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5. Author(s)

1. Pamela B. Hussey
2. Jeffery P. Telgarsky
3. Raymond J. Struyk

6. Contributing Organization(s)

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ABSTRACT

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A number of centrally-planned economies (CPEs) are undergoing major reform and restructuring as they attempt to move toward a market-oriented economic system. The resolution of long-standing imbalances in the economy causes many dislocations:

Increasing inflation;

Falling aggregate demand;

Blockages caused by an inefficient financial sector;

Bottlenecks caused by a lack of labor mobility.

This report focuses on housing's role in mitigating these problems and responding to the deep latent demand for housing in CPEs, with illustrations and suggestions for assistance to the sector drawn from the cases of two countries--Poland and Hungary.

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Transformation of the Housing Sector in Poland and Hungary

March 1990

Prepared by:

Pamela B. Hussey, Jeffery P. Telgarsky,
Raymond J. Struyk and Royce LaNier
The Urban Institute

for the:

Office of Housing and Urban Programs
U.S. Agency for International Development
Washington, D.C. 20523

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The Urban Institute
2100 M Street, N.W.
Washington, D.C. 20037

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EXECUTIVE SUMMARY

TRANSFORMATION OF THE HOUSING SECTOR IN POLAND AND HUNGARY

A number of centrally-planned economies (CPEs) are undergoing major reform and restructuring as they attempt to move toward a market-oriented economic system. The resolution of long-standing imbalances in the economy causes many dislocations:

- Increasing inflation:
- Falling aggregate demand;
- Blockages caused by an inefficient financial sector;
- Bottlenecks created by lack of labor mobility.

This report focuses on housing's role in mitigating these problems and responding to the deep latent demand for housing in CPEs, with illustrations and suggestions for assistance to the sector drawn from the cases of two countries—Poland and Hungary.

A. HOUSING AND THE MACROECONOMY

The housing sector is an important component of the economy and government expenditure. Housing investment accounted for about 6 percent of GDP in Poland and Hungary in 1989; the construction sector provides over 7 percent of total employment in each country. However, the low priority given to housing by economic planners and the pervasive administrative control maintained over the sector in CPEs has led to massive subsidies and chronic housing shortages. Waiting times for obtaining a state-provided apartment range from 15 to 30 years in Poland to 4 to 10 years in Hungary. This history of chronic housing shortages and the staggering amounts of subsidies in CPEs make housing a vital issue—both socially and economically—in the reform process.

A well-functioning housing market can buffer the dislocations caused by economic reform in several ways, as listed below.

Restraining inflationary pressure. A reformed shelter sector can contribute to inflationary restraint by soaking up some of the liquid monetary holdings of households. High "free" market prices for housing show it is a commodity for which they are willing to pay full costs and more. This demand for housing can soak up much of the liquidity held by households in CPEs, reducing the need to curb inflation through more harsh macroeconomic means.

Reduction of subsidies. Housing subsidies tend to make up an increasing portion of on- and off-budget spending by governments in an inflationary environment. Creation of a well-functioning housing market also offers governments the opportunity to cut subsidies, thereby restraining demand and offering the potential for a lower budget deficit—with the bonus of improved efficiency in the housing market. Subsidies for housing, often regressively distributed, amounted to over 5 percent and 4.5 percent of GDP in Poland and Hungary, respectively, in 1989.

Maintaining aggregate demand. A second benefit of a well-functioning housing market is the sector's stable demand—even as restructuring in other sectors depresses overall demand. Thus, the housing market offers reforming economies a sector which can help maintain the level of economic activity while other sectors undergo recession as part of their adaptation to a more competitive economic environment. In Poland, over 400,000 units of housing sit uncompleted because of lack of financing and materials or because of regulatory delays; carefully targeted intervention could accelerate the production of these units and lessen the negative impact of reform.

Improved financial intermediation. With a well-functioning housing market, the financial system will be both broadened and deepened (soaking up excess liquidity in the process) as households will have stronger incentives to save and finance the purchase of housing. Increased savings in financial form creates gains for the economy through more efficient matching of lenders and borrowers through the financial system. Contract savings schemes offer a potential means of increasing the proportion of savings held in financial form. Such schemes not only help borrowers overcome imperfections in the capital market, but also can increase households' motivation for saving in financial form if participation in the scheme establishes priority in the housing queue.

Use of market-rate financing for housing construction and purchase also places greater demands on the financial sector. Improved techniques of risk assessment will be needed to achieve a more business-like allocation of credit and improve the efficiency of investment. New lending instruments, such as dual-index mortgages (DIMs), will be required to maintain housing affordability, protect lenders from adverse interest rate movements, and to shield borrowers from adverse movements in wages relative to interest rates. The development and acceptance of such mechanisms in the mortgage market can pave the way for their wider use in the economy and make an important contribution to the development of the financial sector as a whole.

Expanded private sector activity. Improved functioning of the housing sector serves as a strong incentive for private enterprise to play a larger role in housing supply, with likely gains in productivity and efficiency. The shelter sector is also marked by strong forward and backward linkages in the economy. Thus, increased private sector activity in housing can act as a spur to private sector activity elsewhere in the economy.

Improved labor mobility. Generally, households in CPEs face difficulty in finding new housing if they move and thus bear higher housing costs through high housing prices for those units which do change hands, long commutes to work, and poor housing conditions. Consequently, there is upward pressure on money wages to compensate for these higher housing costs; wages may often exceed their competitive level. One of the key components of economic reform is a reshaping of the distribution of labor and a more flexible labor market. Efficient restructuring of the labor force in response to economic reform will not take place unless housing is available to accommodate those workers who wish to move to areas of labor shortage. Thus, increasing the supply of housing will increase the competitiveness of the country's products while simultaneously meeting consumer demand.

B. HOUSING SECTOR CONDITIONS AND TECHNICAL ASSISTANCE

Table ES.1 gives a compact summary of the current status of the operation of various elements of the housing sectors in Poland and Hungary, e.g., housing finance, the construction industry, the supply of building materials and so forth, with constraints to efficient operations highlighted. The final column of the table lists technical assistance or, where current information is insufficient to define possible assistance, studies that could be the basis for developing assistance later for each element of the sector. In this column the main constraints to designing or implementing technical assistance are noted. The descriptions of the current situation and the possible technical assistance are expanded upon in the case studies presented in Chapters 2 and 3.

A quick review of the entries on "current status" reveals important differences between the two countries. In several respects Hungary's housing sector has moved much further toward a market basis; areas where this is the case include the allocation of much of the rental stock by free exchange rather than by bureaucratic intervention, the importance of private contractors in constructing housing, the significant emergence of private firms to supply and distribute building materials, and the more advanced capital market which could be used to mobilize funds for housing lending through its more developed banking system. On the other hand, the "shock therapy" to which Poland is being subjected is very rapidly moving most prices to their market levels--mortgage interest rates, for example, are already almost there--and may have profound effect on the relative importance of SOEs in the construction and building materials industries in the near term.

Perhaps the most demanding sectoral problems facing both countries are in the area of planning, zoning, land transfer, and provision of residential infrastructure at the local level. The attempt at improving delivery of services in these areas is being complicated by the simultaneous shift of responsibilities to the local level and in Hungary the evolution of a new local governmental structure as well. Unfortunately, it is in this area that the information available to the team was weakest and, hence, little in the way of concrete action can be proposed until further information is developed.

In contrast, "quick starts" appear possible in housing finance, in improving the efficiency of the sales market (especially in Hungary) through better information on transactions prices for units and house plots, in eliminating the handicaps under which small contractors operate relative to State Owned Enterprises, and in improving estate management.

Table ES.1

Status, Constraints and Possible Technical Assistance in Poland and Hungary

Area	Country	Status/Constraints	Possible Technical Assistance/Studies
<u>Finance</u>			
Construction period finance to small/medium size firms	P,H	Constrained by lack of underwriting skills & familiarity	TA developing and applying underwriting guidelines
Mortgage lending			
(a) interest rates	P	Lending rates somewhat below market	
	H	Difficult to judge but lending rates appear below market and major subsidies remain	
(b) mortgage instruments	P,H	ARM recently adopted	TA with developing dual index mortgage and implementing thru lenders
(c) competition	P,H	State savings banks (PKO, OTP), very dominant; more competition needed	Assist nascent institutions to develop & compete; push for privatization at an early date
Funds mobilization for housing	P	Limited competition for deposits; positive real interest rates; primitive capital market	TA with structuring housing - linked contract savings scheme with proper incentives
	H	Limited but increasing competition for deposits; interest rates equal inflation rate; capital market developing	TA with selling mortgage-backed debt instruments in capital markets to mobilize funds. <u>Constraint to action</u>: mortgage interest rates must move to higher level for debt instruments to be attractive, continued development of capital market.

Area	Country	Status/Constraints	Possible Technical Assistance/Studies
Real-side			
Residential construction industry	P	Very limited private sector capability; major effort to remove impediments to private sector required; SOE restructuring necessary	Analysis of impediments & development of action plan for removing; help on privatizing SOEs. Constraint to action: framework/procedures for privatization must be established
	H	Major private sector capability, but still impediments; future role of industrialized housing (SOEs) to be determined and then possible privatization	Analysis of remaining impediments & action plan development; assistance in expanding small firms; help in determining role for industrialized housing & industry structure. Constraint to action: framework/procedures for privatization must be established
Building materials industry	P	Chronic shortages of materials; SOEs very dominant in production & distribution; emerging situation is unclear	Major analysis of industry needed as starting point; some help with privatization may be feasible. Constraint to action: framework/procedures for privatization must be established. Reform of distribution channels must be in context of broader restructuring.
	H	SOEs still dominant but private production & distribution are important and expanding	Major analysis of industry needed as starting point; some help with privatization may be feasible. Constraint to action: framework/procedures for privatization must be established.

Planning, land, and infrastructure	P	Process geared to providing sites for huge housing estates developed by kombinats; wholesale change needed	More analysis of existing situation is essential. TA to introduce certain types of user fees may be appropriate; strategy of working first with one city may be useful. Introduce public-private partnerships. <u>Constraint to action</u>: revenue generation capacity of local government must be strengthened.
	H	Availability of serviced sites is major housing supply bottleneck; massive decentralization of functions to local government may make problems worse in the short run	More analysis essential as starting point; local capabilities limited & rigid and slow planning apparatus must be reformed. Introduce public private partnerships. <u>Constraint to action</u>: new local government structure must be established; revenue generation capacity of local government must be strengthened.
Housing allocation			
rental units	P	Situation changing very rapidly, but now still very deep subsidies & allocation by regulation	Analysis of reform options--including housing allowances--and relation to incomes policy needed as step to privatization. <u>Constraint to action</u>: increasing rents must be coordinated with broader incomes policy.
	H	Rental subsidies remain deep, but housing allowances have been introduced to protect poor and major part of stock being allocated by the market	Principal problem is political will for change. <u>Constraint to action</u>: increasing rents must be coordinated with broader incomes policy.
ownership units	P,H	Free exchange	TA to help improve information on market prices to consumers and producers would greatly improve market operations. <u>Hungary - constraint</u>: regulation forbidding public access to sales data must be changed.
estate management	P,H	Insufficient maintenance a clear result of low rents; quality of estate managers probably needs strengthening	TA to demonstrate/train strong estate management, especially financial aspects. Pilot "work outs" of projects needing moderate rehab.

1

HOUSING AND MACROECONOMIC REFORM

A number of centrally-planned economies (CPEs) are undergoing major reform and restructuring as they attempt to move away from the CPE paradigm of administrative control over the economy toward a market-oriented economic system. The housing sector—broadly defined to include both the real side (the provision of serviced land, the building materials and construction industries, and housing production) and the financial side (construction and mortgage financing)—will play a key role in this transformation. Indeed, the World Bank (1989d) has identified the centrality of housing reforms to overall economic progress:

> The combination of extreme housing shortage and high subsidies in Poland . . . distorts the economy in ways that extend well beyond the boundaries of the sector. . . .
>
> Policy reform affecting the housing sector has the potential to benefit the economy quickly through three different circuits—the real side of the economy, the fiscal side, and the financial side. The incremental nature of housing investment makes it possible to mobilize investments quickly and in a geographically selective way. . . .

The history of chronic housing shortages and the staggering amounts of subsidies in CPEs make housing a vital issue—both socially and economically—in the reform process. To households, the performance of the sector is likely to be one of the benchmarks against which the success of reform is measured. Policy makers in these countries now appreciate the wider macroeconomic impacts of housing shortages and excessive subsidies.

This report focuses on housing's role in mitigating some of the problems caused by reform and responding to the deep latent demand for housing in CPEs. The reform experiences in two countries—Poland and Hungary—are used to illustrate the changes and issues faced by CPEs undertaking this transformation. Both countries are seeking—through very different approaches—to shift to market-based economies, but in doing so to minimize the cost of the dislocations associated with reform. In making the transition they badly need economic support, cogent advice, and well-targeted technical assistance.

This chapter describes the magnitude of housing in the macroeconomy and shows that assisting the reform of the shelter sector offers both short- and long-term benefits to reforming CPEs. In the short run, a more efficient housing sector eases the pain of the economic adjustment process by affecting both inflation and demand. Over the longer term, a well-functioning housing sector helps to lay the foundation for a more efficient economy spurring improvements in the financial sector, giving a larger role to private producers in the sector, and helping shape a more flexible and responsive labor market.

The two following chapters present case studies of two reforming CPEs, Poland (Chapter 2) and Hungary (Chapter 3). The case studies provide more detailed analysis of two countries at different stages in the reform process: Hungary has gradually moved quite far from the CPE paradigm; Poland has made little progress, but is attempting to make radical changes in how its economy operates in a short time. The demographic and economic conditions to which the housing sector has had to respond and the progress of economic reform in the country are surveyed in the cases. They then describe the structure of the housing sector and the issues that link economic reform and the sector. The cases conclude with an outline of what technical assistance might be offered to address those issues.

The final chapter provides a comparative summary of conditions in the housing sector and an overview of the technical assistance opportunities in the two countries.

A. HOUSING IN THE MACROECONOMY

Reform of the economy in Poland and Hungary will have an immense impact on the shelter sector, as well as vice versa. The sector is a major component of the economy in both countries (see Table 1.1 on the next page).

The construction sector made up 13 percent and 7 percent, respectively, of GDP in Poland and Hungary in 1986; housing represents over 60 percent of activity in the construction sector. In the same year, 1.3 million persons in Poland and 350,000 persons in Hungary were employed in construction. The World Bank

Table 1.1
Shelter Sector in the Macroeconomy: Poland & Hungary 1980-86

	Poland		Hungary	
	1980	1986	1980	1986
Construction sector (% of GDP)	10.6	12.9	9.9	7.3
Construction employment (% of total)	8.2	7.7	n/a	7.1
Housing investment (% of GDP)	6.8	6.0	6.7	6.0
Housing (% of total assets)	27.8	28.4	n/a	n/a

Source: Matras (1989b).

(1989d) estimates that gains of up to 4 percent of GDP could be registered if housing production returned to levels recorded in the late 1970s—if the shelter sector could adapt and expand (through joint ventures and privatization) to meet unmet demand.

The housing sector also accounts for a significant part of government expenditure. In 1989, housing accounted for about 30 percent of consumer subsidies in Poland and 36 percent of all subsidies in Hungary (World Bank, 1989c; Tosics and Hegedus, 1990). Given these magnitudes, the performance of the sector and its reform cannot help but have an impact on the path of economy-wide reform.

B. HOUSING AND MACROECONOMIC REFORM

A well-functioning shelter sector in a reforming CPE does not only respond to long-standing social frustrations caused by persistent housing shortages. It also can play a substantial role in the easing transition to and contributing to the efficient functioning of the reformed, market-oriented economy.

As the restructuring proceeds, the resolution of long-standing imbalances in the economy causes many dislocations:

- Increasing inflation as newly-freed prices adjust and excess liquidity, previously held in check by rationing, pushes up the money prices of scarce goods;

- Falling aggregate demand as inefficient state enterprises close or shrink their workforces to raise their competitiveness;

- Blockages caused by a financial sector that is not practiced in allocating credit by evaluating risk and return on a potential investment;

- Bottlenecks encountered as labor is unable to relocate to take up jobs in firms that achieve success in the marketplace.

The housing sector has an important contribution to make in alleviating the macroeconomic pains of reform. A well-functioning housing market can buffer the dislocations caused by economic reform in several ways:

- Households in CPEs have demonstrated strong effective demand for housing—even at very high relative prices where uncontrolled units have been available; meeting this demand can both:

  — soak up liquidity to restrain inflation
  — help maintain the level of activity in the economy during the slowdown associated with restructuring;

- Reduction of subsidies for housing can decrease government expenditure and lessen inflationary pressure through smaller budget deficits—while increasing efficiency within the economy by making households face the true cost of housing;

- A strong housing market can provide impetus for a more efficient and more innovative financial sector;

- Where the housing market has been freed from state control, private construction firms have responded by increasing their share of housing production;

- A more efficient housing market can improve labor mobility and ease the redistribution of labor within the economy that will flow out of restructuring.

1. Restraining Inflationary Pressure

A key objective of governments in reforming CPEs is to keep inflation under control; prices will tend to rise (pushed up by households' forced savings previously held in check by rationing) as they are released from administrative control. Cuts in aggregate demand—including housing—are required in the short-run to reduce pressure on prices. Indeed, one of the key results of the decontrol on prices in Poland in 1990 has been the severe rise in the price of land, building materials, and credit which has drastically cut effective demand for housing. However, a reformed shelter sector can contribute to inflationary restraint by soaking up some of the liquid monetary holdings of households.

The housing market offers households a commodity which is in high demand both as a consumption good and as an investment asset; the "free" market for housing (with prices, in Poland, 2 to 3 times the cost of construction) shows it is a commodity for which they are willing to pay full costs or more (World Bank, 1990). This demand for housing can soak up savings held (often outside the financial system) by households that have long been kept from fulfilling their preferences by the unavailability or low quality of consumption goods. In the early stages of reform, before the structural changes needed to satisfy consumer demand have taken place, keeping liquidity in the economy down improves the ability of the government to restrain inflation. This reduces the need to curb inflation through macroeconomic means, such as forcing down real wages, raising interest rates, or cutting demand through higher prices.

2. Reduction of Subsidies

Access to housing and its financing in traditional CPEs have always been administratively controlled (except for a small part of the sector where households operate outside the state system). Structural impediments inherent in the planners' policy choices (*i.e.*, treating housing as a "non-productive" good and keeping the cost of housing to households artificially low) and the incentive systems employed in CPEs (which emphasized production targets rather than responding to demands from the market) acted as a brake on any improvement in sector performance. As a result, extensive systems of subsidies have been established to keep official housing costs low and try to counter the problem of inadequate housing supply.

Creation of a well-functioning housing market offers governments the opportunity to cut subsidies (thereby restraining demand and inflationary pressure)—with the bonus of improved efficiency in the housing market. Housing subsidies, such as rents and utility charges that do not reflect the full cost of housing and services, up-front capital subsidies, and below-market interest rates, contribute to inflationary pressure when they are not well-designed or targeted to low-income households. Such subsidies not only add significantly to the government budget deficit, but also generate excess cash balances for households who receive the subsidies and do not face the full cost of housing.

Subsidies supporting the operation of state-owned rental housing, which are not strongly linked to household incomes and needs, form a significant part of government budgets. In Poland, raising rents in state housing to cover upkeep and utility costs would reduce central government spending; in 1989, these subsidies accounted for almost 4 percent of government expenditure (World Bank, 1990).

