reserves.

cussions for the local economic development climate, shall be the perspective for much of the multi-family stock. Decisions should be made in the area of ownership structures, which should be rationalized – in particular in Slovakia and Hungary – and await greater professionalism, rising operations and investment cost burdens to be placed on the users – against real management and building quality improvements, and in many cases resettlement aid given to users in case of buildings that cannot be economically rehabilitated and modernized and thus need to be demolished.

Support of New Construction of Communal and Non-Profit Multi-family Housing

After public rental housing construction had collapsed in the early 1990s – in the course of the withdrawal of soft finance and driven by the processes of communalization and privatization – rental housing construction as a whole came almost to a halt in the region. Exceptions were noticed around 1992–1995 in the emerging high price apartment building segment in the most important urban centres of the region, which was allowed to develop as rents for newly constructed units in private rental housing became liberalized early. A mismatch problem arose immediately as simultaneously with lesser supply both income inequality rose during transition and the demand for low-cost housing units by socially disadvantaged persons continued to rise. Since apart from upscale new construction none of the surveyed countries implemented far-reaching rent reforms, excess consumption of sitting tenants in the existing housing stock could not be mobilized for the private or for the social rental sector. At the same time, as would be expected in price-controlled markets, a dynamic grey market for sub-leases emerged.

The reaction of housing policy makers in the region to this largely self-inflicted ‚scarcity' of low cost housing units was to resume public new construction. Partly, new non-profit investor forms were co-opted to implement the programs.[11]

In 1995, the Czech Republic resumed its old financing model for new rental housing construction, in which local governments, central governments and future users co-finance each one third of the investment costs. Since the per-square-meter costs are no longer capped, however, while the central government contribution is, in reality the co-financing share of the central government has dropped to one fifth. At the same time, the 'tenant' is asked to provide significant own resources to the construction, and thus de-facto becomes the owner of the apartment except for a legal transfer of ownership. Clearly, only households with relatively high income, which can afford the capital contribution, can become beneficiaries of the program, which involves substantial public subsidies.

Slovakia has followed the Czech initiative with own new construction programs, which are managed through the State Housing Fund. However, here total costs are capped and the public co-financing share reaches

[11] For an overview over the new programs, see also *Lux* (2001).

40 %. At the same time, the local government can apply a supplementary loan from the State Housing Fund to finance its co-financing share.

Based on similar principles, and with similar weaknesses, is the Polish Program of non-profit housing associations *„Towayszystwa Budownictwa Spoleznego"* (TBS), introduced in 1997. TBS are legal persons, 90 % of which are founded by local governments. The official status of the 'tenant' is fictive here as well: he co-finances the construction with a loan to the developer of approximately 20 % of construction costs, which in turn entitles him to permanently use a rent controlled housing unit (annual rents are capped at 4 % of replacement costs). The remaining investment costs are then shared by local governments (usually through contribution of land and infrastructure) and central government (through public loans of the National Housing Fund under BGK). The 'tenant' receives a call option to purchase the apartment after a certain minimum duration of the lease. While this establishes de-facto ownership, the precise legal conditions of ownership transfer are generally unclear upon signature of the lease. Currently, under the program approximately 10,000 units are being constructed per annum, for which the Polish central government sets aside approximately 10 % of the annual housing budget. The European Investment Bank in 2002 took the decision to support the TBS program with a € 200 million loan to the National Housing Fund.

In Hungary, local governments can receive central government support for measures conducive to ‚increase the share of rental housing units in local government ownership', as well as the construction of pensioners homes, in both cases between 70 and 80 % of total investment costs. The church is another relevant investor group. Socially weak households in addition are entitled to receive loans from local governments in order to acquire housing units or land suitable for construction in own initiative.

Since the start of the current decade, with the help of the afore-mentioned programs both Poland and the Czech Republic have managed to turn around the new construction figures for public or non-profit housing units; Slovakia succeeded in at least slowing down the decline. Despite these statistical successes, it is clear that the subsidies per households paid under the programs are generally excessive and therefore the attack on the general problem of new multi-family construction remains either insignificant or extremely costly. The Polish TBS program in this regard seems to be the most balanced, at least in relative terms; however, the question arises whether few 'tenants', which must be able to come up with 20 % of investment costs of a new apartment upfront, in an economy with elastic land markets and falling interest rates would not be better candidates for unfettered ownership rather than a legally dubious solution. Hungary seems to have adopted a cost-efficient model by allowing local governments to buy existing, thus cheaper housing units from the stock. However, again the absence of a thorough rent reform in the country limits the capacity to mobilize sufficient stock units from sitting tenants.