Other subsidies for housing also form a large portion of government expenditure. In Poland, on-budget subsidies for housing purchase accounted for about 3 percent of government expenditure in 1989. The World Bank (1990) estimates that off-budget subsidies for housing are even larger, totaling between 1 and 2 percent of GDP. In Hungary, Hegedus and Tosics (1990) estimate that support for housing—equal to 4.5 percent of GDP—accounted for 36 percent of all subventions in the central government budget. Over half of these subsidies were to cover the cost of below-market loans for housing issued by state banks.

Rationalization of these subsidies would raise the proportion of household income spent on housing from current low levels (less than 5 percent for most households in state-supplied housing) to levels close to the 15 percent spent by households in other similar countries. Elimination of—or at the least, better-designed—housing subsidies not only results in lower budget deficits which would ease inflationary pressure, but also brings about a more market-based allocation of housing. Given the size of the housing sector, both of these effects are important contributions in the successful implementation of the reform process.

3. Maintaining Aggregate Demand

A second benefit of a well-functioning housing market is the sector's stable demand—even as restructuring in other sectors depresses overall demand. Thus, an efficient housing market offers reforming economies a sector with strong demand and high domestic content—one which can help maintain an adequate level of economic activity while other sectors undergo recession as part of their adaptation to a more competitive economic environment.

In Poland, the freeing of prices under the reform program has led to a burst of inflation as prices seek their correct levels. These higher prices are translating into lower output and rising unemployment. However, demand for housing, once temporarily high interest rates and building materials prices have declined, should return to its former high levels. Over 400,000 units of housing sit uncompleted because of lack of financing and materials or because of regulatory delays (World Bank, 1990). With cost-effective, moderate interventions, such as relaxation of regulatory restrictions or clearing of key production bottlenecks (lack of infrastructure, shortages of a few key materials), the completion of these units could be accelerated. A careful inventory of uncompleted units would be required to identify those with the greatest pay-off. The resulting production would help stabilize the construction industry, which is in a severe downturn and requires large-scale restructuring.

Housing demand in Hungary has also declined as households face high purchase prices (relative to reported incomes) for housing. However, the World Bank (1989c) reports that there is substantial potential demand for housing which the current producers (SOEs and small-scale builders) are unable to produce in sufficient quantity. Also, while Hungarian housing demand based on official statistics appears weak, little account is taken of income which households receive from "second economy" sources. There appears to be much activity that could be spurred by better matching supply (in terms of housing type and quality) with household demand.

Thus, in both countries, the shelter sector appears poised to act as a source of economic activity during periods of economic retrenchment. In the Polish case, where the "shock" approach to reform has the potential of sending production in the economy into a steep decline, the counter-cyclical benefits of unmet demand for housing can play a role in lessening the negative impact of reform.

4. Improved Financial Intermediation

With a well-functioning housing market, the financial system will be both broadened and deepened (soaking up excess liquidity in the process) as households will have stronger incentives to save in financial form and finance the purchase of housing.

Households will be less likely to save in financial form if their assets do retain their value over time (e.g., if the real interest rate on deposits is negative) or if the future availability of goods for purchase with savings is doubtful (i.e., consume what is available today because it may be in short supply tomorrow). The achievement of positive real incentives for saving is not sufficient condition for mobilizing financial savings—adequate supply response from the productive side of the economy must also take place.

In a period of economic change as is being experienced in Poland and Hungary, housing-linked contract savings schemes offer a potential means of increasing the proportion of savings held in financial form. Such schemes not only help borrowers overcome imperfections in the capital market (which are likely to exist in Poland and Hungary), but also can increase households' motivation for saving in financial form if participation in the scheme establishes priority in the housing queue. This would obviously be an attractive feature to households whose previous savings efforts made little impact on their access to housing. Struyk and Friedman (1988) found exactly these positive relationships in an analysis of a contract savings scheme in India.

There are certainly efficiency gains associated with channeling an increased proportion of national savings through the financial system (though quantitative gains are less certain—see below). Greater intermediation by the financial system allows more productive investment by more efficiently matching capital with borrowers—if the credit allocation mechanisms of the financial system are able to accurately assess risk and return of different borrowers.

The measured savings rate (based mainly on savings in financial form) in Poland declined from 17 percent of GDP in 1981 to 8 percent in 1984 (World Bank 1987); it remained low while real interest rates on deposits were negative and while the accumulation of savings did not improve access to desired consumer goods or housing. With the return of positive real rates of interest on deposits and allocation of housing and other goods through a market-oriented price mechanism, households again have reason to accumulate cash balances within the financial system; the early evidence from the 1990 reforms is that households are responding positively.

Use of market-determined interest rates also places greater demands on the financial sector that will require improved techniques of risk assessment and lending instrument design. Lenders in CPEs, particularly mortgage lenders, have not been required to make decisions about credit allocation between competing borrowers and have borne little risk of default by the borrowers because of the state's willingness to grant subsidies to assure repayment. Changes in Poland and Hungary are moving the financial system toward a more businesslike and competitive distribution of credit (both for housing and other purposes) which will improve the efficiency of investment—but also raise the risk of default.

The uncertain economic conditions which accompany reform require innovative housing lending instruments, such as dual-index mortgages (DIMs)[1], to maintain housing affordability and protect lenders from adverse interest rate movements. The development and acceptance of such mechanisms in the mortgage market can pave the way for their wider use in the economy and make an important contribution to the development of the financial sector as a whole.

Demand for housing finance would also provide incentives for other financial institutions to get involved in the sector, providing competition to the existing source of mortgage finance (usually a state bank which previously held a monopoly over the mortgage business). Both Poland and Hungary have removed the monopoly privileges for housing finance granted to state savings banks. However, without an active housing market, there will be little incentive for other financial institutions to attempt to compete in the mortgage lending business.

5. Expanded Private Sector Activity

Improved functioning of the housing sector serves as a strong incentive for private enterprise to play a larger role in housing supply, with likely gains in productivity and efficiency. The shelter sector is also marked by strong forward and backward linkages in the economy. Thus, increased private sector activity in housing can act as a spur to private sector activity elsewhere in the economy.

In Poland, less than a third of all housing is produced by the private sector, with neither state nor private producers operating at an efficient scale: state producers are large, heavily-subsidized conglomerates which can only develop housing projects with hundreds of units on very large sites; private producers are small, under-capitalized, and build mainly single-family units for individual households which have adequate resources to self-finance the unit. With the implementation of reforms described above—increased incentives for saving, improved allocation of credit, affordable lending instruments—to convert latent demand for housing into effective demand, private activity in the shelter sector should grow to meet this demand.

Indeed, this has been the case in Hungary, where the ability of households

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[1] A DIM has monthly payments indexed to wages and the outstanding loan balance indexed to actual interest rates. Divergences are adjusted at the loan's maturity.

to purchase housing provided by private construction firms at free-market prices and the elimination of preferential take-out financing for state housing has led to an increase in private sector share of housing construction from 62 percent in 1975 to 89 percent in 1986 (Matras, 1989a).

6. Improved Labor Mobility

In market economies, labor seeks its highest return by moving to jobs with higher wages offered by more productive firms and industries. Market clearing in this case assumes households having to change locations can obtain housing at a price that still allows their real incomes to rise. If housing is too costly to allow this movement, two kinds of responses can be expected: (1) wages offered will rise further to compensate for the cost of housing; or (2) more housing will be supplied, lowering the cost of housing. Mayo and Stein (1988) report that, in most market economies, housing shortages are eliminated relatively quickly through increased supply.

In CPEs, movement of labor has historically been low. Households face difficulty in finding new housing if they move and are less willing to give up housing they already occupy. Instead, households bear higher housing costs than they would optimally choose, as manifested by relatively high housing prices for those units which do change hands, long commutes to work, and poor housing conditions (evidenced by poor quality construction, lack of amenities, and overcrowding). Consequently, there is upward pressure on money wages to compensate for these higher housing costs; wages may often exceed their competitive level.

Mayo and Stein (1988) find that disequilibrium in the housing market in Poland (as evidenced by housing prices that greatly exceed costs and levels of investment in housing below that found in similar countries) depresses labor mobility. Econometric analysis indicates the influence of housing shortages is large, with most firms responding with higher wages to make up for the costs of the housing shortage. Similar anecdotal evidence from Hungary suggests that the housing shortage was often the key determinant in households' decision to move; state enterprises in Hungary were often able to attract workers, not simply by offering higher wages, but by offering access to housing.

One of the key components of economic reform is a reshaping of the distribution of labor and a more flexible labor market. In Hungary, for example, at least 200,000 workers are expected to change jobs, half of them moving to a different industry (The Economist, 1988). Housing shortages in CPEs are a major impediment to such adjustments, especially if the new job is in another city. Mayo and Stein's (1988) findings provide strong evidence for Poland that major distortions in the labor market are caused by housing shortages in growing areas. In short, efficient restructuring of the labor force in response to economic reform will not take place unless housing is available to accommodate those workers who wish to move to areas of labor shortage.

2

THE HOUSING SECTOR IN POLAND

Among CPEs, Poland has a relatively long history of reform aimed at decentralizing decision making within the economy. These reforms, beginning in the mid-1950s, produced little real movement away from the CPE paradigm until 1981. In that year, with the economy in crisis, the most complete set of reforms to date was introduced. However, poor economic conditions and a resistance by the administrative apparatus of the state to the proposed scaling-back of its powers limited the results of these reforms. In late 1987, a "second stage" of reform was launched, which achieved considerable advances in freeing the economy from central control, but did little to impose discipline on state-owned enterprises.

The inflation and instability that followed has prompted a third round of reform. This stage, which went into effect in January 1990, abandons the incremental approach of previous reforms and attempts an economic restructuring that will rapidly transform Poland into a market economy. The reforms are based on a convertible currency, free prices, and operational freedom for state enterprises, while severely cutting back state spending and support and imposing market rates on previously "soft" lending.

These reforms significantly alter the conditions under which state enterprises function and the prices faced by consumers. These changes will be felt particularly strongly in the housing sector, which has long been dominated by state producers and functioned with large state subsidies (both through capital grants and soft financing).

This chapter examines the implications of reform on the housing sector and identifies how technical assistance might assist the sector in meeting the challenges of the reformed economy. The first section describes the demographic and economic context to which the housing sector responds. The following sections describe the structure of the sector, how it is changing in response to the reforms, and the positive macroeconomic benefits that a well-functioning sector offer the Polish economy during its restructuring. The final section offers some suggestions on what assistance might be offered to support the restructuring of the sector.

A. DEMOGRAPHIC AND ECONOMIC CONTEXT

The performance of the housing sector is influenced by both demographic and economic factors. To adequately satisfy demand, housing must be produced to meet both the increase in the number of households and how households are distributed throughout the country. On the economic side, the environment in which producers and households function impacts on the supply and the affordability of housing in the economy. This section outlines the demographic and economic context in which the housing sector operates.

1. Demographic Trends

Population growth in Poland has been subject to cyclical effects caused by population losses and growth slowdowns during the World Wars. The slow growth during 1939-45 was followed by a dramatic baby boom that echoes through succeeding population cohorts (World Bank, 1987). The result is a population age structure that is unusually irregular The current increase in youngest age cohorts Poland is experiencing is the first echo of the post-war baby boom.

Just as the of number births is affected by the baby boom, so too is the number of elderly persons. Currently, the Polish population is marked by (relative to other industrialized countries) a low proportion of persons over age 65. Their numbers will grow slowly for the next 20 years (see Table 2.1 on next page). Coupled with low levels of fertility, this will push down the dependency ratio. However, a rapid increase in the number of elderly persons will follow as the age cohort bulge begins to move past age 65. Through higher medical costs and increased pension payments, this will place a heavy burden on the social welfare system.

Over the coming ten years, net population growth in rural areas continues the negative trend that began in the 1960s. Urban population growth, which peaked in the decade immediately following World War II, remains positive, but is slowing its pace. This deceleration is driven mainly by lower fertility rates and lessening migration from rural areas.

Table 2.1
Population Growth 1970-2000
(Millions)

	1970	1980	1990	2000
Total population	32.7	35.6	38.5	40.8
Aged 14 and under	8.8	8.6	9.6	8.8
Aged 15-64	21.2	23.4	25.1	27.1
Aged 65 and over	2.7	3.6	3.8	4.9
Dependency ratio* (percent)	54.4	52.4	53.6	50.7
Urban population	17.1	20.7	24.3	27.2
Rural population	15.6	14.9	14.2	13.6
Annual growth (percent)				
Total	0.7	0.9	0.7	0.6
Urban	1.6	1.9	1.4	1.0
Rural	-0.2	-0.5	-0.4	-0.3

* The dependency ratio is the sum of the population under age 15 and age 65 and over divided by the population aged 15-64 expressed as a percentage.

Source: United Nations (1986).

The present effect of these demographic changes is high levels of demand for housing, health services, and primary education in urban areas—a situation which will persist for the coming decade. This demand will ebb, but will be followed by another round in approximately 20 to 30 years as the second echo cohort of the baby boom begins to be felt while the original baby boom cohort starts to move into retirement age.

2. Overview of the Economy[1]

Poland began its reform efforts in 1981 with policy revisions designed to decentralize decision making, adjust the structure of prices, and make state enterprises more financially responsible. Only slight improvements were achieved

[1] Unless otherwise noted, the data presented in this section is drawn from IMF (1989d).

Table 2.2
Economic Indicators 1986-90
(Percentage change at constant prices)

	1986	1987	1988	1989[E]	1990[P]
GDP	4.2	2.0	4.12	-1.0	-5.0
Retail prices	18	25	60	252	395
Real wages	3	-3	15	7	-31
Budget deficit (% of GDP)	1.1	5.5	1.4	8.1	0.8
Current account* (US$ m)	n/a	-417	-580	-2,029	-3,033

E Estimate
P Projection
* Trade in convertible currencies only

Source: IMF (1990).

from these changes, which were incomplete and not fully implemented by the bureaucracy they sought to overcome. In addition, the recovery the reforms hoped to promote was limited by slumping world economic conditions, a large foreign debt burden, and domestic imbalances that served as a disincentive to increased labor productivity.

A second round of reform—with aims similar to the first attempt, but also including modifications to relative prices, subsidies, and real wages—was launched in 1987. Conflicts over price and wage adjustments led to rapidly rising real wages and spiralling prices: wages rose 33 percent in 1987 and 63 percent in 1988 (in real terms); open inflation increased from 25 percent in 1987 to 60 percent in 1988 (Government of Poland, 1989). Imbalances in the economy worsened rapidly, forced wider by the combination of stagnating output, high levels of demand fueled by rising incomes, excessive monetary expansion to finance a growing budget deficit, and inadequate savings incentives. After five years of economic growth averaging 4 percent annually, the Polish economy contracted by at least 1 percent in 1989 (see Table 2.2).

A third reform program, initiated by the new Polish government of September 1989, is being implemented (as of January 1990) to achieve two central aims:

- Stabilize the economy quickly by slowing inflation and eliminating shortages;
- Transform the economic system through greater use of market-based mechanisms.

This reform program will consolidate and extend the changes set in motion in the previous two efforts.

The remainder of this section will examine reforms to date and planned changes in three areas:

- State enterprises and the private sector;
- The financial system and fiscal policy;
- Wages and prices.

Reforms in these areas affect the conditions under which housing producers operate, the financing and subsidies available for housing, and the affordability of housing to households.

State enterprises and the private sector

Reforms since 1981 aimed to equalize the conditions under which state and private enterprises operated. Most of these changes—concerning enterprise autonomy, ownership, and financial responsibility—were focused on the state sector. Other reforms lifted restrictions on private firms and attempted to increase competition in the economy.[2]

In 1981, "first stage" enterprise reforms allowed:

- Most state enterprises to set their own production targets and to control investment, sources of input supply, and level of employment;
- Workers' self-management through an elected workers' council at each enterprise;
- Possible liquidation for enterprises demonstrating continued unprofitability;
- Increased competition through freedom for state enterprises to expand production into new areas and loosened restrictions on private small-scale activities.

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2 Greater competition and freedom of operation has also been allowed with the foreign trade organizations (FTOs), as well as giving state enterprises easier access to foreign trade and investment. However, FTOs still accounted for over 90 percent of Polish trade in 1989 (IMF, 1989d).

In practice, supervising ministries and planning agencies still controlled enterprises both directly (through programs for key commodities or non-competitive government procurements) and indirectly (through command over access to inputs and foreign exchange). In 1986, government controlled the production of over 100 items and the allocation of half the material inputs in the economy.

Workers' councils started functioning in 1983, but never became influential in enterprise management. Personnel and management decisions continued to be dominated by ministerial authorities.

The law on bankruptcy, passed in 1983, provided for a lengthy process before an enterprise could be liquidated. Most enterprises facing difficulty avoided being classed as bankrupt through negotiations with government that provided subsidies or preferential allocation of inputs. The few liquidations that did take place were typically mergers or restructuring rather than a declaration of bankruptcy and sale of assets to pay creditors.

The reforms did not cause increased competition. State enterprises were uninterested in expansion during a time of economic difficulty and while remaining subject to government control. Regulations which imposed additional restrictions and taxes on the sector later hindered the expansion of small-scale private firms which began with the 1981 reforms.

Beginning in 1987, the second set of reforms again stressed enterprise autonomy:

- Central planners abandoned detailed, substantive targets and the planning and control apparatus was cut back;
- Local authorities assumed responsibility for supervision of most state enterprises;
- Government allowed enterprises to control part of their capital base and to transform themselves into joint stock companies;
- State enterprises faced accelerated bankruptcy proceedings;
- Anti-monopoly measures broke up state enterprises to encourage competition within sectors;
- Government imposed uniform tax treatment for both socialized and private enterprises;
- Private enterprises no longer required permission to operate, had no limits on their size, and were granted equal rights to credit and inputs.

Through 1989, the reforms had some effect. The role of central planners and the scope of central control declined. Profitability became a more common benchmark of enterprise performance and bankruptcy proceedings were initiated against 140 enterprises. However, financial discipline remained elusive as ministries still bargained with central government for concessions to support their enterprises.

More decision making devolved to enterprises and their workers' councils; state ownership became more passive. Little progress was achieved, however, on the creation of joint stock companies or sale of state enterprise property.

There was little movement in the degree of concentration and competition in response to the reforms. Although some change took place—the share of recorded private activity in non-agricultural output rose to over 10 percent in 1987 and continued to increase through 1989; almost 300 enterprises were split up in 1988 under anti-monopoly regulations—these changes remained small against the remaining bulk of the socialized economy.

The 1990 reform program is intended to maintain the momentum behind these earlier reforms (see Government of Poland, 1989). Government plans for state enterprises and the private sector include measures to:

- Devise a framework for divesting state ownership, begin the sale of state assets, and establish a securities exchange;
- Break up remaining monopolies, institute anti-monopoly regulations, and remove remaining restrictions on setting up new enterprises;
- Eliminate residual elements of central planning and priority for government orders;
- Update the labor code to allow work force adjustments with greater ease;
- Allow creditors to initiate bankruptcies with streamlined procedures;
- Prepare for comprehensive reform in 1991-92 of the budget and tax system (based on a comprehensive income tax and value-added tax).

Financial system and fiscal policy

Reform since 1981 attempted to move the financial system away from the passive accommodation of state budget and investment requirements by the banking system to multiple sources of financing that reflect the true cost of capital. On the fiscal side, modifications to the system of taxes and subsidies (through more uniform application of taxes and a simpler tax structure) aimed to impose financial discipline on state enterprises and to achieve equality of tax treatment for state and private enterprises.