5 Housing Policy Budgets

The budget figures published under the names of the housing departments in the surveyed countries usually comprise only expenditures for grants as well as capital allocations to the national housing funds. Contract savings premiums and housing allowances are allocated under the budget titles of either finance or social affairs ministries. Tax support seems to be included in the budgets, at least partially, of Poland and Hungary, but is not generally in the Czech Republic and Slovakia. Under these aspects, the following overview needs to be interpreted with considerable caution.

Still in 1991 housing policy expenditures in Poland reached 1.5% of gross domestic product, which was largely due to the high fiscal burden associated with funding subsidies to the old mortgage debt. Until 2002 the ratio of expenditures to GDP had dropped precipitously to just 0.3 %, the lowest level in the region. In 2000, the budgeted tax support, which is not included in the before mentioned figure, amounted to approximately 1 % of GDP. After a temporary decline associated with the discussed change in the tax support system 2001/02, it is expected to increase again in the future.

Slovakia currently is accelerating its formal housing policy budget again, in favour of higher expenditures for the rehabilitation and modernization of the multi-family stock through the State Housing Fund. The government is cutting back both interest rate and contract savings for housing subsidies. Still, the size of the budget of approximately 0.7 % of GDP is only moderate. The additional burden from unbudgeted tax support schemes should be relatively small.

In the Czech Republic, the published housing policy budget has been stagnant for years, at approximately 0.9 % of GDP. The strong increase in premium expenditures for contract savings for housing, which absorbed 55% of the budget in 2002, led to great distortions within the budget, which – because of strong 2001/02/03 savings cohorts – will be only slowly removed after the change of the premium regime in January 2004. Still in 2000, mid-term planning foresaw an increase of the housing policy budget up to 1.5 % of GDP until 2005, in particular by expanding the allocations to the State Housing Development Fund. This goal is unobtainable, due to the strong current fiscal pressure, and the fund likely to be abolished. Attention must be paid to the strong growth of unbudgeted tax support schemes, which according to World Bank estimates already in 2000 exceeded the housing policy budget.

Table 13: Housing Policy Budgets, Scale of Tax Support, and Budget Trends, in Central European Countries in Transition

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

Sources: National budget laws, author's assessments.

The official housing policy budget of Hungary features a rather constant trend as well, however, because of the frequent reformulations of policies it is very volatile. In 2002 it amounted to 0.7 % of GDP. Considering the high burdens stemming from subsidies to the old mortgage portfolio, in the mid of the 1990s the budget had been still in the range of 2 % of GDP. Current budget figures seem to underestimate fiscal costs: according to IMF estimates, support for the mortgage sector, which largely comes from tax measures, is in the range of 1 % of GDP alone. A notorious problem are cost overruns over the budgeted amounts, as many programs provide for legal entitlement whose cost implications are hard to assess ex-ante.[12]

6 Assessment of Housing Policies

An evaluation of the costs and benefits of the individual programs as well as the totality of the housing policies adopted, is still outstanding, mainly because of the institutional deficiencies described before. However, the existing material of individual analyses and market data allows for drawing a number of conclusions. In what follows, these are presented, first on a regional basis and then for individual countries.

Regional Assessment

Since the 1990s were characterized by high costs of new construction and of housing finance, relative to both incomes and opportunity costs (rents), and in addition income and legal uncertainties limited the circle of borrowers, the strong policy focus on support to housing finance came too early and was largely ineffective. Only since around 2000 the region experiences a noticeable recovery of new construction activity and banks start to become more deeply involved in housing finance.

Many support schemes that were newly introduced created imbalances in the distributional incidence of housing policy. In particular the strong use of tax support tended to accrue benefits with the upper middle class, which happened also to be the group to which access to finance was limited.

12 See The Economist (2003).

In the markets for modernizations and smaller real estate transactions, for example property sales of local governments, the economic preconditions were more favourable. In this area, the contract savings schemes of the Czech Republic and in particular of Slovakia generated certain successes. However, the price for this result is high, since support focus on subsidizing savings, rather than lending or investment, and high subsidy costs induce mostly low loan investment ratios of the institutions.