Starting in 1981, the first round of reform set out the following changes:

- The Ministry of Finance ceased to have jurisdiction over the National Bank of Poland (NBP), though the NBP still had to coordinate credit availability with the central annual plan;
- Legislation directed state banks only to loan funds to enterprises that met self-financing criteria;
- State banks were allowed to raise interest rates and accept time deposits;
- Government imposed an income (profits) tax on enterprises.

Though the NBP was formally freed from government control, a Banking Council and informal pressures kept it closely linked to ministries and the planning apparatus. Similarly, the government granted waivers and preferential access to credit for a number of activities and sectors. The flow of credit to the state sector, both for investment and working capital, remained substantially unchanged.

Interest rates were raised only marginally and were still negative in real terms. Households had little incentive to save and reduced their excess money holdings through purchases in the "second" economy. Enterprises with excess cash invested it in expansion projects or stockbuilding. Without positive real interest rates, the financial system failed to actively intermediate between potential savers and borrowers.

The budget deficit fell to an average of less than 1 percent of GDP in 1983-86, due mainly to the elimination of many non-systematic subsidies. However, the tax system remained a complex set of highly differentiated taxes. Over 400 different turnover tax rates, ranging from zero to 90 percent, applied to sales of different products. In addition, enterprises sought relief from the income tax and other taxes to replace the subsidies which had been eliminated. This created a wide range of effective tax rates between sectors and enterprises.

The second stage of reform (starting in 1987) recognized the importance of resolving issues which the 1981 reforms did not tackle: establishing positive real interest rates; making the banking system more independent and a better intermediary; and simplifying the tax system. The government took the following steps:

- Nominal interest rates were raised;
- A two-tier banking system was established with commercial banks, independent from the NBP, operating on a self-financing basis without restraints;
- Bonds were allowed to be issued by any legal entity and purchased by both enterprises and individuals.

However, the functioning of the credit market showed little improvement. The accelerating inflation of 1987-89 wiped out the effects of higher nominal interest rates, keeping them negative in real terms. The growth of credit was more expansionary that planned. The central government budget deficit grew under inflationary pressures that drove up expenditures on subsidies (particularly for food and energy) and eroded the real value of periodic tax payments.

The new institutional structure of the credit market did indicate a strong desire to press ahead with reform. The new independent banks—the former state banks (such as PKO Savings Bank) and nine new regional commercial banks—were, in principle, freed to compete in the provision of all banking services to all customers. Bond issues were actively encouraged by the removal of restrictions on their use. It is still too early to judge the effects of these changes.

The 1990 reform program relies heavily on positive real interest rates as a key economic stabilization and restructuring tool (Government of Poland, 1989). Positive real interest rates are necessary to stimulate financial savings, improve the efficiency of investment, and discourage switching into foreign exchange. Fiscal reform, untouched in the second stage, is also an element in the government's current plans. Specific measures include:

- Maintaining positive real interest rates through monthly adjustments to the NBP refinance rate;
- Ending all lending at preferential interest rates and only subsidizing (in a transparent manner) lending for agriculture and housing;
- Loosening of reserve requirements and payment of interest on all deposits held within the banking system;
- Establishing the full independence of the NBP with a mandate for maintaining a stable currency;
- Reducing the central budget deficit from 7 percent of GDP in 1989 to 1 percent in 1990 through the elimination of most subsidies (except for transport and housing);

- Placing limits on government borrowing and refraining from using the NBP to finance expenditure;

- Planning for a major tax reform in 1991-92 to simplify the tax system using comprehensive corporate and personal income taxes and a value-added tax.

Prices and wages

Through 1989, changes affecting prices and wages were only slowly and incrementally put into effect. The government remained committed to administered price revisions. The exchange rate experienced a similar transformation, with slow adjustments gradually moving domestic and border prices together. In all, the trend was toward greater price freedom in the economy.

On the wage side, reforms intended both to promote greater wage variation reflecting productivity differentials and to restrain the overall growth of enterprise wage bills. The inflationary spiral of 1989-88 is testimony to the failure of these reforms.

In 1981-86, during the first stage of reform, the government took these steps to reform the system of prices and wages:

- Prices were grouped into three categories:

  — Administrative prices, set by government, for basic household and production goods,
  — Regulated prices, set by producers and monitored by government, and
  — Contract prices, set freely in the market place;

- Controlled prices were raised;

- Exchange rates for foreign trade were consolidated and simplified along with depreciation (by more than one half) of the zloty in 1982;

- Exporters gained limited access to their foreign exchange earnings and an auction for other enterprises was started;

- Wage rates, within mandated minimum and maximum limits, were freed;

- A series of taxes were imposed on wage bill increases above specified norms.

The changes to the pricing system did reduce imbalances, but not enough to bring markets into equilibrium. The rises in controlled prices were insufficient to offset continued excess demand. While the scope of contract pricing increased during the first reform, producers faced a number of restrictions on price rises, such as limits on price changes and taxes on "excessive" price increases.

The reform of the exchange rate failed to translate into an incentive for export within the economy, as the system of price equalization (using taxes and subsidies to bring foreign prices in line with domestic prices) remained in effect.

Enterprises failed to take advantage of their freedom to set wages to reflect productivity. Rather, wages were increased by moving employees up through the wage scale with little regard to qualifications. Other actions by enterprises, such as hiring low-skilled workers to reduce the growth rate of average wages or negotiating exemptions from wage taxes, reduced the effectiveness of taxes in curbing the growth of wage costs.

The government, responding to the deteriorating economic situation, carried on the second stage of reform in 1987-89 with similar approaches to changing the system of prices and wages:

- Goods with regulated prices were shifted to the contract pricing category and removal of goods from the administered price list was simplified;
- Exporters' returns became more closely linked to world prices and their access to foreign exchange was improved;
- Additional taxes and penalties for excessive wage growth were imposed on enterprises.

The cost of correcting the structure of relative prices, through greater price freedom and bringing domestic prices in line with world prices, was accelerating inflation as wages kept up with—and even exceeded—changing prices. Wages grew despite tax disincentives as enterprises were successful in negotiating exemptions.

To break inflation, the government's 1990 reform program aims to use the exchange rate and wages to anchor prices once the one-off changes in the price system have worked through the economy (Government of Poland, 1989). The major components of the program include:

- Freeing all prices (except for about 10 percent) from administrative control as of January 1990;
- Unifying the exchange rate and defending convertability after a devaluation of over 10 percent (compared to the December 1989 free market rate);
- Limiting wage increases to only a portion of price rises—enterprises granting higher rises in wages will be liable for taxes (without exemption) at punitive rates.

The program intends to reduce inflation decisively in 1990. If wages can be restrained, disinflation can be achieved—but at potentially great cost in terms of reduced output and employment. The economy is expected to shrink by 5 percent in 1990 and unemployment estimates range upward from 400,000. Restructuring the economy is a long-term process: capital and labor have limited mobility in Poland and management is unfamiliar with a market-oriented economy. The early supply response to the revised price system will be modest. Without some progress in overcoming the most obvious imbalances in the economy (such as in the supply of food, consumer goods, and housing), public support for the reform effort could weaken.

B. THE HOUSING SECTOR[3]

The housing sector in Poland, characterized by the shortages and heavy subsidies found elsewhere in CPEs, has been further weakened by the economic problems since 1981. The disappointing performance of the housing sector reflects the past difficulties in achieving effective reform throughout the economy. Moreover, it indicates a failure to recognize the large costs that a poorly-functioning housing system imposes on the economy in terms of subsidy costs, uneven distribution of benefits, inefficient production, and reduced labor mobility.

Poland exhibits the most severe housing shortages in Eastern Europe. While other countries have succeeded in overcoming the deficits caused by war-time damage to the housing stock, Poland still has not caught up with its initial post-war shortfall of 1.5 million units. In 1985, the country had 18 percent (or 1.4 million) more households than dwellings.

This deficit manifests itself through lengthy waiting times for housing: over 15 years in major cities; over 5 years in smaller cities. Turnover in the housing stock has virtually stopped as households seek to retain whatever housing they have been able to obtain.

Poland's persistent housing deficit is explained mainly by its low levels of investment and productivity in the sector (compared to countries with similar incomes or housing deficits)—see Table 2.3 on the next page. The share of housing in total investment declined from 16 percent in 1965 to 13 percent ten years later.

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3 Data in this section is from World Bank (1987) unless otherwise noted.

Table 2.3
Housing Investment and Production 1970-1985

	1970	1975	1980	1985
Housing Investment (% of GDP)				
Czechoslovakia	4.95	5.27	4.01	3.66
Hungary	4.11	5.99	5.59	5.36
Romania	n/a	4.67	4.59	2.30
Yugoslavia	5.76	6.77	7.76	n/a
Poland	3.89	4.34	5.52	6.10
Housing Production (units per 1,000 population)				
Czechoslovakia	n/a	n/a	8.4	7.2
Hungary	n/a	n/a	8.3	6.8
Romania	n/a	n/a	8.9	4.6
Poland	6.0	7.3	6.1	5.1

Source: United Nations (1986), World Bank (1987).

Since the mid-1970s, in response to improved economic conditions and public pressure, the share of housing in total investment has risen to over 20 percent (Matras, 1989a). However, lagging productivity in the sector and rising unit costs have prevented these gains in resources from translating into higher real output. In fact, the per capita number of dwellings completed, after rising initially, has fallen to 4.1 units per 1,000 persons in 1989 from its 1979 peak of 8.1 units per 1,000 persons.

The broader reform taking place in the Polish economy offers an important opportunity to reverse the decline of the housing sector as well as support the structural adjustment process. The remainder of this section describes the sector's evolving structure, on both the production and financial sides, and the constraints and problems that need to be addressed in the ongoing reforms.

1. Housing Production and Delivery

Like other CPEs, in the post-war era there were three main sources of new housing in Poland: the state, cooperatives, and private firms. Following World War II, the state stepped up its role and provided an increasing share of new housing.

In the late 1950s, the state had begun to shift its resources to housing developed by cooperatives; by 1965, they were the major source of new housing. About half the current housing stock is privately owned; the rest is about evenly split between state-owned and cooperative housing.

The different stages of economic reforms have caused the control of housing development, production of dwellings, and allocation of units to change over the past decade; further change is certain under the current reform program. These steps in the housing production process are examined in turn below.

Planning, land, and infrastructure

The public sector still retains a dominant position in developing land for housing. The majority of urban land in Poland is owned by the state; only 30 percent is privately owned (World Bank, 1990). Reform has, in principle, made these state lands available for sale and development. However, pending an inventory (now under way) and clarification of ownership of urban land, no state-owned land can be transferred.

Land use planning in cities has usually focused on zoning and reserving large parcels of land suitable for development with blocks of apartments using industrialized, pre-fabricated panel techniques. These sites, often on the periphery of cities, traded easy access to the builders with expensive infrastructure extensions to the site. This pattern is being maintained in Warsaw; the municipal planning office is proposing to concentrate future housing production on three very large sites (World Bank, 1990).

Land use plans often specify low-density development (particularly in those areas designated for single-family housing) to counter environmental problems caused by inadequate infrastructure. (Cities are responsible for infrastructure planning, but in the past had to rely on centralized agencies for implementation.) As a result, urban housing is often developed without access to piped sewerage and lacking connections to gas and heating networks. Thus, residential sites are overly large (to safely accommodate septic tanks) and coal is used for home heating (contributing to air pollution). This pattern of development, requiring excessive investment to extend trunk infrastructure, contributes to inefficient consumption of land and increasing urban sprawl.

Shortages of infrastructure and inefficient use of urban land exert a strong influence on the price of land sold in the "free" market for housing. The price of agricultural land on the periphery of large urban areas increases by 200 to 400 percent when it becomes available (without services) for residential development. Fully serviced land can raise the price another ten-fold. This price for serviced land is 2 to 3 times the cost of providing infrastructure.

Though there are no formal restrictions on land sales (apart from the current freeze on transfers pending the land inventory), individuals and private construction firms have several obstacles to overcome to obtain land and permission to build. For example, development rights are granted to the applicant and not tied to the land parcel; sale of the developed land or housing unit requires the purchaser to repeat parts of the approval process. Gaining development permission also involves obtaining similar approvals from different levels of the administrative system. Recent changes to the Spatial Planning Act guarantee equal access between different kinds of investors (state, cooperative, or private), but land use planning and development approvals remain complex.

Prior to reform, when large subsidies were available for housing, the real cost of providing developed land was not reflected in the price charged. Direct subsidies for land development and infrastructure are still available through the Land Management Fund (financed by a 1.5 percent tax on construction) and the Housing Economy Fund (World Bank, 1990). Despite changes through the Land Use and Expropriation Act of 1985, which mandated a commercial basis for the sale of state-owned land, state bureaucracies still make free or underpriced transfers of land to housing investors. This has caused land hoarding, particularly by cooperatives who receive land but lack the resources for land development and construction. With uncontrolled pricing and elimination of subsidies, land and infrastructure standards will have to be tailored to meet a market test of affordability rather than simply respond to city planners' view of household needs.

One way to counter some of these problems have already been found by city planners in Krakow. A land use inventory there identified several hundred sites suitable for in-fill housing development. Raising residential densities takes advantage of existing infrastructure networks and obviates the need for costly expansion, assuming the existing infrastructure can handle the increased loads.

Construction and building materials industry

Housing production in Poland exceeded 250,000 units annually during the latter half of the 1970s. In the 1980-88, production slowed down as economic conditions deteriorated; annual production only averaged 193,000 units. Production in 1989 is estimated at only 149,000 units (World Bank, 1990), the lowest level since the 1960s. Some of this decline can be traced to the problems of the construction sector.

Producers of housing in Poland are divided into two main groups:

- Large, state-owned building enterprises (*kombinats*) mainly building apartments (about 140,000 units in 1988) for cooperatives or for state-owned rental housing;

- Small-scale private builders mainly building single-family houses in rural areas and small cities (about 50,000 units in 1988).

Kombinats. The kombinats are the largest producers in the sector, but have traditionally been more concerned with production volume than meeting household needs. They are vertically integrated and control many of the producers of building materials for the construction industry. Kombinats rely on pre-fabrication technology that uses large-scale panels for constructing multi-story apartment blocks. The process is capital- and energy-intensive and the production plant and equipment represent high fixed costs for the producers; labor accounts for only 15 percent of the cost of the panels (World Bank, 1990). The factories are large and designed to operate at high volumes of production. As a result, the kombinats dominate their local area in a monopolistic fashion.

Under central planning, the kombinats provided panels in response to requests channelled through the planning agencies (who also controlled funding for land development and infrastructure provision). The large capital costs of their technology could only be covered by developing large sites with thousands of similar units. To meet their goal of keeping housing production volume up, the planners had to develop housing in suburban and peripheral urban areas to respond to the technological and cost structures of the kombinats. This approach led to low average residential densities in cities and pushed up infrastructure costs.

The reliance on this construction technology, intended to meet chronic housing shortages through high-volume production, demonstrates several weaknesses:

- The design of units is rigid and monotonous and does not offer the choice households are beginning to demand;

- Variations in panel dimensions and damage in transit lead to frequent on-site repairs, poor joints and assembly, high maintenance costs;

- The technology is not labor-saving as planned because of the extensive field work required to correct factory flaws and transport damage.

The results of these problems are housing units that, in terms of both household satisfaction and cost, compare unfavorably with traditional housing construction.

Productivity in state construction, after rising during the 1970s, has fallen in the 1980s. At present, about 160,000 units remain unfinished (World Bank, 1990). The average time required to complete a state housing project increased from 17 months in the 1970s to 27 months in the 1980s. Housing unit costs have risen steeply. There are a variety of causes for this poor performance:

- Kombinats often operate far below their theoretical capacity during economic slowdowns and pass their high fixed costs into the cost of their housing;

- Falling labor productivity as kombinats have failed to reform their wage policies or restructure their workforce;

- Shortages of building materials, fittings, and tools and equipment and lack of coordination with infrastructure installation.

Private builders. The private sector construction industry has grown despite being hampered by the dominant role of the kombinats. Most private builders employ only a few workers—until 1988, a private company could not have more than 6 employees—and have faced difficulty trying to expand. The kombinats, employing thousands, control most construction workers. The industrial approach to house-building has reduced the numbers of conventional building tradesmen and as well as supplies of traditional building materials. Private construction firms have also been constrained by their lack of access to building materials, credit, and construction equipment. In spite of these problems, activity by private builders was expanding (until the recent price surges caused by price deregulation) in response to the removal of restrictions on private firms.

Productivity in the private sector is also low; over 100,000 units remain unfinished in urban areas. The average construction period for private housing units is 6 years (World Bank, 1990). Apart from materials shortages and financing difficulties, the pace of private housing construction is often slowed because of administrative restrictions. One of the principal factors in the long construction period is the regulation, lifted in January 1990, forbidding a household from owning more than one dwelling. As a result, parents will begin construction of a house, but delay its completion until one of their children marries and is eligible to occupy one of the units. This rule explains why Warsaw had 15,400 unfinished housing units and only 630 dwellings completed in 1989 (World Bank, 1990).

Reform in 1990. The reforms of 1990 should cause major restructuring in the construction industry. Kombinats, which have long received low-cost loans to finance their operations (as well as tax exemptions and production subsidies), will be required to borrow at commercial rates to finance their operations—making units produced at the current two-year pace unsalable to most households. As many as 70 percent of the kombinats have severe financial problems and could face closure in the future. Some enterprises are already laying off workers; others may break up into smaller production units and shift production from large panels to smaller components such as window units or precast concrete elements that can be used more flexibly by different builders.

The reforms, which augur poorly for the kombinats, represent an opportunity for the growing private construction industry:

- Construction labor will become available as state construction enterprises close and surplus equipment may be available for lease or purchase;
- The break-up of kombinats into smaller production units could increase and diversify the supply of building components;
- Greater freedom for other private businesses should spur demand for small-and medium-scale construction to build and renovate offices, storefronts, and other workspaces.

An important issue for small construction firms will be access to commercial credit. This capital will allow investments in tools and equipment to expand and increase productivity and be used as construction period financing. However, it is unclear whether the commercial banks established by the financial sector reforms will be willing or able to undertake this kind of lending. The Ministry of Construction is considering establishing a National Housing Development Bank which could act as a lender to private construction firms.

Housing allocation and tenure

As in other CPEs, housing in Poland is obtainable from three sources:

- The state, through state-owned enterprises and local governments;
- Cooperatives, which are now the principle source of new housing units;
- Private housing, almost exclusively single-family dwellings.

Table 2.4
Investors in Polish Housing 1970-1985
(Percent)

	1970	1975	1980	1985
State and enterprises	23.5	33.5	18.6	22.4
Cooperatives	48.9	43.2	55.7	47.7
Private sector	27.6	23.7	25.7	29.9
TOTAL	100.0	100.0	100.0	100.0

Source: Matras (1989a), United Nations (1986).

Shares of housing investment since 1970 by these three types of investors are shown in Table 2.4.

State housing. The two types of state housing accounted for 40,000 new units in 1989 (33,000 from state enterprises and 7,000 from local governments), just under a quarter of the new units available (World Bank, 1990). These units are built exclusively as rental housing, although some local governments and enterprises have begun selling units to their tenants. In fact, as many as 1.5 million units may have been sold in the last quarter of 1989 as tenants acted in the face of higher interest rates and rents and utility charges that reflected true costs (see Section 2 on housing finance below). The government, as yet, has not established a policy on selling off the housing stock or how to price the units. At present, units are being sold to their occupants at an administratively set price averaging about US$1,500, or about 10 percent of their "free" market price.