Direct support to housing investments in all four surveyed countries suffers from the fact that, 14 years into the transition, fundamental reforms in the housing sector have not yet been undertaken. These are: a) a fundamental price reform (rents), which could mobilize the necessary investment capital from users – here the strategy of adjusting energy prices while leaving rent control intact has backfired on governments through the need of higher housing subsidies – b) a thorough institutional reform, which would encompass the aggressive promotion of new investor classes, such as non-profit and private rental housing investors, and enforce a minimum investment capacity of condominium owners, and c) general sector development concepts driving decentralization and investment promotion; in particular the long overdue division of the multi-family housing stock in to those units that economically can and those which cannot be rehabilitated and modernized, as well as the carving out of a sufficiently large stock of social housing units. Given these omissions, even the multi-facetted and deeply subsidized programs of the new public housing funds were unable to obtain satisfactory results. The public housing programs taken up again in the region after the mid-1990s must be interpreted as signs of inability to reform the sector. They produce expensive housing units for a few, and almost never for the socially weak.

The promotion of single-family house construction through construction grants independently of leverage, in turn, has shown relatively strong production impact, as they were targeted to groups that were latently willing to invest. However, the implementation in Poland and Hungary was less than optimal, resulting in major abuse. The current trend to replace direct grants through tax support for loans and interest rate subsidies must be met with scepticism, since such instruments will largely benefit households with higher income levels that would invest in any case.

Everything considered, the countries in the region have established housing policy activities of considerable diversity, scope and scale. In doing so, they obviously aim at following Western models of the 1960s and 1970s. However, there is lack of sustainability, consistency and steadiness of the program mix as well as of willingness to tackle the necessary broader housing sector reforms. Correspondingly, a large proportion of the fiscal impulses is wasted.

Fortunately, the current phase of relative macroeconomic stability and reorientation of the banking sector towards housing finance is taking away a substantial part of the pressure to stimulate new construction activity from governments. This should be seen as a welcome opportunity to adjust the levels of support, in particular of finance subsidies, downwards and refocus support to young and needy households – in particular given the aspect of access to finance. Also, bolder steps are needed to attack the rehabilitation and modernization problem of the existing stock.

Poland

Within the region, Poland puts the greatest emphasis on direct support to housing investment, in particular in multi-family housing, through national fund loans and tax support to private investors. The social policy component of housing policy, in turn, is only weakly developed. Any attempt to boldly subsidize housing finance was intercepted in the past by the challenges posed by high and volatile interest rates. The steps taken since 2001 towards introducing mortgage interest deductibility therefore establish a break with a prudent tradition, and should be seen with concern.[13]

Given the largely completed development of housing finance institutions and quickly falling mortgage interest rates, housing policy has gained room for manoeuvre to refocus its program portfolio on socially weak groups and – in particular young – households at the threshold to homeownership. In order to seriously turn housing policy into a social policy effort, low-cost units should be mobilized from the existing housing stock; and young households be supported to solve their access to finance problem, either by promoting pre-savings or by introducing suitable loan guaranty systems. At the same time, local governments should be better empowered to provide serviced land to willing investors. A larger part of the budget than so far should finally be devoted to urban renewal operations, which need to include a significant number of demolitions of housing units whose economic lifetimes have since long elapsed.

Slovakia

In Slovakia the main thrust of housing policy throughout the 1990s were finance subsidies; however, given the high interest rate levels these predictably yielded unsatisfactory results. It took the highly subsidized contract savings for housing schemes until around 2000 to turn into a productive force in the modernization market, fostered by an aggressive political commitment to expand lending. In the same vein, the policy of deep interest rate subsidies through public lending, in the 1990s pursued by both the State Housing Fund and the public savings bank *Slovenska Sporitel'ňa*, served only few privileged households. This focus meant that much time and investment capacity was lost for direct investment promotion, in particular in the area of rehabilitation and modernization of the multi-family stock. The most radical tenant privatization effort in the region, exacerbated by the difficult economic situation of many regions in the country, created additional complications. A fiscal austerity program that followed the banking sector crisis after 2000, furthermore limited the room for manoeuvre for housing policy.

In Slovakia, too, the current interest rate decline process has helped to overcome the limitations to the housing policy budget in the past years. This should provide an opportunity for focussing what resources are available more clearly on the most pressing bottlenecks in the sector. A

13 It is hard to disentangle this decision from the parallel discussion about the introduction of a U.S. *Fannie Mae* type of secondary market institution among Polish housing policy makers.

priority goal should be made of avoiding further multi-family housing stock losses, by restructuring the ownership rights and accelerating modernization investments. This would provide for a minimum of life quality in regions disfavoured in the past by both housing policy and economic opportunity. New construction support should be limited to projects for specific needy groups. Subsidies to finance should be phased out up to a few exceptions, – e.g., a better targeted contract savings premium.

Czech Republic

Both Czech Republic and Slovakia pursued similar policies after their separation in 1993, including almost identical formulations of individual policy instruments. In the Czech Republic, the policy of high subsidies to finance was as misguided as elsewhere in the region, because of insufficient conditions for housing finance demand. The contract savings for housing scheme, whose premium level was fixed in the 1992 enabling law and could not be changed for full 12 years despite a strong interest rate decline in the meantime, is only the most extreme example. Subsidies in the mortgage finance sector reached soon excessive levels, supported still by the recycling of the excess liquidity of the contract savings system, and resulting in what is among the lowest mortgage interest rate level on record in Europe.

Contrasting with Slovakia, however, the Czech Republic refrained from comprehensive tenant privatization of the multi-family housing stock. This move did not pre-empt other, very wasteful policies such as hard rent controls (on extremely low levels) and the revival of public housing construction, which were ultimately directly tied to an artificially created scarcity of housing. However, the clearer ownership structure in the multi-family stock opens the perspective of a well-designed housing sector reform with a subsequently more effective rehabilitation and modernization program that is selective on the units to be invested in, provided that political opposition to such reforms be overcome.

In the Czech Republic, too, the need for a tight fiscal policy will increase the adjustment pressure on the housing sector, perhaps at least until the end of the decade. While the current low interest rate levels provide tail wind to housing policy, the part of the rate decline that is traceable to the excess subsidization of housing finance will need to be unwound. As in the Slovak case, the scarce public resources should be focussed on the areas of the greatest social policy impact, in particular by modernizing the multi-family stock, as well as the support of the investment capacity of local governments.

Hungary

The Hungarian housing policy is the most affected in the region by conceptual and budgetary stop-and-go conditions. There is almost complete absence of a housing policy formulation capacity devoid of conflicts of interest. When banks formulate parts of the housing policy – led by the OTP, which had been historically in that role – a focussed and targeted support framework cannot be established. At regular time intervals, impressive program announcements – with the name *Széchenyi* in 2000, policy makers played with the connotation of sweeping reforms in the 19^{th} century – fall apart as a result of subsequent budgetary crises. The vast subsidies for mortgage finance are in the meantime threatening to reach a scale that may create negative repercussions on the date of accession of the country to the European monetary union.

Like in the rest of the region, modernization of the urban multi-family housing stock in Hungary is very slow, kept back by rent controls, the negative implications of tenant privatization on investment willingness and capacity, and the shift of public resources towards the owner-occupied sector. The delay to invest where it is most needed increases the costs of future investment required to close the rehabilitation and modernization gap.

Hungary should take its current fiscal crisis as a signal to completely redesign its housing policy. To this end, an independent government institution should be created that could credibly formulate and implement a housing policy program. While more subsidies to the owner-occupied sector are politically opportune in a country with a homeownership ratio in excess of 90%, they do not contribute to the solution of the housing policy problems of the country. Still, the facilitation of access to homeownership should have a certain priority – paradoxically, despite the high general finance subsidies, young households are strongly disadvantaged when taking up loans. In order to arrive at a rational management of the housing stock that would benefit in particular young and socially weak households, a comprehensive rent reform program, followed by a similarly comprehensive rehabilitation and modernization program, is overdue.

D Housing Policy in Central Europe after the Accession to the European Union

With regard to the upcoming EU accession of the four surveyed countries, two questions regarding the implications that this step might have on the existing housing policy program are particularly pressing:

- Are there EU Directives or comparable legislation, which regulate the public support for new construction and modernization of housing? Does the current subsidy policy have to be changed, for example as a result of conflict with EU competition policy rules?
- Can financial support be expected from the EU for the housing sector?

1 EU Regulations

The Maastricht Criteria and Access to the European Monetary Union

Of great relevance are the Maastricht convergence criteria, which should induce the countries in the region – all fighting high budget deficits – to implement fiscal reform programs in the coming years in order to control, or reduce, their debt levels. Without such reforms, the access to the European Monetary Union as scheduled is strongly jeopardized. Considering the expected budget adjustments that need to be made, high and untargeted interest rate and tax subsidies should become a matter of the past.

Moreover, the pressure to more conformity of the tax systems to general EU practices will rise. These are increasingly uniform in such areas as value-added taxation and capital income taxation, and more defacto harmonization can be expected.