Enterprises are free to set their own eligibility requirements for access to housing. They also receive indirect subsidies from the state to support construction of this housing: financing for half the capital cost (formerly at low rates, but at commercial rates as of January 1990); and exemption from taxation of retained earnings used for housing. Local government housing is available to low-income residents and is also used to attract skilled workers in short supply to the area. Capital costs for this housing are covered through budgetary grants to the local government.

Cooperatives. Cooperatives are the largest source of housing in Poland, providing about half the new units in 1989; 73,000 for rental and 12,000 for purchase (World Bank, 1990). These units are usually constructed by state construction enterprises.

Cooperatives provide three kinds of tenure for their participants: tenancy, condominium ownership, and ownership of single-family dwellings. In the first two cases, the cooperatives continue to exist after construction of the units is completed. Members of owner cooperatives have the right to sell their units on the open market. Capital subsidies received from the state must be repaid when the unit is sold (although there is no data on how strongly this regulation is enforced). Tenancy cooperatives do not allow units (or their leaseholds) to be sold. However, tenants can buy out the equity in their unit and gain ownership.

Cooperatives are eligible for "credit remissions" (*i.e.*, government reimbursement of part of the loan to finance construction). These subsidies typically account for 14 percent of total costs for ownership cooperatives and 21 percent for rental cooperatives, assuming typical 70 percent loan-to-value ratios (World Bank, 1990).

Private housing. Private housing is mostly built in small cities and rural areas where state housing is often not available and land is more readily obtainable. Private housing accounted for 39,000 new units in 1989 (World Bank, 1990). Private housing is generally much larger than housing in the socialized sector (in 1984, 101 square meters per unit versus 54 square meters per unit, respectively) and offers greater choice than is available from state or cooperative housing which relies on industrially-produced units. Households that purchase private units also receive credit remissions, intended to boost private housing production, equal to 30 percent of the loan on the house--about 15 percent of total costs in the typical case with a loan-to-value ratio of 50 percent (World Bank, 1990).

There are no restrictions on the sale of private units. The transfer tax on housing sales has been substantially reduced in past years; there is no tax on the purchase of a newly-built unit and a 2 percent tax on the sale of an existing unit.

Households that opted for private housing or buying a unit on the "free' market in the past faced high prices—caused by inefficient housing production and the shortage of units—relative to their incomes. In 1985, the typical price for a 50 square meter flat was 8 annual incomes at cost and between 12 and 24 annual incomes on the open market. Thus, households could not realistically finance the purchase of housing on their incomes and had to rely on accumulated assets, either through incremental construction or long waits to build up their own financial resources.

The current situation is similarly marked by high prices—now driven by high building materials prices, a result of shortages and price deregulation under the economic reform program—relative to income. Construction costs have now risen to the levels of "free" market prices in the past; the price of a 50 square meter flat on the private market (at cost) is now 22 annual average incomes (World Bank, 1990). These prices are unaffordable to almost any household that requires financing for their house purchase. However, if the current reform program achieves its stabilization objectives, affordability in the housing sector should increase sharply by the end of 1990. Housing prices would fall, mainly due to a decrease in building materials' prices from their current unsustainable peak, and interest rates should decline, reducing the financing cost.

2. Housing Finance System

The dominant issues in the Polish housing finance system are subsidies and affordability in a highly inflationary environment. Subsidies make up a large part of the government budget deficit, accounting for more than 7 percent of expenditure in 1989, and add to inflationary pressure. While some subsidies, such as the credit remissions for cooperative and state housing, have fallen in real terms (because of inflation and declining output), other subsidies, such as operating supports for state rental housing have increased (because of failure to match rent increases with escalating maintenance costs). Until January 1990, when interest rates were raised to market levels, off-budget subsidies granted through below-market interest rates on housing lending increased dramatically with rising inflation in 1988-89.

As noted in the previous section, rapidly rising prices have pushed housing costs outside the affordable range for most Polish households. At the same time, those fortunate enough to occupy state housing spend only about 2 percent of their income on housing and a similar proportion on centrally provided services such as central heating and hot water. Cooperative housing units were typically priced (until the January 1990 interest rate reform) to cost their owners between 5 percent and 12 percent of their monthly income. By comparison, households in countries with income levels similar to Poland typically spend between 20 percent and 30 percent of their income on housing.

The issues of subsidies and affordability/expenditure apply to both housing purchase—how to eliminate subsidies (or at least make them more effective) while keeping housing affordable—and the operation of the state rental stock—how to raise the proportion of income spend on housing services and make the system self-financing. This section looks at the two areas in turn.

Finance for house purchase

Financing for the purchase of a house or cooperative unit is presently available from only two sources:

- PKO Savings Bank, which is the sole source of mortgage lending for individuals;
- Narodowy Bank Polski, which lends to cooperatives constructing housing.

In principle, the reform of the financial sector allows other banks to undertake lending for housing, but this has not yet happened.

Until January 1990, financing for housing was available to any borrower through fixed-rate mortgages at concessionary rates (World Bank, 1990):

- Cooperative-tenants (*i.e.*, households that are members of a cooperative and rent units, mainly in apartment blocks, from the cooperative) were eligible for 40-year loans (made to the cooperative) at 3 percent that financed up to 90 percent of the cost of the unit;
- Cooperative-owners (*i.e.*, households that are members of a cooperative and purchase their unit, mainly single-family dwellings, from the cooperative) received 40-year loans at 6 percent that financed up to 80 percent of the cost of the unit;
- Private owners received 40-year loans at 6 percent subject to limits on the size of the unit (less than 95 square meters) and the loan amount (normally about half the cost of the unit).

With the inflation of the past two years, the interest rates on these loans were highly negative in real terms and granted an indirect subsidy to mortgage holders. This indirect subsidy represented 1.4 percent of the national budget in 1989 (World Bank, 1990). The subsidy is regressive since the windfall to the borrower increases with the size of the loan.

The reforms of January 1990 raised interest rates on all new and outstanding lending. Henceforth, the interest rate is to be variable and will be determined each month by the central bank. The refinancing rate for the PKO Savings Bank for January was set at 34 percent per month, 6 percentage points below the 40 percent rate offered for other lending (World Bank, 1990). Despite the modestly preferential rate, the cost of servicing mortgages under new terms (essentially adjustable rate mortgages (ARMs) with revisions on a monthly basis) has increased explosively. Most households are unable to meet this jump in housing costs; World Bank (1990) calculations show that, in the early months of the 1990 reform, middle-income households will face monthly mortgage payments in excess of 50 percent of monthly income. The increase in payments is being spread out as follows (Government of Poland, 1989):

- The borrowing household pays 8 percent of the increase in the mortgage payment;
- The state pays 32 percent of the increase as a subsidy;
- The remainder of the increase in the payment is capitalized into the outstanding debt (which ratchets up the household's payment and the state subsidy).

In principle, raising interest rates and restructuring lending toward ARMs, in conjunction with the other economic reforms, helps lessen some of the worst problems of the housing subsidy system that existed previously. Some of the changes include:

- Subsidies are now more "transparent" and can be more effectively targeted on households that need assistance;
- Distortions caused by low-cost finance, such as households waiting years to get a state-sponsored or cooperative unit, are diminished and the private sector is more competitive with the socialized housing producers;
- Households have greater incentive to save for housing because returns are higher on savings and price is becoming a more important factor in the allocation of housing.

However, the possibility exists—particularly if inflation does not fall rapidly under the stabilization program—that many households with outstanding mortgages will default on loans as the payments increase.

Financing operation of the rental stock

As noted above, rents charged to tenants in state-owned rental units are low. At the beginning of 1990, after large increases which brought rents back to their real levels in 1986, rents still only covered one fifth of the maintenance costs associated with state rental housing; subsidies for the other four fifths accounted for 2 percent of the national budget (World Bank, 1990). The share of maintenance in total government subsidies has been increasing in the past two years as materials for repairs have become scarce and more expensive under price deregulation. (Cooperatives, being self-financing, pass almost all the costs of maintenance on to their tenants.)

The subsidy is regressive. It is granted to every tenant, regardless of income, and occupants of larger units receive a proportionately larger benefit.

Part of the reform of 1990 makes cost recovery of operations and maintenance a high priority; state owners and managers of rental housing will be required to collect adequate rents to cover their costs. This implies an average five-fold increase in rents, but this will only raise the share of housing in average household income to 10 percent. Rents will be indexed to inflation to keep them constant in real terms. Further rent increases are expected over the coming 5 years as the government has indicated rents should also cover major repairs (World Bank, 1990).

Tenants in both state- and cooperative-owned rental also benefit from low billing rates for central heating and hot water. These payments, made to heating companies in cities, accounted for a quarter of housing subsidies in 1989—2 percent of the central government budget. Tenants pay only between 10 and 25 percent of the true cost for providing these services (World Bank, 1990). In contrast, households that do not have access to these services and rely on individual suppliers are not subsidized and pay full cost. Businesses and industries, even if linked to the central system, are required to pay full cost as well.

Like the maintenance subsidy, this support is regressive. The subsidy is granted to households without regard to income levels and households with larger units receive a larger benefit. In addition, the subsidy provides a strong disincentive for reducing consumption of heat or hot water—the more consumed, the greater the subsidy.

The reform of 1990 has apparently eliminated these subsidies. However, some price controls remain on coal and other energy supplies; it is not clear if the new prices for central heating and hot water reflect their "true" cost.

The government has set up an expanded "social aid" program to protect low-income households, such as pensioners, against the increases in rents and heating charges.

C. TECHNICAL ASSISTANCE AND TRAINING

This section outlines types of possible technical assistance which could be provided to Poland's housing sector. As suggested at several points, there are three general objectives in providing such assistance: (1) to improve the efficiency with which housing is developed, delivered and managed in order to lower housing prices and increase production; (2) to help actualize latent demand for housing through increasing the availability of mortgage financing at market rates; and (3) as part of the conditions for providing effective assistance, to change those government policies which now interfere with well-functioning markets.

The discussion on technical assistance is divided into three parts. The first discusses options for the "real" sector; *i.e.*, housing production and delivery. The second focuses on housing finance in the context of broader financial markets. Section 3 summarizes the discussion of the prior sections.

Throughout, the focus is on actions that will foster the development of a vibrant private housing sector by eliminating impediments to small producers developing housing efficiently and expanding over time and to households being able to freely compete for housing services and assets in the market place.

Omitted from this discussion is assistance with several large scale actions that would be instrumental in improving the volume, and possibly the efficiency, of sectoral output, but which we view as beyond the scope of this work. Such actions include:

- Revision of local government finances to make them capable of funding infrastructure investments;
- A major infrastructure investment program for servicing vacant land for residential purposes;
- Reform of the pricing and allocation of rental housing;

- Creation, to the extent still necessary, of a legal structure and regulations for privatizing SOEs;
- Reforms in land law as necessary to facilitate land transactions and titling.

The lack of detail treatment of these assistance programs should not be taken to imply that these topics do not merit further consideration.

1. Housing Production and Delivery

Why focus on the housing production and delivery system?

Housing production is on the verge of collapse in Poland. Hyperinflation in the input process (labor and materials), a decline in household incomes when measured against inflation and an uncertain situation regarding housing credit all contribute to the current crisis. As described in Chapter 1, a well-functioning housing sector has a strong positive impact on the economy; the economic implication of a collapse of housing production transcends the narrow, sectoral viewpoint and calls for urgent measures to avert such a possibility. A key ingredient to re-starting housing investment is action to complete the several hundred thousand partially built units; the World Bank is designing assistance in this area.

Other actions will help transform the housing delivery system so it can respond when widespread effective demand reemerges after the initial shock therapy is over. This new system will depend on local government initiatives and on emergence of a strong private sector. In this section, technical assistance for reform of the housing production and delivery system is addressed in three separate sub-sections: (1) Planning, land, and infrastructure; (2) Construction and building materials industry; and (3) Allocation, tenure and management.

Planning, land and infrastructure: Context

The limited material available on these topics suggest that more detailed analysis may be needed, but the following areas appear to be the major constraints:

- The process of obtaining planning and development approvals and permits has been unduly complex.
- Access to land for housing construction is problematic.
- Recent reforms will shift more responsibility for infrastructure to local governments but it is not yet clear how they will raise the resources required.

- Lack of serviced land has led to a low density development pattern (to accommodate septic tanks) for private sector construction of single-family houses, thus increasing the cost of land and of eventually providing services.

- Public sector construction has focused on multi-family apartments developed on large tracts—usually at some distance from the city center—where 10,000 or more units can be accommodated.

Technical assistance

Local governments are the key institutions in this element of the housing production and delivery system in Poland. While much more study is needed before a comprehensive program of technical assistance for local governments could be outlined, several areas offer promise for removing the constraints to production and delivery outlined above.

The logical first step may be to offer a package of technical assistance to a specific city. The solutions to current problems developed for this city could be transferred to others on a peer-to-peer basis. The city selected should be one where local officials understand that their role needs to change and are prepared to explore alternative approaches. Reports from the World Bank as well as from a recent Peace Corps mission to Poland suggest that Krakow city officials are already exploring new approaches to housing and that the private sector business community is aggressively preparing for the new challenges.

A modest initial package of technical assistance to a selected city might include the following:

1. Planning and regulatory instruments. Government policy clearly intends to encourage a greater private sector role in the production of housing. However, it is not clear that the existing planning and regulatory processes are suited to the changing role local governments must play as facilitators and managers of urban growth, using incentive mechanisms rather than direct control over investment decisions.

An important element of a technical assistance program for local governments would be a review of regulatory instruments—such as planning standards, subdivision ordinances, building codes and zoning ordinances—as well as an assessment of the overall planning process and the procedures required for obtaining permission to develop land. The study would recommend changes needed to streamline procedures and eliminate unnecessary constraints on private sector development while retaining the ability of government to influence the pattern of urban growth. The review could serve as the basis for a broader program of assistance and training to local governments.

2. *Public/private partnerships.* The concept of land acquisition, land development, unit construction and sale as an integrated approach to producing and delivering housing apparently does not exist in Poland. Either state agencies or the municipalities have performed each of these functions separately. Changes are underway to give municipalities broader responsibility and authority for development. In addition, local governments have certain assets—land, existing housing stocks, infrastructure, and zoning powers, for example—that could be used to stimulate development, but municipalities do not readily think of themselves as developers. Nor is it likely that private sector developers who can undertake all the steps of land development will emerge spontaneously, except as joint ventures with foreign companies. However, such joint ventures have higher foreign exchange costs (through imported inputs and profit repatriation) than domestic development and may be less desirable than wholly domestic developers from a macroeconomic perspective.

One solution to this constraint is to have local governments work with private sector entities to produce development. Training for key municipal agencies, supported by short term advisory services, could assist them in using unutilized public sector resources (such as dilapidated or vacant housing or state owned land) to make private development happen; *i.e.*, how to create private sector initiatives in housing.

Training and technical assistance could focus on understanding how this approach has worked in other countries, assisting the city formulate one or more public/private partnerships, and training key staff in such skills as land economics. Joint ventures with foreign companies may initially be necessary as the local companies may not have the skills needed to assess markets, estimate costs, arrange financing, and manage projects but technical advisors could help structure such ventures to maximize local benefits.

3. *Infrastructure financing mechanism.* The provision of infrastructure is critical for new housing development. The leap-frog pattern of development caused by large, SOE-built housing projects suggests that vacant land exists with utility lines readily accessible. However, it is not clear infrastructure systems were designed with excess capacity to handle additional loads from infill construction. If not, it may still be more efficient to add downstream capacity to the existing system than to provide services to land on the periphery of the city.

Recent changes have shifted responsibility for infrastructure to local governments. In time, this approach should be superior to the previous system whereby local governments had to submit plans for infrastructure extensions to central agencies which installed them on their own time schedule and with their own resources. However, municipalities are presently ill-equipped to assume the responsibilities for financing infrastructure. Local governments in Poland are presently dependent on central government budget allocations—which are unlikely to be adequate under current economic conditions—and do not have a well-developed independent resource base. Increasing local governments' revenue generation capacity is a long term undertaking. Meanwhile, the provision of infrastructure is critical to the immediate need for maintaining adequate levels of housing production. Fortunately, mechanisms exist which, because they are supported by user fees rather than general revenues, can be initiated independent of overall fiscal reforms.

One possibility would be the creation of Special Use Utility Districts. A small team could study the feasibility of using this mechanism to add services in areas not presently served (such as low-density single family developments built by the private sector). The addition of services would allow increased densities through the subdivision of large plots, creating additional serviced plots for new housing construction. Service extensions would be financed by the land owners who benefit from the increased value of their land. Once the feasibility of the approach has been demonstrated, a short-term advisor could be provided to assist the local government in setting up such a district. This assistance would include preparing the legal framework as well as the terms and conditions for levying the assessments.

Another technique used in California to finance infrastructure for new housing developments may also prove useful. "Mellaroo Bonds" are issued by a city to finance infrastructure for a private development; the cost is passed on to the homeowners through user fees which pay off the bonds over a 30 year period. This is an alternative to private financing through the developer (which increases the purchase price of the house) or to up-front, one-time assessments levied on the home purchaser by the municipality to recover the service installation costs. Technical assistance could be provided to assess the feasibility of issuing such bonds in Poland and provide short-term consultants to advise local governments on initial bond issues.

Other donor actions

As discussed above it appears likely that the French government will provide some assistance to local governments in Poland. FFr90 million (US$16 million) has been set aside for technical assistance and training to Poland over a three year period. Approved projects include training for municipal management/democratic processes in local government and a center for banking system modernization.

The Delphi International Group's PACE Program (Professionals Assisting Central Europe) has identified public administration as one of fourteen areas where professional advisory services are needed. Delphi is attempting to raise US$500,000 from public and private sector donors to support the first year of this program.

The World Bank has cited adjustments in land use regulations and infrastructure provision as areas needing long term housing sector assistance in Poland.

In addition, the EEC may make large infrastructure loans available through the Eastern European Development Bank or through a new Bank for European Reconstruction and Development which has been proposed by the French government.

Construction and building materials industry: Context

Drastic changes are required in the construction and building materials industry in response to restructuring of the Polish economy:

- The domestic building products industry (building materials, building components, construction tools and construction equipment) has been a long standing bottleneck to housing production, characterized by:

  —inadequate production to meet demand;
  —monopoly position of state enterprises;
  —lack of access to credit by private entrepreneurs.

- The construction industry has been dominated by large state owned building enterprises (kombinats) which produce a very limited range of products not well-suited to market demand and at a high fixed cost.

- Despite constraints including limited access to scarce building materials, lack of credit, and lack of management experience, small private builders produced about 50,000 units—one quarter of the total built in 1988.

- Recent reforms have in principle removed the special access to materials and the direct subsidies for construction period financing enjoyed by the kombinats.

Technical assistance

The need for technical assistance and training for newly emerging companies and for re-training of construction workers is a substantial long-term effort. Fortunately, many of the changes required in the construction and building material industries will occur in response to market forces unleashed by the restructuring of the economy. There are, however, two areas of technical assistance to the industry where use of A.I.D. resources and expertise may be appropriate.

1. ***Privatization of the state owned building materials enterprises.*** Privatization of the SOEs which currently dominate the industry, carried out so as to avoid creating private sector monopolies in either production or distribution, could greatly increase competition and efficiency in the sector. Technical assistance to promote this outcome might include:

- A study of the building materials industry to identify supply and demand constraints, evaluate the comparative advantage of domestic production versus importation, and identify particular materials and products where competitive advantages exist as possible candidates for privatization;
- A team of advisors working with the Ministry of Industry to formulate strategies and implemention plans for privatization of one or more enterprises.