For example, all surveyed countries with the exception of Hungary will remove their split of value-added tax rates in favour of housing during 2004. At the same time, a 15% minimum withholding tax, which was agreed between EU finance ministers in spring 2003, will have to be implemented for foreign investors, which should pose challenges to the form of mortgage bond support in the Czech Republic, Slovakia and Hungary.

Competition Policy

In order to protect sufficient competition in the internal market, state aid, which includes the support program for the housing sector, is subjected in the EU to very strict rules. Any assessment must be based on Article 87 of the Treaty Establishing the European Community (EU Treaty), Amsterdam version.

Article 87 EU Treaty

(1) Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

(2) The following shall be compatible with the common market:

a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned; …

(3) The following may be considered to be compatible with the common market:

a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; ...

c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;

...

Article 87 EU Treaty declares in paragraph 2, letter a) that aid of a *social character, granted to individual consumers* is compatible with the Common Market. While clearly Member States have great political latitude to fill the room left by this definition, it is inconceivable that it would allow for a subsidization of the entire housing sector, or equivalently the entire housing finance sector. Particular constraints are imposed by the limitation to *individual* consumers, which is designed to pre-empt public aid whose targeting is blurry and not means-tested, for example by supporting the broad middle class. Hence it is not sufficient to simply define the good housing per se as meritorious or social; rather, demonstrable results of policies with respect to the improvement of affordability and housing provision of socially vulnerable groups must be presented.

In paragraph 3, letter c) state aid designed to *promote certain economic activities* are considered as eligible for clearance by the EU Commission. One might be tempted to subsume both the housing and mortgage sectors under such activities. However, in practice it would be difficult to argue in favour of such aid, since the development of both sectors is not impaired by obstacles that the private sector could not overcome by its own means. In contrast, examples for support schemes that could receive clearance are conceivable – e.g., temporary housing allowances with the purpose of mitigating the social consequences of rent reform.

In practice, transition countries might argue that from the perspective of the EU Commission a focus on housing or mortgage sector subsidies would be of subordinate priority, because these have a stronger social character relative to other subsidies and are almost meaningless for the internal market due to low levels of cross-border trade. Moreover, they might hint to the practice of housing subsidies in the past in Western Europe, which in practice was formulated almost without conceptual limits or limits to subsidies, despite the clear rules established by Article 87.

However, a number of case law decisions have been made in the past decade, which jointly work towards narrowing the room for manoeuvre left to escape the rules.

In the case of the Czech Republic, the Commission admonished that the state had provided excessive support to certain banks, when it permanently took over under-performing assets during the privatization process. As in other countries in the region, the transfer of mortgage credit portfolio was inter alia affected.

Case law in a number of instances – e.g., in the case of German Landesbanken or Austrian Landes-Hypothekenbanken – can be interpreted to portend to a factual interdiction of public loan guarantees and other instruments (e.g., recapitalizations) that directly sponsor designated lenders, unless these instruments do fulfil a clearly defined promotional or social purpose. These rulings would collide with certain housing policy projects in the region – for example the introduction of publicly sponsored secondary market institutions (under consideration in Poland) or the establishment of a central mortgage insurance fund without further means-testing of the programs, often practiced in smaller countries (e.g., Lithuania). Moreover, public banks, such as the to-be-privatized PKO BP in Poland, would have to continue their operations without explicit public guarantees.

Internal Market and Consumer Protection Policy

Questions of an internal market in housing services are so far not addressed in official documents of the European Union. In the spirit of the subsidiary principle they fall under national jurisdictions.

As a result of the sequencing of the transfer of national competencies to the EU level hitherto adopted, the Commission intervenes in particular in the sectors of monetary and fiscal policy, capital market as well as banking and insurance regulations. Also, major construction projects must be tendered on EU level. Most existing EU regulations have been transposed already by the new Member States in a 1:1 format.

But the division of labour described before gives rise to paradox constellations, with repercussions on policy effectiveness. For example, the EU is not allowed to develop a uniform framework for rent or tenant-landlord relationship legislation; at the same time, several EU Directives are committed to regulate – economically comparable – lending relations between banks and owner-occupiers. This means that the central relative price of the housing sector – the rent – is still subjected to highly idiosyncratic national regulation. This fact puts severe breaks on cross-border investments, both in the housing and the mortgage sector.

Mortgage finance itself is currently only partially affected by harmonization attempts. Despite the EU policy focus on capital markets, there are still no common standards for mortgage-related securities, such as mortgage bonds. Also, the inclusion of mortgage loans into the framework of consumer protection applicable to other consumer loans is highly controversial. Many relevant areas of legislation, e.g., questions of land and lien registration, of property appraisal standards, or the regulation of traditional special banking conduits fall legally unequivocally, but economically questionably, within the ambit of the subsidiary.