Technical assistance of this type fits well with the mandate of the Center for Privatization which is funded by A.I.D. However, the center has not previously worked in this sector and would most likely welcome additional input in undertaking such a program.

2. ***Assessment of the potential for privatization of the kombinats.*** Privatization of the kombinats as in their current conglomerate form may not be an effective strategy; experience to date indicates their high degree of integration does not yield significant benefits to the sector. Increased efficiency might be achieved by a component-by-component privatization process known as "shredding". Some of their functions, such as assembly of particular building components, might be restructured and sold as private companies. Certain kombinat assets, such as heavy construction equipment, could be sold to newly created equipment leasing companies. A technical assistance program could evaluate the validity of this approach and support its implementation:

- An initial step would be a study of the kombinats in terms of the potential to privatize them by shredding.

- If the shredding approach proved feasible, a team of advisors could be provided to draft a strategy and assist with the actual shredding of a particular kombinat.

Other donor actions

Consultations with members of a recent World Bank mission to Poland indicate that reorganization of the building material supply and distribution system is a high priority and will likely be included in the Bank's new program. A number of other potential sources of assistance exist, although they have not yet been earmarked for this purpose.[4]

Allocation, tenure and management: Context

There are three sources of obtaining housing in Poland: the state, through state owned rental housing agencies or through local governments; cooperatives, and the private sector. As central government investment in construction of new rental units declines, local governments, the cooperatives and the private sector are expected to take up the slack. However, there are a number of constraints:

- Rents remain far below the cost of even maintaining the units, requiring heavy government subsidies and discouraging private investment in rental housing;

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[4] These include the following:

The Eastern European Fund created by the EEC has substantial grant funds available to assist industry and credit investments in Poland mainly for small and medium-sized enterprises.

The SEED Enterprise Fund for Poland can be used to support and strengthen local private building materials firms and to explore joint-venture prospects and opportunities

TDP can fund feasibility studies for U.S. building products manufacturers interested in establishing joint venture operations with Polish firms.

U.S. and European investment funds targeted for East Europe could help capitalize direct U.S. investment in Poland by U.S. construction tools, equipment, building materials and building component manufacturers.

As mentioned above, the Center for Privatization has grant funded resources from A.I.D. and could assist in formulating and implementing privatization of the kombinats and of specific building material enterprises. The center is already working in Hungary and would like to work in Poland.

- Responsibility for maintaining and operating the state owned rental housing stock is being shifted from SOEs to local governments;

- There is no clear policy on selling off the state-owned housing stock and no guidelines on how to price units for sale.

Technical assistance

While there is a need for reform of the rental rate structure, this is an area of great complexity. Rent levels are clearly linked to wage policies and a complex system of subsidies which have only been partially dismantled. Rent reform is not an area where technical assistance to the housing sector alone would make an immediate contribution, although expert analysis could be provided to support a broader program of economic transformation. Two other areas, however, do offer opportunities for action independent of wider macroeconomic policy changes:

1. Rehabilitation of dilapidated units. An enormous inventory of dilapidated public housing units exist in Poland's urban areas. Municipalities will soon be bearing operating and maintenance costs of this inventory with little prospect of relief from the central government and undeveloped revenue sources of their own. A strategy that relieves them of this financial and managerial burden and at the same time makes them a partner in increasing the supply of suitable housing may be very attractive. As described in the construction industry section above, technical assistance could demonstrate opportunities to privatize state-owned housing by developing partnership arrangements between the municipality, private developers, and the rehabilitation/construction industry.

2. Housing estate management. The United States has acquired an impressive body of experience, at both the national and local level, in managing low- to middle-income public housing units. In Poland, as financing and management responsibility for state-owned flats has shifted to local councils, officials at the local level have suddenly found themselves responsible for large blocks of deteriorated and chronically under-financed public housing units. They will need to adopt sound financial analyses and management to bring the operation of these units to a self-financing basis and to elicit the involvement of tenants in recurring maintenance problems. The U.S. has a cadre of competent managers of large multi-family residential properties (assisted by sophisticated computer software) who know how to plan and implement efficient programs of property renovation and to design and operate efficient project maintenance programs. The skills of these managers could be used to restructure operations and finances of a few pilot projects, training managers as they did so, and then to conduct broader training short-courses.

Successful implementation of these initiatives would require adequate financing for the housing authorities—bridge financing in the case of redevelopment of the dilapidated units and longer term loans to support improvements of the rental properties. For such lending to happen will require that commercial banks become more skilled in underwriting these types of loans and that they price credit in line with the risks to which they are being exposed.

Allocation, tenure, and management: Other donor actions

Although it appears that the World Bank may develop a program of this type in Hungary, there are apparently no other donor actions dealing with allocation, tenure or management of housing in Poland.

2. Housing Finance: context

Before discussing specific areas in which technical assistance might be provided, it is useful to recall several key attributes of the current situation in Poland's financial markets and housing sector:

- The PKO Savings Bank has a monopoly on mortgage lending in the cities; such lending is done by cooperatives outside of the cities.
- The Ministry of Construction is apparently seriously considering establishing the National Housing Development Bank which would be a retail lender for housing and would provide construction period financing.
- Little development period financing for residential construction is available at present to small firms.
- In the January 1990 reforms, interest rates on mortgage lending were raised to market-approximating rates but some subsidies apparently remain.[5]
- In addition, up-front capital grants or "credit remissions" continue in the system for all housing lending, even that for purchase of purely private housing.

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5 According to the January 1990 World Bank housing sector mission to Poland, Bank PKO bases its lending terms on its refinancing rate with the central bank plus a margin. Bank PKO receives a favorable refinancing rates; therefore, some, albeit limited, subsidy remains. In January, for example, the refinancing rate to PKO was 34 percent but 40 percent to other banks.

- Capital markets are at best primitive; government is just beginn bills, and there is certainly no secondary market in government bond market is very thin.

- The financial system is not skilled in underw:'ting loans using risk assessment and financial criteria.

- There is a great deal of confusion present in financial and real r the moment and hyperinflation has greatly reduced the producti demand for housing. Such conditions may continue for a r months; this offers the opportunity for some changes to be i while the demand for financial services is limited.

Technical assistance

Four types of technical assistance in housing finance are badly nee(include improving loan origination, introducing more appropriate instruments, aiding in funds mobilization, and introducing competition PKO Savings Bank for mortgage lending.

*1. **Loan underwriting.*** Underwriting of mortgages and construct loans both need considerable strengthening. Traditionally in Poland lending has been a safe proposition for the originator: loan-to-value ratios because of front-end capital subsidies and relatively low loan limits, economy was carefully controlled so that continuing employment was a were stable earnings.[6] These conditions have already been radically chan the case of the up-front subsidy, may change in the future. Together th require that housing lenders begin underwriting loans in a more busine: in order to avoid high default rates on future loans. The weakness of th system in performing such underwriting is well-documented.

Some help in this area is already being provided to commercial bar is very doubtful that this initial assistance will address specialized Assistance could be provided in the form of a careful analysis c underwriting practices and then the development of stronger guidelines lines of those used in other countries. Working closely with Polish bank be essential. A training program for loan officers would be part of the

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6 We do not have information on delinquency and default rates for Bank they are believed to be low.

7 For example, the World Bank Project, "Industrial Export Development," i one goal to "improve the capabilities of selected banks in project financing'

Critically, development of an ex post monitoring system should also be included.

At least as important as stronger underwriting for mortgage lending would be improving the skills of those making development period loans to construction companies. With the dramatic increases in interest rates and materials' prices, the parameters of housing development have been dramatically altered. Making routine loans to kombinats could well be disastrous, as the housing built could be vastly more expensive than forecast and would be virtually unsalable without huge subsidies. On the other hand, solid underwriting might well permit very small producers who need short-term bridging loans to receive them. Indeed as part of technical assistance package to a bank, those providing assistance could help underwrite several loans to small firms to demonstrate their feasibility. One might even go further and get a commitment from the assisted institutions to make loans for perhaps 2,000 units to small firms in exchange for the assistance.[8]

2. *Mortgage instruments.* Until the January 1990 reforms, the PKO Savings Bank made all mortgage loans using a fixed rate mortgage (FRM) instrument. In January these were switched to adjustable rate mortgages (ARMs). However, in realization that under the exploding interest rates household would not be able to meet the new payments, the increase in payments were allocated as follows: 8 percent paid by the borrower, 32 percent paid by the state as a subsidy, and 60 percent is capitalized into the outstanding debt (which in turn raises the household's payment). While adopting ARMs is in principle a step in the right direction, under Poland's very volatile economic conditions, they may well lead to wholesale delinquencies by causing borrowers' payments to rise to unbearable levels, which could over time simply become loan defaults which government may be loath to foreclose. This precedent could undermine sound housing lending for a decade or more.

A number of economists have argued that under conditions like those in Poland, the dual-indexed mortgage (DIM) is the appropriate instrument. Under this instrument, which has been used in Mexico for the past five years and is under careful consideration in Chile, Turkey, and Ecuador, monthly payments are indexed

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8 It is unclear, based on the materials available, the extent to which the PKO Savings Bank currently makes development period loans. However, given the movement toward more universal banking, it seems likely that before long Bank PKO will be making such loans. We assume that similar technical assistance will be provided to commercial banks as part of a broader strengthening program for them.

to wages and the outstanding balance to actual interest rates; any divergence between the two indices results in limited adjustments to a loan's maturity. In short, DIMs protect the borrower from payment shock and protects the lender from having to partially or fully write off the loan.

Many borrowers will not be able to carry the high monthly payments of loans made at the maximum loan-to-value ratios, and they will face the other aspect of the affordability problem: assembling a large downpayment. Even after the economy stabilizes and prices in the housing sector recede from their current extraordinary levels, downpayments will remain a problem (as they were before economic decontrol). Over the longer term this might be dealt with by offering smaller, more affordable "starter homes" or flats; in the short-term other solutions are necessary. As noted, government thus far has addressed this problem through "credit remissions". Private owners, for example, receive a 30 percent write down of the amount of funds borrowed; at a typical loan-to-value ratio of 70 percent, this is a 21 percent up-front capital subsidy. Another option, however, is to employ a type of shared appreciation mortgage (SAM), under which the bank takes an equity position in the house which must be paid off when the house is sold or when the borrower is able to pay it off (possibly through a subsequent loan). In other words, the bank buys 20 percent of the house and places a lien on the property. When the house is sold (or title transferred), it receives 20 percent of the proceeds of the sale.[9] The Bank is betting that the rate of return on the property will be

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9 This arrangement is different from the SAM as usually defined, which involves a reduction in interest rate in exchange for a lender's claim on a share of the equity (McKenzie, 1980; Dougherty, van Order, and Villani, 1982). Advantages of this "simple SAM" are that consumers will readily understand it, market interest rates will be clearly applicable to the loan, and it will interact much better with a DIM, if it is adopted.

There has been some experience with the standard SAM in the U.S. In the early 1980 Advance Mortgage Corporation began offering SAMs in several states. And in 1982 the Federal Home Loan Bank Board issues regulation to allow federally chartered S&Ls to originate SAMs. Freddie Mac purchase a modest volume of SAMs on an informal basis. The instrument did not really catch on, however, in part because interest rates receded from their very high levels and because of difficulties at the time of sale of defining the lender's share of the equity on the original unit versus the value of the original unit plus improvements the owner had made.

competitive with that on other investments over the period.[10] In countries like Poland, which have traditionally had low mobility rates, the Bank might require that a second loan be taken out to pay off its equity position after the first loan is paid off. There is no reason why the SAM and DIM could not work together.[11]

Obviously, these are new instruments for Poland and they would need to be introduced with great care. The broad technical assistance elements are clear: bankers would have to understand them fully, proper software must be installed for changing monthly payments and tracking payments, and borrowers would have to be educated about the terms and conditions of such instruments. Each of these tasks can be done with moderate effort, but the package together is a substantial undertaking.

3. Funds mobilization. At present the PKO Savings Bank obtains its funds from household savings and central bank refinancings. Because of the weakness of Poland's financial markets and their slow development, in the near term the PKO Savings Bank—and other potential housing lenders—will have to concentrate on raising funds from the household sector. Under free interest rates and evolving competition from other banks, this will expose them to significant disintermediation and interest rate risk unless these risks are addressed by the development of appropriate savings instruments.

Potentially, the housing-linked contract savings scheme has an important role to play in mobilizing funds for housing. The PKO Savings Bank has offered such a scheme, and its attraction to savers was that it paid higher interest rates than regular savings accounts. However, fulfilling the savings contract did not give the saver any advantage in obtaining housing. Hence, the scheme had limited overall attractiveness. The contract savings scheme has considerable possibilities in Poland, if the contracted savings period is fairly long (a minimum of at least five years and

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10 Careful underwriting would be required on some properties. For example, a small unit in an older state-developed project which has not been well-maintained may not be an acceptable risk as it may fail to appreciate adequately.

11 To alleviate the potentially messy end-of-term problems of dividing the value of the unit between improvements and their appreciation on the one hand and the original property and its appreciation on the other, the growth in the lender's share might be capped at the interest rate applicable over the period plus 100 or 200 basis points. Alternatively, the SAM could be replaced with a simple deferred payment mortgage, where the mortgage principal would be equivalent to the size of the lender's equity position under the SAM.

. preferred period of 7 to 10 years) and if those completing their contract are given some genuine advantage in the housing market. The relatively long savings period is needed to help lending institutions match the durations of their liabilities and assets. It would also help tie up some of the excess purchasing power held by households, and control the rate at which housing demand was actualized. This in turn allows time for other reforms in the production of housing to take hold.

The advantage in the housing queue is needed because the scheme would pay attractive interest rates on deposits and charge regular rates on mortgages. The high rates on savings encourage households to participate and the high lending rates insulate the lender from risks of negative spreads if it uses funds raised from other sources for part of its lending to these borrowers. The bank could guarantee accelerated processing of loan applications from these borrowers and negotiate deals with developers to which it makes construction period loans for preferential treatment of savers who had fulfilled their contracts.

Since the PKO Savings Bank has operated a contract savings scheme in the past, the amount of technical assistance required might be quite modest, depending on the software systems in place, etc. Significant attention might have to be given to helping tailor the first deals with developers and for determining whether households participating in the current scheme should be permitted to shift to the new system, and, if so, under what conditions.

4. Increasing competition. The PKO Savings Bank has had and continues to enjoy a monopoly on mortgage lending in urban areas. It is unclear the extent to which its operations have been grossly inefficient or the degree to which it has used its monopoly power to direct loans to its "preferred customers". In general, of course, such monopolies are inefficient. The record of Indonesia's government housing bank offers stark support on this point (Struyk et al., 1990).

An important element of technical assistance would be to introduce competition for mortgage lending into the system. This, however, may be quite difficult to accomplish in the short term, particularly if a private financial intermediary is sought. In 1989 Poland created nine new commercial banks to carry out the credit and other commercial operations previously conducted solely by branch offices of the NBP (IMF, 1989: 58). Each of these bank's operations are largely, but not exclusively, limited to a particular geographic area. They will eventually be free in practice as well as theory to set their own deposit and lending rates. However, at the current stage of financial development, Poland continues to separate business and consumer banking. Business banking is the province of commercial banks and consumer banking is allocated to the PKO Savings Bank and, in rural areas, the cooperatives. Hence, for any of these new banks to do mortgage lending would require a merging of the two still independent banking sectors.

Another option would be the creation of a new consumer bank or a housing finance specialty institution. As noted above, there is active consideration of the creation of the National Housing Development Bank. Little, however, is known about this institution's probable ownership, funds mobilization strategy, or lending program. It is possible that A.I.D. could act quickly to help shape the bank's form and operation.

Other possibilities may develop, however. According to Smith (1990) a number of new institutions are planning to establish banks of their own.[12] These new banks would concentrate on lending for small enterprise development, and this could include small-to-medium size residential construction firms. These new banks will need a great deal of help early on, and A.I.D. could provide assistance with selected aspects of their operations as part of a larger package of assistance.

Complementary actions required. For the technical assistance in housing finance to bear fruit would require varying degrees of action in other areas, besides the creation of a reasonably stable macroeconomic environment. Three areas in particular can be cited. First, the supply of housing must be increased. As outlined above, action is needed on building materials, local infrastructure, and the residential construction industry. Without greater output, there may well be a limited demand for housing finance. Or, if housing finance were made widely available while supply remained unresponsive, increased demand could drive up housing prices.

Second, the financial system will have to continue to mature at a rapid rate. The banking system will have to expand, competition increase, and the elements serving the corporate and consumer sector integrated. Eventually, the development of a capital market will permit housing lenders to tap sources of funds which in other countries are a mainstay of mortgage finance.

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12 Those institutions include The Economic Foundation and The Stefan Batory Foundation.

Third, further reforms on housing subsidies is necessary. While most of the interest rate subsidies have been eliminated, this process should be driven to its conclusion. In addition, government should be encouraged to wring out all of the subsidies for operating rental and cooperative housing. This will create a "level playing field" between owners and renters and make home purchasers more willing to pay full costs. Whether government should eliminate the up-front capital subsidies is a more difficult question. If Poland decides it must subsidize housing, this is probably the best way to do it, as the subsidy is on-budget and absolutely clear. As suggested earlier, however, it may be possible to sharply reduce these subsidies through use of shared appreciation mortgages. Those that do remain could be far more sharply targeted than under the current system where they are available to all borrowers.

Housing finance: Other donor actions

Among the donors, the World Bank is being looked to for leadership for assistance in the housing sector. The Bank staff have done substantial studies of the sector in recent years and mounted a mission to Poland in January 1990. In the housing finance area, Bank staff are stressing the need for technical assistance for the introduction of the dual-indexed mortgage instrument as a high priority. (They are *not* considering introduction of the shared equity mortgage.)

3. Technical Assistance Summary

From the foregoing it is clear that many elements of the housing system in Poland could profit from some form of technical assistance. At this stage in the development of a program for Poland, it is not possible to establish clear priorities, because the intentions of the other donors are still evolving. A.I.D. has not determined the likely scale of the assistance effort, and there remains much ignorance about key facts needed to design assistance in several areas. On the other hand, because the problems confronting the sector are so pervasive and because at some point any neglected sector may well become the critical bottleneck, there are many opportunities for very constructive intervention.

Table 2.5 presents a summary listing of the areas discussed above and assigns to each a rough, qualitative estimate of the size of the commitment which assistance would entail and an indication of the "next step" in pursuing each. For reasons stated in the introduction to this section, we have not attempted at this stage to assign priorities to these opportunities. However, we have rated some areas as being probable major constraints to an expanded housing supply (*i.e.*, those marked with a "+" in the table). In broad terms these include the planning, land, and infrastructure functions and the construction and building materials industries; in addition, improving underwriting skills for construction period financing may be key in getting funds to all contractors under the new economic regime. The initiatives suggested in the planning, land, and infrastructure area would make a start by improving the operations in these areas by working with an individual city as a basis for two-way learning; subsequently the lessons learned could be transferred to other localities. The actions proposed for the building materials and construction industries depend on other actions being taken first by government, but would again involve initial small-scale attempts, as a basis for later larger-scale intervention. In both sectors, the process for substantial improvement in the efficiency of housing delivery may be lengthy. On the other hand, particularly in the planning and land areas, local governments may simply decide to take radical steps in exercising truly minimal control in order to permit more housing to be developed quickly. In this case the need for technical assistance clearly remains but its delivery is not on the "critical path" of expanding supply.