EU law does also not foresee an official function for the national ministers, which are responsible for housing. Despite this, since 1989 unofficial meetings of the ministers have taken place, during which various housing policy issues were discussed, such as social housing finance, private rental housing, social segregation, access to homeownership, and housing for the elderly. Moreover, so far two conferences concerning the sustainability of housing policy took place, in 1996 in Copenhagen and in 1997 in Amsterdam.

All these meetings primarily served the purpose of information exchange and the evaluation of general recommendations; they were not designed to develop specific rules or recommendations for national housing policies, nor did they result in calls on the EU to increase its low level of activity in the sector.

The Accession Procedure

Roebling (2003) describes the procedure that precedes the individual accession treaties. In the precedence case of the EFTA states, Austria, Finland and Sweden, decisions made by the EFTA Surveillance Authority (ESA) were accepted and transposed by the EU. In the case of the Central

European countries in transition, such an initial regulatory body is absent. Therefore, the following steps should be followed:

1. The transition countries implement the body of EU regulations according to the *Acquis* presented to them. The EU Commission signals no objections.
2. All national regulations which are not accepted by the EU Commission are submitted to the two-stage review process of Article 88 (3) EU Treaty. The Commission eventually asks for changes to be made.
3. There are two exceptions to this procedure: a) if the accession treaty provides for a specific transitional rule; b) for national regulations introduced prior to 12/10/1994, for which grandfathering has been agreed on.
4. Moreover, there are two sector exemptions, which however do not affect housing.

Objections should be anticipated primarily in the aforementioned areas of principal relevance for the Common Market, such as tax policy and competition policy. Social elements of the national housing policy programs, which focus on the supporting the housing needs of young or socially weak households, should survive the test.

2 EU Support for Housing

It is explicitly mentioned in the EU Treaty that means of the EU structural funds – e.g., regional development funds (EFRD), social funds (ESF) – shall not be used to finance housing investments. Too great is the political concern that an expansion of EU resources to the housing sector could create a second agricultural sector, i.e. a sector with high and potentially bottomless claims for subsidies.

To avoid conflict, the European Investment Bank has indirectly supported the housing sector in the past in a small scale under the umbrella of urban renewal programs. With the signature of a lending agreement over € 200 million in 2002 with the Polish development bank BGK with the goal to support the Polish social housing program, however, a new dimension has been reached that will trigger further debate.

Various EU programs, which do not explicitly address housing provision, but at the same time support the social integration of vulnerable groups as well as social cohesion, have an indirect housing sector impact. The same holds true for programs designed to urban renewal in environmental or socially neglected areas, to the improvement of living conditions and social infrastructure, and to support environmental friendly and sustainable construction.

From today's perspective, transition countries should not expect significant direct financial support for either housing construction or rehabilitation and modernization. On the other hand, the need for greater public investment in many economically depressed regions in the surveyed countries is acknowledged. The housing sector should here receive attention similar to other sectors. Both at EU and national level the insight should be promoted that a decent housing situation, while not being sufficient, may well be necessary for general economic development in the Central European countries in transition.

E Statistical Annex

Table 14: Real GDP-Growth in Central European Countries in Transition

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003 (1)
Poland	7.1 %	6.0 %	6.8 %	4.8 %	4.1 %	4.0 %	1.0 %	1.4 %	2.0 %
Slovakia	6.5 %	5.8 %	5.6 %	4.0 %	1.3 %	2.2 %	3.3 %	4.4 %	4.1 %
Czech Republic	5.9 %	4.3 %	-0.8 %	-1.0 %	0.5 %	3.3 %	3.1 %	2.0 %	2.5 %
Hungary	1.5 %	1.3 %	4.6 %	4.8 %	4.2 %	5.2 %	3.8 %	3.3 %	2.5 %

Source: Statistical offices. Note: (1) Forecast.

Table 15: Consumer Price Inflation in Central European Countries in Transition

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003 (1)
Poland	28.0 %	19.8 %	15.1 %	11.7 %	7.3 %	10.2 %	5.5 %	1.9 %	2.0 %
Slovakia (2)	9.9 %	5.8 %	6.1 %	6.7 %	10.6 %	12.0 %	7.3 %	3.3 %	9.2 %
Czech Republic	9.2 %	8.8 %	8.5 %	10.7 %	2.1 %	3.9 %	4.7 %	1.8 %	2.5 %
Hungary	28.4 %	23.6 %	18.3 %	14.2 %	10.0 %	9.8 %	9.2 %	5.3 %	4.7 %

Source: Central Banks.
Notes: (1) Forecast. (2) Core inflation estimate for 2003 is significantly below consumer price inflation: 3 %.