As can be seen from the chart, there is a mix of initiatives which could start quickly (assuming they are agreed to by the Polish government) with a mission to detail the technical assistance effort and those with a longer gestation period; *i.e.*, initiatives requiring studies to clarify the current situation and to define an appropriate package of technical assistance, if any. Presumably, a program of assistance would include a mix of small, "quick success" projects and those with a longer lead and execution time. The "quick start" projects (indicted in the table by a "#") are expected to have significant positive effects within a year of initiating the assistance. For example, better underwriting skills are anticipated to lead to expanded construction period lending very soon after the guidelines are developed and training completed. Likewise, improved management—coupled with an infusion of cash for repairs and higher rents—could result in near-term, visible improvements in the existing stock.

One idea for a large scale intervention is to work with a mid-sized city on comprehensive improvements in several interconnected areas of delivery. These could include land transfer, municipal planning and zoning procedures, building and subdivision standards, and provision of infrastructure services. The procedures developed in working with the city would then serve as a model for other cities. The principal advantages are that a whole series of problems is addressed simultaneously and those providing the assistance would build up a solid working relationship with local officials that would, over time, help facilitate change. The disadvantage may be the level of resources needed for success.

Table 2.5
Summary of Potential Technical Assistance to Poland

INITIATIVE	COMMITMENT LEVEL*	INITIAL STEP**
Planning, Land and Infrastructure +		
o review and revision of planning and regulatory instruments	2	mission to analyze current situation and recommend changes to eliminate constraints to private sector housing development
o increase local government understanding of public-private partnerships	1	send key officials for special training course in U.S.
o design and implementation of program of public/private partnerships	2	mission to identify potential projects and to define TA needs
o design and introduction of infrastructure financing mechanisms	2 #	mission to explore constraints, to identify potential projects and to define TA needs
o adopt a city for pilot TA program in planning, land and infrastructure	3	exploratory mission to define specific program
Construction and Building Materials Industry +		
o design and implementation of program to privatize state-owned building material industry	3	study of building materials production and distribution to identify candidate enterprises for privatization and to outline TA program
o design and implementation of program to privatize state-owned construction enterprises (kombinats)	2	mission to analyze the operations and structure of kombinats and to outline a plan for privatization and a TA program
Allocation, Tenure and Management		
o design and implementation of program to rehabilitate and sell dilapidated rental units	2	(see public/private partnership initiative above)
o improve housing estate management capacity of local housing authorities	3 #	mission to define TA needs and to organize management and maintenance training courses
Finance		
o strengthen underwriting of construction loans and mortgage financing	2+#	exploratory mission to define specific TA program
o design and introduction of more suitable mortgage instruments	3	exploratory mission to define specific TA program
o design and introduction of contract savings scheme for fund mobilization	2	exploratory mission to define specific TA program
o support to proposed National Housing Development Bank and/or Coops to increase competition	3	mission to analyze current situation, to identify target institutions, and to design TA program

* Commitment Level: 1--short duration, modest cost (<$75,000); 2--medium duration and cost ($75-$250,000); 3--longer duration, more substantial cost (>$250,000).

** Following expression of interest by government.

+ Possible major constraint to expanded production

Activity with high short-term payoff

3

THE HOUSING SECTOR IN HUNGARY

For 20 years Hungary has experimented with piecemeal reforms aimed at educing the rigidities inherent in a command-driven economy. At each step in the process the removal of one constraint has led to the recognition of another layer of constraints. As a result, the history of Hungary's reform experience since 1968 is eplete with little successes and frustrating setbacks, of formal controls and lirectives from the center being gradually relinquished and then new measures being introduced to ensure indirect control.

One of the paradoxes of this chipping away process is that although it appeared to succeed in creating conditions of macroeconomic stabilization between 1968 and 1986, it did not create the basis for sustained economic growth (IMF, 1989). Although corrections were introduced at the macro level of the economy, hey tended not to be based on deep, systemic reform. Correspondingly, instead of stimulating economic growth, microeconomic policies tended to act as a brake on growth.[1]

A. DEMOGRAPHIC AND ECONOMIC OVERVIEW

1. Demographic Trends

Hungary is a small country of 10.6 million people. A homogeneous country, Hungary has avoided the strife of multi-ethnic countries such as Yugoslavia. Demographically, several trends are of particular interest:

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[1] Thomas, 1989: "For example, fiscal balance has been achieved in part by tightening wage and price controls, putting quotas on imports, and increasing taxes on entrepreneurial activity, rather than addressing the "black hole" of governmental and quasi-governmental expenditures."

Population

- After decreasing in the exodus years after the 1956 revolution, population increased slowly during the 1960s and 1970s, stabilized during the 1980s, and is expected to increase gradually throughout the 1990s.

- Hungary has a rapidly aging population: currently, for every two persons employed, one person is retired and receives a pension.

- In 1980, the last census year, there were about 3.7 million households of which 2.7 million were single-family households and 700,000 one-person households

- Households are expanding at a rate higher than the population making it easy to underestimate the housing shortage

Urbanization

- About 56 percent of the population lives in urban areas; in 1960 the figure was 39.3 percent

- Of the 30 percent of the population in the 9 largest cities, 19 percent, or 2.1 million live in Budapest; with the next largest city at 220,000 (Miskolc), Hungary clearly reflects the old urban settlement pattern of the dominant central city

2. Economic Overview

We begin with this summary of reforms to the economy at large because it establishes the context for developments in the housing sector.

State enterprises

Up until 1968 and the introduction of the New Economic Mechanism (NEM) which was Hungary's first effort to achieve some measure of market reform, the economy was patterned on the classic principles of a centralized system of planning. The NEM, radical in its time, attempted to modify management of the economy by eliminating plan directives from the center and permitting greater enterprise autonomy in planning, production, and pricing. Decision-making power which had been vested exclusively in supervisory agencies—ministries or local authorities—and used to set physical output targets and allocate materials for production, was modestly decentralized, though measures to retain indirect control were implemented concurrently. What occurred in practice, however, was that state enterprises bargained back and forth with the authorities for preferential treatment in the application of the instruments of indirect control: credits, subsidies, and tax exemptions. In fact, the bargaining process acted as a disincentive to any real financial discipline and the notion of pretax profitability as an indicator of performance was virtually ignored. This pattern of operation continued for nearly 10 years.

The reform process picked up again in 1977 and has continued throughout the 1980s. A number of important laws, acts, and measures were implemented over this period. The most germane ones relating to the evolution of state enterprises are summarized below (Thomas, 1989). The third paragraph describes very recent legislation related to privatization.

Enterprise autonomy, incentives and property rights. The State Enterprise Act of 1977, with amendments in 1981 and 1982, and related legislation effective in 1985, was intended to decentralize decision-making in state enterprises, relying on self-management with worker participation. But with macroeconomic imbalances becoming an increasing source of concern in 1986, tax-based wage controls were tightened and rules requiring notification of central authorities prior to making price adjustments were enforced more strictly.

The Bankruptcy Law of 1986 was intended to facilitate the restructuring or liquidation of inefficient enterprises. State subsidy payments would be stopped to creditors that failed to enforce the collection of overdue claims, and tax forgiveness to loss makers discontinued. But insolvent enterprises were allowed to opt for reflotation with government support instead of bankruptcy. Creditors have been reluctant to initiate bankruptcy proceedings against large, chronic loss-makers that may be their principal or sole customers. Thus far, most proceedings have been initiated by the insolvent enterprises themselves; only one major enterprise has been liquidated.

Legislation was passed on Jan. 25, 1990 that established a National Property Agency (NPA) which will facilitate privatization. A bill providing for "Protection of the Property of the State" was approved on the same day to ensure that the interests of the State, as owner-seller, are protected, both from the point of view of national policy interests and avoidance of bargain transfers wherever possible. One role envisioned by advisors to the Agency is that it will help develop Hungary's capital market through the sale of shares and bonds to the public, to financial institutions and mutual funds that will lead to secondary market activity. It is likely that the government will permit "spontaneous privatization" (selling off of state-owned assets by management and workers' councils in self-governing enterprises at a fraction of their value) to continue but will place limits on the "dumping" that has been occurring (Tomlinson, 1990).[2]

Of the 2,700 state-owned enterprises (SOEs) in Hungary, constituting 90 percent of all enterprises in the country, the top 20 percent, or 500, will be the focus of the NPA. Of the 2,700 SOEs, 80 percent are run by employee-managed councils in which management and workers jointly hold shares in the company. In the past, some 1,800 laws have governed SOEs in Hungary. Close to 1,000 reportedly have been repealed (Levintow, 1990).

The private sector

As a result of the postwar policy of industrialization in Hungary, a classic feature of all CPEs, most enterprises were merged to facilitate central control and to promote large-scale production. Few small and medium sized enterprises (SMSEs) survived. Just ten years ago, in 1980, the IMF estimated that "the share of industrial employment in enterprises of up to 50 employees, which is about 15 percent in market economies, was only 0.1 percent in Hungary" (IMF, 1989).

During the 1980s, however, Hungary took a number of progressive steps to open up the economy and promote greater competition. Although initial efforts focussed on nurturing the creation of small and medium-sized enterprises in the socialized sector, other efforts supported the growth of small-scale cooperative associations. By the end of 1986, some 35,000 new, small enterprises with 440,000 employees (about 9 percent of the labor force) had been created. By 1987, the IMF reports that "the share of incomes earned in the private sector [totalled] 20.5 percent of household disposable income" (IMF, 1989).

While this was encouraging, numerous restrictions continued to hamper the development of a competitive private sector. However, significant improvements have been recently registered in three areas. The Corporate Association Law in 1989 permitted both private residents and nonresidents to establish a variety of enterprise forms, including unlimited liability companies and joint ventures with a limited liability, as well as joints stock companies. Second, private businesses may now employ up to 500 workers, usually considered the threshold level for a

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2 The Center for Privatization, through a grant from A.I.D.'s Private Enterprise Bureau, will be providing both technical assistance and training to the NPA, as well as a long-term advisor (Levintow, Farley, 1990).

medium sized firm. And third, beginning in 1989, a number of new initiatives were introduced to facilitate trade and foreign investment.[3]

During 1987, 24 new share corporations, including 8 banks, were established in Hungary, and in 1988 an additional 89 new share corporations were set up. By mid-1989, 16 countries had participated in about 280 joint ventures in Hungary. One known investment fund, the First Hungary Fund Limited, has been established to help finance joint venture projects, privatization efforts, and provide venture capital for start-up companies. Created by Hungarian financier George Soros, the First Hungary Fund Limited has secured both IFC participation and National Bank of Hungary investment guarantees.

Two major clouds hang over this encouraging investment climate. One is Hungary's foreign debt which at the end of 1989 totalled $20 billion; annual interest payments of $1.3 billion represent 4 percent of GDP. Hungary's debt service ratio, on a convertible export basis, is expected to reach 40-50 percent in 1990 (Komaromi, 1990). Although it has failed to reach agreement with the IMF on a new standby loan agreement, Hungary to date has not defaulted, been in arrears or rescheduled any of its debt obligations. The second is the currency risk associated with the non-convertability of the Forint and the steady devaluation of the Forint relative to convertible currencies. In 1985 the exchange rate was $1.00 to Ft 49.7; today, $1.00 = Ft 60; the black market rate was Ft 90-100 in early 1990.

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3 The most important of these were codified in 1989 with the passage of the Act of Foreign Investment, The Companies Act, and The Transformation Act. The effect of these Acts is particularly important in several areas (Commerce, 1989):

- A foreigner can own up to 100 percent of a newly-established joint venture company and up to 80 percent equity share in a Hungarian company that has issued shares;
- A joint venture may acquire real property necessary for the conduct of its business (though not speculate in land or establish real estate firms)
- Tax exemptions for up to 5 years are available to firms investing in selected industries with high export earning potential;
- Foreigners can open and maintain hard currency accounts, including, in March 1990, at any commercial bank;
- Joint ventures can repatriate their profits under a limited convertability arrangement for the forint.

Financial system in Hungary

The 1968 reforms in Hungary excluded the banking sector. As a result, the banking system continued to operate with a monopolistic, highly specialized and segmented structure. The major features of this system prior to the major banking reform of 1987 can be summarized as follows:

- The National Bank of Hungary (NBH) maintained central control over the flow of capital in the country. It kept all the accounts of the state enterprises, allocated credit to them at the request of the supervisory agencies, and managed nearly all the foreign currency operations.
- The National Savings Bank (OTP), supplemented by the postal savings network and the savings cooperatives, acted as the banker of the population and local authorities. It collected deposits at low interest rates, most of which were relent at even lower (3 percent) rates for housing.
- A number of small financial institutions designed to finance innovations and to pool capital for selected state-controlled developments were established in the early 1980s.
- Savings Cooperatives operated only in rural areas and small towns, were limited in the forms of deposits they could accept and were not permitted to extend credit to the private sector.
- The State Insurance Company monopolized the Hungarian insurance market.
- Available savings instruments were limited to life insurance policies with the State Insurance Company, small amounts of bonds issued in 1983, coop share certificates, and real estate.
- The propensity to save was discouraged by: (1) guaranteed lifetime employment; (2) negative real interest rates on savings deposits; and (3) the availability of heavily subsidized housing loans.

In an effort aimed at strengthening enterprise autonomy, stimulating savings, and introducing competition among profit-oriented commercial banks, the government, beginning in 1985, initiated a number of far-reaching reforms in the banking sector. The most important of these, which set the stage for fundamental restructuring of housing finance, are summarized below.

Commercial banking. In 1987 the National Bank of Hungary retained its central bank functions but transferred its commercial activities to three new commercial banks set up as joint stock companies owned directly by the state. All the current accounts of state enterprises and cooperatives were distributed among the banks with the objective to instill profit-oriented credit granting behavior into commercial bank practice. The banks were also free to set loan rates to enterprises, although the average charged could not exceed the refinancing rate of the NBH more than 1.5 percent (IMF, 1989).

The dozen or so small financial institutions created in the early 1980s that operated as innovation or investment project funds have been transformed into commercial banks.

Despite the reforms just enumerated, several problems have become apparent: (1) management and technical skills needed to assess credit risk are noticeably absent; (2) the banks have been reluctant to cut off lending to inefficient enterprises; (3) consumer lending is only just beginning; and (4) there appears to be little in the way of policy or incentives to lend to private sector SMSEs (e.g., little evidence that commercial banks are making construction period financing available to small builders (Friedlander, 1988; Elwan, 1989; Winchester, 1990).

Savings cooperatives. In 1985 the Savings Cooperatives, of which there are presently 262 with a total membership of 1.8 million, were permitted to offer banking services similar to the National Savings Bank (OTP). Small public and private enterprises were allowed to transfer their accounts from OTP to the savings coops in order to facilitate their transactions with the state enterprise sector.

Other developments. Other changes in the structure of the financial system include:

- As of July 1986, any agent of the enterprise sector can establish an insurance company, including one with foreign participation. Several have done so. The State Insurance Agency retains a monopoly for export insurance and obligatory collision insurance.

- Two foreign banks with foreign participation operate now: the Central-European International Bank Ltd., an off-shore trading company; and Citibank Budapest Rt. which began operations in 1986.

There were two key reforms in 1989 in the housing finance system that effectively ended the historical segmentation between commercial and savings banks. First, the granting of housing loans at low (3 percent) rates of interest was discontinued, ending OTP's virtual monopoly on mortgage lending and greatly reducing the interest rate subsidies. Second, the large outstanding stock of these concessional loans was transferred to a newly established Housing Fund in exchange for bonds with market-related yields. The losses of the Fund were covered by budget transfers (IMF, 1989; World Bank, 1989b). Under these

Table 3.1
Financial Institutions in Hungary

English Name	Magyar Acronym	Year Founded	Capitalisation (million HUF)	Ownership	Chief Functions
National Bank of Hungary	MNB	1924	1,500	SO	Central Bank, Monetary Auth Supervise CBs & Set Int Rate
AGROBANK	A	1984	1,500	JS 458 Co-op SH	Ag & Food Processing Finance & Co-op & Private
Budapest Bank Ltd	BHB	1986	6,400	JS State-61% 394 SH	Small & medium sized Co-op & Private Business Financing
Commercial & Credit Bank Ltd	K&H	1987	10,600	JS State-50% + 400 Ag Ind & Trd SH	Joint Venture Financing
Hungarian Credit Bank	MHB	1987	14,000	900 SH Co-op/Int/Ind	Short Term Crdt. Some Cons & Mortgage Finance (See Text)
Hungarian Foreign Trade Bank Ltd	MKB	1950	6,000	Primarily SO	Foreign Trade & Currency
Innovation Bank for Construction Industry	EIB	1983	1,200	JS 61 Const/Coml/ Ins & Bank SH	Commercial/Ind RE Cons/ Mortgage/Prop Mgt
INTERBANK for Foreign Trade Ltd	I	1980 (pvt 1988)	2,200	JS SH Foreign Trd & Co-op	Develop Financing Import/Export
General Banking & Trust Co Ltd		(original 1922) 1952 (pvt 1986)	1,500	JS	
General Bank for Venture Financing Ltd		1985	2,200		
MEZOBANK National Banking Inst of Agri Co-ops Co Ltd	MB	1986	2,000	JS Ag & Co-op	Ag Co-op Financing
National Savings Bank	OTP	1949	1,300 (deposits 280,000)	SO	Res RE Constr, Mktg/Fin PLUS (See Text)
Post Bank	PB	1988	2,200	SO	Collection of Deposits & Loans to other banks
Savings Co-operatives	T	1957	10,000	SO	Analogous to Credit Unions
Real Estate Bank Ltd		Being Formed 1989		JS	Formerly Subsidiary of MHB for RE Brokrg/Devel/Lending

SO – State Owned, JS – Joint Stock (private); SH – Shareholders, Ag – Agricultural; Co-op – Co-operatives; Ind – Industrial, Trd – Trade, Cons – Construction, Int – International Firms

Source: Parry (1989).

conditions commercial banks could be permitted to compete with the savings banks for deposits and for consumer lending business.

The major banks in Hungary and their key functions are presented in Table 3.1.

Current available savings instruments. The current rate on 1-year time deposits is about 19 percent (net of a 20 percent withholding tax), raised from 13.5 percent in early 1990. With current inflation at about 19 percent, the interest rates offer little incentives for savings.

Treasury bills are bought by both households and enterprises and banks. Households pay a fixed rate (comparable to the deposit rate at the OTP, which is lower than the deposit rate at the commercial banks.) Raised in early 1990, a 9-month T-Bill currently pays an annual rate of 19 percent (after tax). T-Bills sold at auction to enterprises and banks are zero-coupon bills. The cost of these funds to the government is significantly higher than the fixed-rate bills. For instance, the February 8 rate was 26 percent (Winchester, 1990).

Some commercial banks are competing very actively with OTP for household savings. One bank, for example, has introduced 3 and 6-month CDs. In general, though, the volume of funds brought into the commercial banks is still quite low. One banker attributes this to the fact that many households have large housing loan debts to OTP, which combined with inflation, are soaking up excess liquidity (Winchester, 1990).

The issuance of bonds was resumed in 1981 after a hiatus of 30 years, first by local councils to finance infrastructure, and since 1983 also by state enterprises. Volume declined in 1988, however, because of four factors: (1) government guarantees for bonds were discontinued in early 1987; (2) enterprises and banks were anticipating increased inflation which would make fixed-rate bonds unattractive; (3) competition from T-Bills and CDs increased in early 1988; and (4) there is no reliable accounting information on the enterprises and banks to evaluate their creditworthiness as debtors.

Apart from the insurance companies, there are no non-bank financial institutions, although there are plans underway to establish brokerage houses. A stock exchange is expected to begin operation in 1990. At the current time, there are no pension funds, though there is a large block of trust funds comprising all the State-controlled pensions.