Table 16: Interest Rates in Central European Countries in Transition (Discount Rate)

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003 (1)
Poland	25.0 %	22.0 %	24.5 %	18.3 %	19.0 %	21.5 %	14.0 %	7.8 %	5.8 %
Slovakia	9.8 %	8.8 %	8.8 %	8.8 %	8.8 %	8.8 %	7.8 %	6.5 %	6.0 %
Czech Republic	9.5 %	10.5 %	13.0 %	13.0 %	6.0 %	5.0 %	4.0 %	1.8 %	1.0 %
Hungary	31.3 %	21.6 %	19.1 %	16.6 %	12.9 %	11.3 %	9.2 %	8.5 %	9.5 %

Source: Central banks. Note: (1) as of August 2003.

Literature

Apathy P., Die Treuhandschaft, Manz-Verlag (1995).

Bretschneider R./Fessel-GfK, Die Länder Mittel- and Osteuropas am Beginn des 21. Jahrhunderts, lecture script, Vienna (2002).

Bufton R., Where State Guarantees Supporting Commercial Banking Activities Distort Competition, They Must be Abolished. EC Competition Policy Newsletter, 2002 – Number 2 – Summer, Brussels *(2002).*

Butler S./Dübel A./Merstallinger P., Economic and Financial Issues in Mortgage and Capital Market Development in Slovenia, Study commissioned by the Ministry of Finance of Slovenia. Ljubljana (2001).

Bydlinski S., Bauträgervertragsgesetz and die Änderungen des Wohnungseigentumsgesetzes 1975 durch das Bundesgesetz BGBl I 1997/7, Manz-Verlag, Vienna (1997).

Diamond D., The Transition in Housing Finance in Central Europe, Study commissioned by USAID, San Diego/CA (1999).

Donner Ch., Wohnungspolitiken in der Europäischen Union, Eigenverlag (2000).

Dübel A., Financial, fiscal and housing policy aspects of Contract Savings for Housing (CSH) in Transition Countries – the Cases of Czech Republic and Slovakia, Study commissioned by the World Bank, Washington D.C. (2003).

Dübel A., Housing Subsidy Expenditures in the Czech Republic, in Public Expenditure *Review for the Czech Republic,* The World Bank, Washington D.C. (2000).

Dübel A./Lea M./R. Welter, Study on Mortgage Credit in The European Economic Area Structure of the Sector and Application of the Rules in the Directives 87/102 and 90/88, Study commissioned by the EU Commission (DG XXIV), Brussels (1998).

The Economist, Hungarian mortgages – House party, August 21, London (2003).

European Central Bank, Structural Factors in the EU Housing Market, Frankfurt (2003).

European Commission, Commission Notice on the application of Articles 87 and 88 of the EC Treaty of State aid in the form of guarantees, Official Journal of the European Communities, Brussels *(2000).*

Hegedüs J., „A Case of Subsidised Mortgage Program: Success or Failure? – the Hungarian Tax Credit for Home Loans", Metropolitan Research Institute, Budapest (2003).

Hegedüs J./Mayo S./Tosics I., Transition of the Housing Sector in the East Central European Countries, Regional Housing Indicators Project sponsored by USAID, Budapest (1996).

International Monetary Fund, Code of Good Practices on Fiscal Transparency, Washington D.C (2001).

Kingsley G. T./Mikelsons M., The Czech and Slovak Republics: Housing as a 'Second Stage' Reform, The Urban Institute, Washington D.C. (1995).

Kiss G./Vas E., Housing Finance in Hungary, Country paper prepared for the 2002 OECD Workshop on Housing Finance in Transition, Budapest (2002).

Lux M., Social Housing in the Czech Republic, Poland and Slovakia, European Journal of Housing Policy 1(2), 2001.

Magyar Nemzeti Bank, Report on Financial Stability, Budapest (2003).

Marikova Leeds E., The Development of the Mortgage Market in the Czech Republic, in: Housing Finance International March 1996, The International Union of Housing Finance Institutions, Chicago (1996).