Wages, the "Second Economy," and prices

Wage policy in the pre-1968 period was driven by the ideological tenets of socialism. Food, shelter, health care, education and transport were viewed as social rights and provided to every citizen at heavily subsidized prices. Wages were not intended to reflect the cost of or scarcity of labor. However, central planning judgments on compensation were supplemented with consumer price subsidies and social benefits in money and kind, much of which was financed by heavy taxes levied on enterprises.

Successive reforms of the wage system were introduced in 1968, 1976, 1980, 1983, 1985, and 1988. Each reflected an effort to allow for a differentiation of wages to permit payment of better incentives for performance, and in 1985 to stimulate labor mobility. Some reflected complex schemes to regulate wages through enterprise taxation. In 1988 a personal income tax, along with a 50 percent corporate profit tax on wage increases was introduced. In every case, though, these various schemes were not based on a real policy of deregulation. They were enormously complex to implement and administratively onerous for both the state and local authorities as well as the enterprises themselves.

The low and continuing undifferentiated wage structure, together with the gradual reduction of retail price subsidies accelerated the pace at which workers entered the second economy. It is not unusual today for a worker to hold two or even three jobs. Second economy earnings are reported to be considerably higher than enterprise sector wages which today average $140 per month. What has occurred as a result of this phenomenon is the informal creation of two income classes: one that is completely dependent on first economy wages and another that enjoys combined income from first and second economies. The differential purchasing power of the two income classes is having a significant effect on household ability to buy goods and services in Hungary today, an ability that is especially startling in the housing sector.

Price reforms were an integral part of the 1968 economic reform effort, as well as subsequent efforts throughout the 1970s and 1980s to experiment with the use of market signals to producers and consumers. However, indirect administrative controls and special fiscal instruments, such as taxes, tax exemptions, and subsidies, had a dampening effect on these experiments. Nevertheless, Hungary was able to avoid the major distortions to relative prices that are a common feature of most CPEs.

As of April 1988, "20 percent of consumer prices remained subject to administratively set ceilings, 22 percent to an obligation to report intended price increases in advance to central authorities, and 5 percent to price consultation processes. The remaining 53 percent were subject only to the import price limitation and other general pricing rules that ensure compliance with the law against unfair trade practices." (IMF, 1989) By 1989 about 62.5 percent of prices were set "freely" in the Hungarian economy.

B. THE HOUSING SECTOR IN HUNGARY

Not surprisingly, Hungary's housing policies over the last 40 years have reflected the rhythm of its broader economic policies. In the 1960s housing was enshrined as an entitlement. A broad array of administrative powers were exercised by the state to control housing investment as well as the allocation and pricing of housing. In response to unintended and disappointing effects of public policy, various corrective measures were introduced in 1971, 1983, and 1989 to stimulate production and reduce inefficiencies and inequalities that had arisen. Partial reform measures induced partial performance improvements. Market mechanisms have been tinkered with but not fully embraced. Nevertheless, there has been an overall movement toward market-driven operations in the sector.

Overall, Hungary's housing sector has performed quite well in comparison to other Eastern European countries. By 1987, the share of housing investment in total state investment outlays reached 19 percent and housing investment as a share of GDP has remained steady at close to 6 percent (Mattras, 1989).

Today 90 percent of all new housing being produced in Hungary is for private ownership and only 10 percent for state ownership. However, the state still owns approximately 25 percent of all the dwelling units, including 60 percent of the stock in Budapest and 30 percent in the other towns. Although Hungary's homeownership rate stands at a remarkably high 75 percent, it's growth in urban areas, especially Budapest, has been impeded by policies favoring the production of heavily subsidized rental units. In Budapest, only about 34 percent of households own their units while 66 percent in the towns (settlements with more than 8,000 people) do, and 92 percent in the villages (Sillince, 1985).

1. The Housing Delivery Process

Overview. It may be useful to start with a definition of housing types found in Hungary and a scheme (see Figure 3.1 on next page) which attempts to depict Hungary's very complex housing delivery system (Baross, 1987).

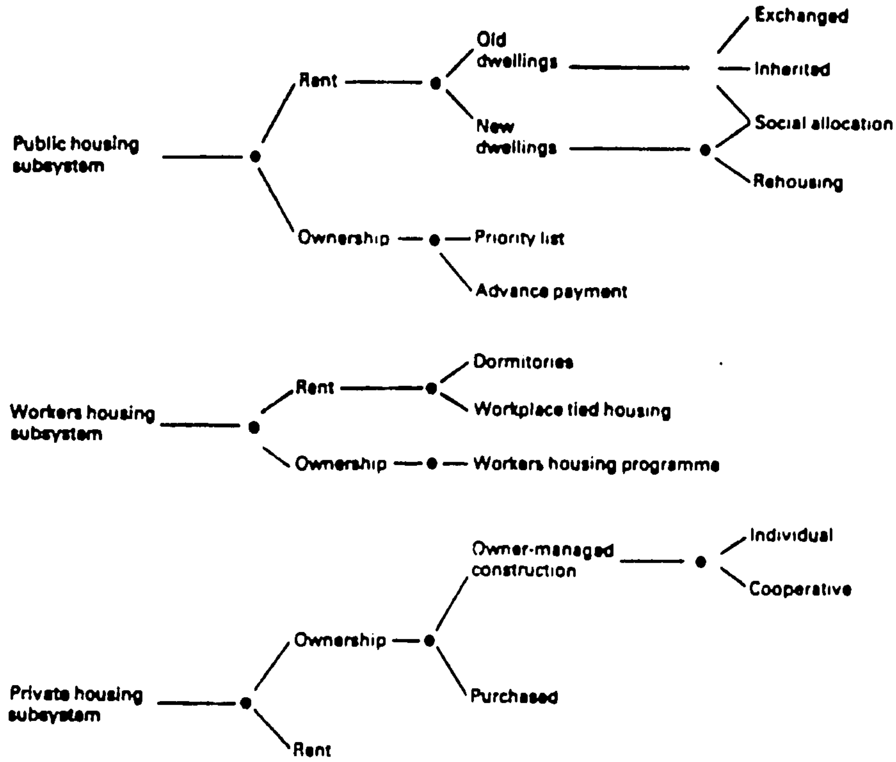
Under the public sector delivery system three housing types are found:

- Apartments (nationalized, old upper class 3-5 story buildings in central locations);
- Flats (newly-built high-rise blocks on the outskirts of the city);
- Tenements (nationalized former working class rental units, usually with common service provision).

Another three housing types are found in the private sector:

- Villas (single family houses in prestigious locations);

Figure 3.1
Housing Delivery System in Hungary



Source: Baross (1987).

- Condominiums (modern, newly constructed private apartments, generally low rise, built as in-fill projects replacing war-damaged buildings);
- Family houses (newly constructed single family dwellings built in the outer suburbs where infrastructure and related services may or may not exist).

Who gets access to which housing class at what cost has been one of the most enduring questions in Hungary, one that has produced a startling range of policy responses over the last 30 years.

In contrast to structure types in the public and private sectors, there are three major subsystems in Hungary's housing delivery system, each of which has a rental and ownership element (see Figure 5.1):

- Public housing (government produced and allocated);
- Worker housing (tied to enterprise employment);

- Private housing (mostly families who either individually or in small cooperatives finance the construction of their houses).

Some of the subsystems overlap. For example, some of the new units produced by the municipal authorities (local councils) are sold to individual families and end up in the private housing subsystem. In addition, household who live in municipal housing engage in a number of different private transactions, such as exchange, co-renting, and sub-renting.

Planning, land, and infrastructure

Historical overview.

The government responded to the immense inequalities and scarcities at the end of World War II by (1) redistributing the existing housing stock and (2) establishing state enterprises to construct housing and operate the rental housing sector. Both the nationalized existing flats as well as newly built ones were allocated on the basis of need.

Planning in the socialized sector was performed by State authorities, who also approved individual projects. Implementation was the function of the local council. During the period of heavy industrialization in the 1950s, the State concentrated on building flats in the new industrial areas of the north. By 1960, however, the number of households exceeded the number of dwellings by 16 percent. These chronic shortages induced the government in 1960 to launch the First 15-Year Housing Plan (1960-1975) aimed at constructing 1 million new units. Planning authority became highly centralized. It was decreed that 60 percent of the new units should be built in the capital and industrial areas; 60 percent should be constructed by the State and 40 percent by private sources. The Ministry of Construction determined the number of new units to be constructed, the number of rooms, types of amenities, and the construction technology employed. Although the plan target was met and even exceeded by 50,000 units, the net addition was less over the 15 years because of the demolition of 230,000 units. Of the total units built over this 15 year period, only 36 percent were built directly by the State.

The Second 15-Year Housing Plan (1975-1990) was aimed at constructing 1.2 million new units or 80,000 dwellings per year. Net additions after demolitions were set at 550,000-600,000 for the plan period. Demolitions, which represented 19 percent of all new construction in the First Plan period, were anticipated to jump to 50 percent in the Second Plan period. In fact, because the heavily

Table 3.2
Dwelling Units Built 1960-89
(Average units built per year, thousand)

Year/Period	Budapest	Other Towns	Villages	Total	Units per 1,000 Population
1961-1965	10.2	18.6	27.7	56.5	5.6
1966-1970	11.8	23.5	30.2	66.5	6.5
1971-1975	15.5	36.5	35.7	87.7	8.4
1976-1980	17.1	40.3	33.1	90.5	8.5
1981-1985	14.9	32.0	27.1	74.0	6.9
1986	10.0	33.3	26.2	69.5	6.5
1987	10.3	25.9	21.0	57.2	5.4
1988	8.5	22.4	19.6	50.5	4.8
1989 (first half)	1.1	n/a	n/a	n/a	n/a

Source: Parry (1989).

subsidized rents charged by the authorities did not cover maintenance, quality progressively deteriorated, and because subsidy incentives were offered for new construction, it became more advantageous to demolish the old units.

As indicated in Table 3.2, annual plan target for the Second Plan period were exceeded during the first five years (1976-1980) when they averaged over 90,000 units per year. Over the next five years (1981-1985), housing production declined to around 74,000 units per year and has continued to drop over the last five years to levels of 50,000-60,000 units per year.

Current situation. It is difficult to tell from available data precisely how roles have been transformed in the planning for housing, the control and development of land, and the provision of infrastructure. For many years, the State Development Agency, the National Savings Bank, enterprise organizations, local government councils, and certain forms of cooperative associations had preferential access to land for multi-unit development. Private individuals could obtain vacant plots to build their own houses but private contractors were not permitted to assemble land to build for sale housing. In 1989 these restrictions were lifted and an element of competition has been introduced into the system of land and housing development. However, it is unclear whether a functioning market for land has been established, how land is priced, how real estate belonging to state owned enterprises will be valued, and what options exist for land and building ownership. The availability of serviced land for private development is one of the most serious constraints inhibiting the expansion of private construction in urban areas in Hungary.

The provision of infrastructure is now apparently under the sole authority of local councils. It is unclear, however, what role the central government continues to play in the allocation of grants to finance capital costs or in the exercise of planning controls. In the past, capital investment was funded from a combination of state development grants, contributions from state-owned, including local council-owned, enterprises. It is also unclear how maintenance is managed and funded. As traditional sources of funds to finance capital and recurrent costs dry up, however, the issue of organizing a new resource base becomes critical.

A reorganization of housing functions at the central government level took place in early 1989. These functions are now divided between three ministries:

- Ministry of Transport, Communication and Building

  —Construction industry and administration
  —Physical planning

- Ministry of the Interior

  —Settlement development and policy
  —Planning and financing of local governments
  —Housing and communal services

- Ministry of Industry

  —Building materials industry.

Construction and building materials industry

Housing construction costs in Hungary have risen dramatically over the last few years, contributing to weak effective current demand. The skyrocketing costs of building materials and the premium prices private builders have to pay for them, as well as the higher cost of second economy labor which produces much of new housing, appear to be the key factors in the rising costs of new housing.

In the period 1987-88 the average construction cost of a new dwelling unit ranged between Ft825,500 - Ft961,700 (US$15,575-US$18,145 at the 1988 exchange rate of US$1 = Ft53) (Komaromi, 1990). This represents a 68 percent increase over 1983 average construction costs which ranged between Ft516,957-Ft530,600 (US$12,508-US$12,941 at the 1983 exchange rate of US$1 = Ft41) (World Bank, 1985). In Budapest, average per square meter costs for housing constructed by enterprises and cooperatives (36 percent of all housing units), increased 19 percent from 1987-89.

In line with most East European CPEs, housing in Hungary has been produced by state-owned enterprises, cooperatives, and the private sector. As indicated in Table 3.3, the construction industry in 1987 employed close to 400,000 workers, or about 8 percent of the total labor force. About 67 percent of these workers were employed in state-owned enterprises or state-supported construction cooperatives. Approximately 32 percent of non-governmental workers were employed as one-two person private contractors.

State construction enterprises. One of the main elements of Hungary's socialist housing policy was the promotion of state construction enterprises.

Table 3.3
Construction Industry Organization and Employment 1987

Organizational Form	Number of Organizations	Workers Employed (thousands)
State constructors	164	190.9
Cooperative constructors	909	74.8
Sub-Total	1,073	265.7
Architectural/design & investment enterprises	187	26.5
Specialized industrial & servicing coop groups	403	12.2
In-company economic partnerships	2,305	25.6
Private economic partnerships	2,305	23.7
Small-scale industry*	24,917	42.1
Sub-Total	30,603	130.1
TOTAL	31,676	395.8

* Licensed craftsmen working as principal occupation or as a pensioner.

Source: 1988 Hungarian Statistical Yearbook.

Designed to meet large-scale production plan targets, they generally employed 4,000 to 6,000 workers, and had monopolistic access to finance, building materials, and serviced land. Despite all the preferential treatment they received, however, State sponsored housing still constituted only 30-35 percent of all new construction during 1950-1978 (although in urban areas their share rose to 57 percent).

Although state residential construction enterprises have slimmed down to an average size of 3,000 workers and now comprise less than 1 percent of all enterprises, they still account for over 30 percent of the value of works carried out (Elwan, 1989). SOE construction of housing declined about 22 percent between 1987-1988.

The construction SOEs in Hungary are being kept afloat by preferential treatment by the heavily state-owned commercial banks that now manage their accounts, by use an obsolete, inflexible, and unpopular technology (prefab panels), and by virtue of their state status have first access to scarce building materials. It is difficult to say from available data whether some functions are more efficient than others and could be shredded from parent SOEs and privatized. It is also unclear if the government has any near-term plans for pushing the commercial banks to deny credit to unprofitable construction SOEs. One reason that credit continues to be granted to these enterprises may simply be the absence of skills in the banks to assess credit-worthiness and risk. Finally, although they do produce housing at a lower unit cost that the private sector (because of access to materials at official prices and because wages in the first economy are much lower than they are in the second economy which employs the small private contractor), the quality is reported to be very poor.

Cooperative sector. One of the most enduring forms of housing development in Hungary is the housing cooperative. Workers in state-owned enterprises, as well as groups of private individuals, form temporary cooperative associations to take advantage of construction subsidies offered to them and preferential access to state-owned lands and building materials. After the construction is completed, they usually disband. Although the cost of construction under the cooperative mode is often more expensive than SOE-constructed housing, it is still generally less expensive than private house building because of the cost-reducing bundle of services and preferential access they enjoy.

Other, more permanent forms of construction coops have been established by larger, multi-purpose or special-purpose cooperatives.[4] Other cooperatives serve housing maintenance functions. In Hungary, as in Poland, housing cooperatives are generally classified, along with construction SOEs, as part of the socialized sector. As access to credit, building materials, and serviced land is equalized in Hungary, cooperatives will have to compete with private contractors in housing and land development.

Private sector. Businesses on three scales operate in this category:

- The day laborer or private tradesman employing only a handful of workers;
- The small-sized firm employing anywhere from 5 to 200 workers;
- The medium-sized company of 200 to 300 employees.

No large private sector construction capacity has emerged, certainly in part because of legal impediments. Although equal access to credit, equipment, and materials is supposedly in place in Hungary, legislation still sets a limit of 500 workers per private company.

According to one source, informal (non-legalized) sector construction in 1981 comprised about half of private sector residential construction and dominated the maintenance and renovation of privately-owned apartments. In the same year 70-80 percent of all maintenance and renovation of private apartments was allegedly carried out in this second economy (Galasi, Sziraczki, 1984). If this is true and the share of the second economy in housing construction has continued up to the present time, the implications are significant. The much higher wages in the second economy could be driving building costs up; and unrecorded, unpaid taxes on earned income has a direct effect on the revenue stream of government.

There is some evidence that the government is interested in transforming what was previously a top-heavy production structure into a pyramid-shaped one. The pyramid would have a large group of small contractors on the bottom and a

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[4] An example is NOVARAT, a coop of 860 employees that grew out of a larger parent agricultural coop. NOVARAT is engaged in the design and construction of new housing, as well as project management and manufacturing of some building products. They issued bonds to finance construction. These bonds were guaranteed by the state (until government guarantees for bonds were discontinued in 1987). NOVARAT sells single family houses and individual flats (as condominiums) to people with remittances (Elwan, 1990).

proportional number of medium-sized contractors. Their combined capacity would be sufficient to respond to a range of construction job sizes (Elwan, 1989).

Numerous and serious constraints exist for the small and medium-sized contractor. Some of the more important ones include:

- Restrictions on ability to import required building products and modern, appropriate scale equipment and tools not available in the domestic market;

- Poor access to commercial credit (how much this is a function of the lack of experience in the commercial banking sector in terms of assessing the creditworthiness of real profit-making firms and how much is simply bureaucratic inertia and timid conservatism is unknown);

- Weak contract management skills that impede efficient expansion and ability to participate in bid competition (which is reported to have increased from 3 percent in 1983 to 24 percent in 1988, an impressive jump);

- Lack of skilled labor, especially in traditional skill areas such as plastering, carpentry, framing, and masonry;

- Undifferentiated and onerous administrative procedures (such as uniform tax reporting forms for the smallest or largest firms).

Building materials industry There is a paucity of current data describing the structure and general performance of the building materials industry in Hungary. It appears that the state still continues to hold a dominant though not monopoly position on building materials production and distribution. At least up until 1985, the industry was organized as described below.

On the production side, it appears that the major inputs for residential construction such as cement, lumber, and steel are all produced by SOEs. Private sector competition may have been opened up for some building materials such as red bricks, insulation, roofing and floor tiles. It is not known whether equal or partial access has been granted to private firms for the manufacture of construction equipment, tools, hardware, and fixtures, for example.

On the distribution side, in 1985 the dominant distribution channels belonged to state entities. Some producers (e.g.,steel, cement) supplied materials directly to the construction SOEs and cooperatives on a priority basis and then filled orders for private firms. Most other building products were distributed through a network of building materials distribution centers (EPTEK) and consignment stores run by EPTEK which sell building materials in smaller quantities (World Bank, 1985). As of early 1990 building materials are sold by both state and private stores. Small contractors purchase from private stores, whose prices are only moderately higher than those of the state stores. Consistency of availability may be a problem.

The constraints facing the industry include:

- Perceived inability of existing light industry to manufacture the range of products, tools, and equipment needed to construct high quality, non-prefab residential housing;
- Lack of management skills and technological know-how inhibiting development and growth of productive private building materials producers and distributors;
- Lack of private sector access to commercial credit to finance plant, equipment, and inventories;
- Perceived lack of competition in the building materials distribution system;
- Lack of clarity on the structure and operation of the building materials distribution system.