Merrill S./Lea M./Chiquier L./Brzesk W. J./Rabenhorst C./Mikelsons M./McLennan D./TurnerB., et al., Building on Progress: The Future of Housing Finance in Poland, Study commissioned by USAID, Warsaw (1997).

Ministry of Regional Development of the Czech Republic, Housing Policy Concept, Government Resolution of 18th October 1999, Prague (1999).

Ministry of Regional Development of the Czech Republic, Housing Policy Concept, Prague (2001).

Ministry of Construction and Regional Development of the Slovak Republic, The Principles of State Housing Policy up to 2005 with an Outlook up to 2010, Bratislava (2000)

Ministry of Construction and Regional Development of the Slovak Republic, Housing Finance System, Slovak Republic, Country paper submitted to the 2002 OECD Workshop on Housing Finance in Transition, Bratislava (2002).

Moody's Investor Services, Country Credit and Mortgage Bank (FHB), Moody's Analysis, New York (2003)

Mortgage Credit Foundation, Housing Finance by the Banking Sector in Poland, internal presentation, Warsaw (2000).

Organization for Economic Co-operation and Development, "Housing Finance in Transition Economies", Summary of the OECD-Conference of 2000 and individual country reports, Paris (2002).

Roebling G., Existing aid and enlargement, EC Competition Policy Newsletter. 2003 – Number 1 – Spring, Brussels (2003)

Roy F., Mehr Geld für die eigenen vier Wände, in Economy in Hungary, Deutsch-Hungariane Industrie- and Handelskammer (2002).

Schönmann Hans-Günther, Geschichte des deutschen Hypothekarkredits; in *Rüchardt K.* (Hrsg), Handbuch des Hypothekarkredits, Frankfurt am Main (1993).

Stöcker O., Die Hypothekenbanken and der Pfandbrief in den mitteleuropäischen Reformländern, Fritz Knapp Verlag (1998).

Struyk R. (Ed.), Economic Restructuring of the Former Soviet Bloc: the Case of Housing, The Urban Institute Press (1996).

Tarki Social Research Center, Household, Work and Flexibility, Budapest (2001).

United Nations – Economic Commission for Europe, Housing Sector Country Profile Slovakia, Geneva (1999)

State Office for Housing and Urban Development, Housing Program against the Background of Current Reform and Economic Strategy, Warsaw (2001).

State Office for Housing and Urban Development, Information on Actions Taken and Planned by the Government in the Sphere of State Housing Policy, Warsaw (2001).

Würth H./Zingher H., Wohnrecht 2000, Manz-Verlag (2000).

Web Links

Poland

State Office for Housing and Urban Development, http://www.umirm.gov.pl
Statistical office, http://www.stat.gov.pl
Central bank, http://www.nbp.pl
BGK development bank, http://www.bgk.com.pl
REAS consulting, http://www.reas.pl
Mortgage Credit Foundation, http://www.fukrehip.pl

Slovakia

Ministry of Construction and Regional Development, http://www.build.gov.sk
Statistical office, http://www.statistics.sk
Finance ministry, http://www.finance.gov.sk
Central bank, http://www.nbs.sk
VUB Wuestenrot Stavebne Sporenie, http://www.vub-wustenrot.sk
Prva Stavebna Sporitelna, http://www.pss.sk
CSOB Stavebna Sporitelna, http://www.csobsp.sk

Czech Republic

Ministry of Regional Development, http://www.mmr.cz
Statistical office, http://www.czso.cz
Central bank, http://www.cnb.cz
Czech-Moravian Guarantee and Development Bank, http://www.cmzrb.cz
Czech Academy of Science / Socio-economics of Housing, http://www.soc.cas.cz
Banking association, with mortgage committee, http://www.bankovnasociace.cz

Hungary

Ministry of economics, http://www.gm.hu
Statistical office, http://www.ksh.hu
Central bank, http://www.mnb.hu
ITD development bank, http://www.itdh.hu
Metropolitan Research Institute, http://www.mri.hu
Tarki center of social research, http://www.tarki.hu
OTP Bank, https://www.otpbank.hu

Regional Institutions

OECD, Workshop on Housing Finance in Transition 2002,
http://www.oecd.org/document/13/0,2340,en_2649_34849_1845261_1_1_1_1,00.html

European Union, Enlargement Website,
http://www.europa.eu.int/comm/enlargement/index.htm

UN-ECE Country Paper Program for Transition Countries,
http://www.unece.org/env/hs/cph/welcome.html

World Bank, Europe and Central Asia region,
http://lnweb18.worldbank.org/ECA/eca.nsf?OpenDatabase