Allocation and tenure

Historical overview. Uniform rent controls were introduced in Hungary in 1950. By 1970, rents consumed only about 2-3 percent of the average household budget. Maintenance costs were estimated to be 3 times higher than the municipal agency received from rents (Baross, 1987).

The first Housing Reform of 1971 ushered in a complicated multi-channel system of allocating housing and subsidies. Apartments and applicants were classified by categories. A queuing mechanism was introduced that ordered applicants by social status, number of children, per capita income, socio-political merits, and other non-welfare measures. Local authorities were in charge of allocating flats to households. The reform also required that families assigned to them pay a "housing user-fee," or key money. As explained by Daniel and Partos (1989), the process proceeded as follows:

> Dwellings built according to different constructions schemes received different amounts of state subsidy, which was reflected either in the amount of the apartment's key-money in the price of the apartment, or in the terms of the loan. The various construction schemes were as follows (in order of decreasing state subsidy):

- State-owned rental dwellings allocated by local authorities to low income applicants, where the tenant had to pay key money for the apartment in addition to rent;
- Dwellings sold by the local authorities to applicants with the higher per capita income;
- Dwellings built with National Savings Bank investment, but sold by local authorities or by the applicant's employer;
- Dwellings built with the investment of housing cooperatives, but sold by local authorities;
- Dwellings both built with National Savings Bank investments and sold by the Bank;
- Dwellings built with the investments of economic organizations (enterprises) and sold by them;
- Privately-owned single family houses.

One effect of the allocation criteria was that it resulted in privileged access by the elite to the most heavily subsidized and best quality housing. The urban managerial class was able to exploit the housing allocation channel that would provide them with the best housing solution, irrespective of their income (Baross, 1987). It was an inefficient use of the housing stock: it targeted subsidies to the building, not to the need of the household, and levied an unequal financial burden on the less well off household.

The Housing Reform of 1982-1983 substantially reduced this differentiation of allocating preferential loans and subsidies according to settlement categories and types of construction. It also unified the system of subsidies for construction based on private sources and the different types of private construction (condominiums, units built by the National Savings Bank investment, privately-owned single family houses) received very similar access to preferential loans. The new unified loans carried terms of a 3 percent interest rate and a 35 year loan period. To protect the National Savings Bank from decapitalization resulting from inflation, the state subsidized the interest up to 7 percent (Daniel and Partos, 1989).

However, several other types of behavior indicative of market distortions continued unabated. These included the operation of a dual housing market and a "gray" market.

Dual housing market. The 1968 economic reform package sanctioned employment outside the formal state and cooperative enterprise sector and led to a flourishing second economy of largely unregulated, higher wages. In the housing sector this had the effect of stimulating savings and the investment of these additional resources in the private production of housing. While this eased the burden somewhat on government expenditures devoted to housing investment, it also exacerbated existing inequalities and distortions in the sector. Those enjoying two streams of income were able to either enter the privately owned housing market or were able to bid up the price of rental housing.

Households who rented flats from the state could sell their tenancy rights, or under a reprivatization initiative could sell their unit back to government at a price approximating market value which permitted tenants in effect to capitalize their subsidies.

Two other practices evolved. Because of lifetime occupancy rights, tenants in state-owned rental housing actively swapped flats to collect key money which has been estimated to fluctuate between 3-5 times the yearly rent payment. Those with several incomes were able to pay the premium while households with lower incomes who were in the housing queue were often forced to seek sublets in either publicly or privately owned housing. Sublets did not fall under state rent control policies and a flourishing market in higher priced, often exploitative, sublets ensued.

Current situation in rental housing. Hungary has approximately 3.9 million housing units. Of these, about 800,000 or about 20 percent are state-owned rental apartments, over half of which are concentrated in Budapest. Although rents were increased about 250 percent in the early 1980s and are expected to increase by another 100 percent this year, heavy subsidies continue to make rental housing the most attractive and affordable housing option. Although recent efforts have been made to target subsidies according to the number of children in the family, a coherent welfare policy of basing subsidy according to need has not yet emerged. To reach market levels, rents would have to be increased 400-500 percent from 1989 levels (Wright, 1990).

The subsidy policy continues to sustain several inefficient practices:

- Even the highest paid workers still enjoy privileged access to low rents;
- Lifetime occupancy rights and large subsidies, together with the high cost of new housing, have created a kind of freeze on the supply of available

apartments on the market which in turn has had a devastating effect on the ability of workers to exploit demand for labor in other locations;

- Even with the increased rent levels, rents collected cover only about 50 percent of the amount needed to cover maintenance.

This last factor has led to an increasingly dilapidated rental housing stock, currently estimated at up to 200,000 units. In Budapest alone, about 120,000 units require extensive renovation. Deferred maintenance constitutes a continuing financial threat to government and is a major reason that government is actively promoting privatization of state flats. The intentions is to pass on the accumulated deferred maintenance costs to the purchaser. However, many of the flats offered in the program to date have been the oldest and smallest in the rental stock and are not in demand.

In early 1990 rents were raised 35 percent, but annual inflation is running about 20 percent. In addition, the 1990 legislation introduced a housing allowance system which caps rental payments at 25 percent of income (Tosics & Hegedens, 1990).

Current situation in the private ownership market. The average price of a new dwelling unit in 1988 was reported to be Ft.2 million—or $37,735 at the 1988 exchange rate (Parry, 1989). This is more than twice the reported average cost of construction in 1988. An average housing unit is now estimated to cost 10-14 times the average household income in Hungary. Though reliable income data is notoriously difficult to come by in Hungary, one source reports average household income in 1988 at Ft.220,000, which (at $1=Ft53) is $4,150 per year or $345 per month (Parry, 1989). This compares to 2.5 for some developed countries and a value of 5 to 6 for most developing countries. However, this estimate does not include all second economy income and therefore may be overstated (Wright, 1990). In any event, housing affordability remains one of the most perplexing and pressing issues in the sector today.

One emerging feature in the private housing delivery system is the creation of a real estate service industry. By the middle of 1989, 55 real estate broker companies were reported to have set up shop, 30 of them in Budapest. Commissions average 2-3 percent. Although the shift to the brokerage system from the state setting home sales prices is reported to have caused a 15-20 percent increase in home prices, it has also widened the range of choices for the home seller who previously had to rely exclusively on OTP and other banks to price their house (Parry, 1989). Each local council also operates a real estate office to serve buyers and sellers of the housing stock and the land it owns.

2. Housing Finance

Finance for housing includes both development or construction period finance and take-out or mortgage financing. The situation in Hungary is somewhat different from other CPEs due to the government's experimentation with indirect instruments over the past twenty years.

Development period financing. The story here is very simple. Commercial banks lend to the large construction enterprises at standard rates for residential as well as other development. Such financing is not always needed, however, as when the state allocates funds for the development of flats the funds are available to pay for the project's development. On the other hand, small builders do not now have access to development period credit facilities. Beginning in 1989, interest rates on these loans have been at market rates.

Take-out financing. The terms under which long-term finance was provided prior to 1989 is a complex story, a complexity which paralleled the numerous distinct channels through which housing was developed and delivered as described earlier. The 1989 reforms produced a major simplification in the sense that all consumer borrowers of the same family size now face the same terms; however, the terms vary among different households sizes as discussed below.

Rental housing

Like the macroeconomic planners, those dealing with the housing sector have tried a number of different approaches over time. The highlights of the evolution of rental housing finance can be summarized in the following five points.

- Prior to 1971 rental housing was financed in the classic CPE fashion through a combination of grants from the state budget and no interest, very long term loans to local governments. Rents were held to 2-3 percent of household incomes—insufficient to cover operating costs, which were partially met by additional subsidies.

- The reforms of 1971 were geared to increasing the share of the total costs of rental housing paid by tenants and to requiring tenants to make significant payments (key money) prior to occupancy. The rent increases of 1971 were one-time affairs which were soon eroded by inflation (Daniel & Partos, 1989, p.20); rents were raised again in 1983, but again on a one-time basis (Ministry of Finance, 1983). The exact situation currently is not known, but substantial rental subsidies continue (Daniel & Partos, 1989).[5] Rents do vary to some degree with unit location and quality (Ministry of Finance, 1983, pp. 17-18).[6]

- The development of state rental units was sharply curtailed in favor of cooperatives in the 1980s. There is, however, not a great difference between rental coops and state rentals.

- Hungary has had an ambitious program of selling rental units to their occupants. The State's objectives in selling the units were to reap a one-time revenue windfall and to pass along to the new owners the cost of the renovations that many buildings needed. These objectives were not realized as tenants in deteriorating buildings were reluctant to buy the units and because government provided huge subsidies to the purchasers —in terms of low prices and 3 percent long term loans from OTP. Only about 10 percent of state rental units have been sold to date.

Owner-occupied housing

The watershed in housing finance prior to 1989 was the package of reforms implemented in 1983 which imposed a fairly unified set of financing terms on households, regardless of which of the housing distribution "channels" they were acquiring their unit through. The standard terms were an interest rate of 3 percent on a 35 year loan; maximum loan-to-value ratios were 60 to 70 percent, although these were seldom reached because of loan maximums (Daniel & Partos, 1989, p. 17). The state granted a modest up-front subsidy, which varied with family size. If the cost of a unit exceeded a norm, the interest rate was 8 percent, the term reduced to 15 years, and a lower maximum loan-to-value ratio applied; however, apparently only a small number of units fell into this category.[7] The OTP in urban

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5 We have not identified estimates of the total cost of such subsidies or of the cost of all housing sector subsidies as a percent of government expenditures or GDP.

6 The key money charges have been significant. In 1983 they could be as high as Ft.70,000 (Ministry of Finance, 1983, p.12). Tenants were, however, permitted to borrow from the National Savings Bank (OTP) at highly subsidized rates for this purpose. Importantly, these payments have given the tenants right to sell the occupancy rights to the units; in effect this allows tenants to capture the capitalized difference between the subsidized rent and market rents (Daniel & Partos, 1989, p. 23). The "purchasers" of these units are generally households with "second economy" incomes.

7 Data on loan terms from Ministry of Finance (1983), Chapter II.

areas, with its 600 branches, and savings cooperatives in the countryside were the only institutions providing mortgage credit.[8]

The 1989 reforms simultaneously moved housing finance toward market conditions and then introduced whole new clusters of subsidies to insulate home purchasers from the impact of higher interest rates on housing affordability. As noted earlier, among the innovations introduced in the reform package were:

- Moving interest rates up substantially, from 3 percent to an effective rate of 18.8 percent, closer to but still not at a market rate;

- Making the standard loan instrument an adjustable rate mortgage (however, it is still not clear to what index interest rate changes have been tied, what the schedule for adjustments is, and whether there are consumer protections included);

- Permitting direct competition between commercial banks and the National Savings Bank, on both the asset and liability sides of the balance sheet; while some commercial banks have begun competing sharply for deposits from individuals, they are generally approaching consumer lending—including mortgage lending—cautiously.

A very recent and positive step in diversifying and expanding real estate lending has been the creation of an independent, private financial institution in Budapest, the Real Esta e Bank Ltd. This institution, which is a subsidiary of the Hungarian Credit Bank (MHB), will specialize in mortgage lending as well as financing for commercial and residential development and offer real estate brokerage services (Parry, 1989 and 1990).

The subsidy system introduced at the same time consists of up-front grants or remissions and reductions in the mortgage payments required, i.e., interest payments are reduced.[9] All borrowers with children receive both types of subsidies, although the amount of each subsidy received by a household depends on its size—larger households get larger subsidies. (Childless couples only get the mortgage payment subsidy.) While there is a single program for up-front subsidies (the Socio-Political Subsidy), there are three different interest payment subsidies for

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[8] Beyond the subsidized loans from OTP, home purchasers could obtain additional assistance from three sources: interest free loans from employers for Ft 100,000 to 150,000; a "social allowance for children" which in the 1980s covered about 10 percent of the cost of construction; and, local council grants which only began in 1986 and provided Ft 100,000 to 150,000 (Daniel and Partos, 1989, p. 18).

[9] This description relies heavily on Parry (1989).

which a household can qualify.[10] The interest subsidies are additive. The interest subsidies last for 15 years and are reduced in steps over time. Apparently for childless couples there is a single reduction to a lower level at the end of the fifth year of the mortgage; for families with children there are steps at the end of the fifth and tenth years. Thus, taken as a whole, the system can be fairly complex. The effects of these subsidies can be summarized with reference to two cases.

- A childless couple purchasing a Ft3.4 million home with a 70 percent loan would not receive the downpayment subsidy. They would obtain 30 percent relief on their mortgage payment for the first five years and a 15 percent reduction over the next ten years.

- A family of four purchasing a Ft4.3 million unit with a 70 percent loan would receive a Ft200,000 subsidy for its downpayment. Mortgage interest payments would be reduced by 36.6 percent for the first five years, 33 percent for the next five, and 31 percent for years eleven through fifteen, at which time the subsidies end.[11]

Obviously, these subsidies are deep, similar of those granted higher income American households through the tax system. It should be emphasized, however, that beginning in 1989 these subsidies are being explicitly financed from the budget, with OTP being reimbursed for its lost interest charges. Thus in contrast to earlier periods, government will know the cost of these subsidies accurately. Overall, the housing finance system in Hungary has been and continues to be used as a wide channel for directing subsidies to both renters and homeowners.

The total subsidies to the housing sector are staggering—in 1989 about 4.5 percent of GDP. These are roughly evenly divided between support for rental housing and homeowner interest rate subsidies (Hegedus & Tosics, 1990: 16).

C. TECHNICAL ASSISTANCE AND TRAINING

This section outlines types of possible technical assistance which could be provided in Hungary's housing sector. There are three general objectives in providing such assistance: to improve the efficiency with which housing is

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10 The first two are the General and the Dependent subsidies. The third is conditioned to a household having participated in a contract savings scheme.

11 It is not clear whether households can still obtain additional subsidies from their employers, local councils and through the "social allowance for children" which were available prior to 1989.

developed, delivered and managed in order to lower housing prices and increase production; to help actualize latent demand for housing through increasing the availability of mortgage financing at market rates; and, as part of the conditions for providing effective assistance, to change those government policies which now interfere with well-functioning markets.

The discussion on technical assistance is divided into three parts. The first considers options for the "real" sector, i.e., housing production and delivery. The second focuses on housing finance in the context of broader financial markets. Section three summarizes the discussion of the prior sections. The focus is on actions that will encourage the development of a vibrant housing sector, encouragement that will come from elimination of impediments to small producers developing housing efficiently and expanding over time and to households being able to freely compete for housing services and assets in the market place.

We have omitted from this discussion assistance with several large scale actions that would be instrumental in improving the volume, and possibly the efficiency, of sectoral output which we view as beyond the scope of this work. Such actions include: reforming local government finances to make local governments more capable of funding infrastructure investments; developing a major infrastructure investment program for servicing vacant land for residential purposes; creation, to the extent still necessary, of a legal structure and regulations for privatizing SOEs; reform of the rent and allocation policies for rental housing; and, reforms in land law as necessary to facilitate land transactions and titling.

1. Housing Production and Delivery

Hungary's housing delivery system is subject to major inefficiencies. Most prominent are the problems in urban planning, land transfer and infrastructure provision. Management, including financing, of existing rental complexes is another major problem area. On the other hand, the construction industry is in relatively good shape compared with typical CPEs.

In this section, technical assistance to support reforms of the housing production and delivery system is addressed in three separate sub-sections: (1) planning, land and infrastructure; (2) construction and building materials industry; and (3) Allocation, tenure and management.

Planning, land and infrastructure: Context

The limited material available on these topics suggests that a detailed analysis is needed to identify the principal constraints which affect production and delivery of housing. In particular, the following characteristics of the system indicate the need for such analysis:

- Apparently there is no inventory of land with clear demarcation of state owned versus municipal owned versus private land.

- Stringent laws intended to prevent land speculation prohibited private developers from assembling land to build for sale housing. Although this restriction was supposedly lifted in 1989 it is not clear if the present regulations really allow land banking by private developers.

- It is clear that there is an acute shortage of serviced land for housing construction.

- Local councils have the sole responsibility for provision of infrastructure but do not have a well developed resource base. Planning/zoning procedures are rigid and very time consuming.

Technical assistance

Local councils are the key institutions in this element of the housing production and delivery system in Hungary, and technical assistance should be directed to improving their capabilities and policies.

1. Identify regulatory constraints to private sector housing development. While government policy clearly intends to encourage a greater private sector role in the production of housing, it is not clear that the existing planning and regulatory processes are suited to the changing role which local councils must play as facilitators and managers of urban growth primarily through indirect control and incentive mechanisms rather than through direct control over investment decisions. An important element of a technical assistance program for local councils would be a review of regulatory instruments such as planning standards, subdivision ordinances, building codes and zoning ordinances as well as an assessment of the overall planning process and the procedures required for obtaining permission to develop land. The objective of the study would be to recommend changes needed to streamline procedures and eliminate unnecessary constraints on private sector development while retaining the ability of government to influence the pattern of urban growth. The results of this study could serve as the basis for the development of a broader program of assistance with regulatory and administrative reform. This program of assistance might employ the strategy of focusing on one city first, and then promulgating new flexible procedures to other cities after they have been tested in the pilot city.

2. *Provide training in the utility of public/private partnerships.* Local councils in Hungary have broad authority for housing and for provision of infrastructure, but they do not have a well developed local tax base. They do have certain capital assets, however, such as land and a stock of rental housing as well as regulatory powers over land use and density which can be used to create land value and to stimulate private sector investment.

One approach is to provide training supported by short term advisory services to key municipal agencies or departments to assist them understand how to make use of government resources such as dilapidated (vacant) housing stock or state owned land to make private development happen, i.e., how to create private sector initiative in housing. The training could focus on understanding how public/private partnerships have worked in other countries. The short term TA could be aimed at assisting local councils formulate one or more public/private partnerships and in training key staff in such skills as land economics.

Other donor actions

It appears likely that the World Bank will develop a program which includes broad technical assistance to local councils in Hungary aimed at strengthening their administrative structure and ability to mobilize resources in order to improve the availability of urban land and infrastructure for housing construction.

In addition, the EEC may make large infrastructure loans available through the Eastern European Development Bank or through a new Bank for European Reconstruction and Development which has been proposed by the French government.

Construction and building materials industry: Context

The problems of producing building materials are myriad and there are substantial inefficiencies in housing development. Competition in both areas will increase efficiency and lower the cost of housing. Recent policy changes make this possible, but technical assistance could help to assure success and speed the process.

Technical assistance

1. Increase competition in the building materials industry. Competition in the building materials industry (both production and distribution) would help improve efficiency and lower costs. An aggressive program of privatization should be undertaken. Technical assistance in support of this objective might include:

- A study of specific building materials and building products to identify supply side as well as demand constraints, including the comparative advantage of domestic production versus importation;

- A team of advisors working with the Ministry of Industry to formulate a strategy and implement the actual privatization of individual enterprises, assuming the necessary framework for sale of SOEs were in place.

2. Increase competition in the construction industry. Competition in the construction industry, while much greater than for building materials, could still be improved. Especially important is the emergence of middle-sized private firms, since there are many private, small producers now operating and competing in the market. There are two areas of technical assistance that would support this process.

Privatization of construction SOEs. Assuming that after due analysis, Government decides that there is a continuing market for industrialized housing, then one approach might be to aggressively undertake to privatize the SOEs engaged in construction. This approach would most likely involve separating off specific functions such as equipment leasing or window frame assembly, a process known as "shredding," and is unlikely to lead to creation of large, private sector construction companies. A core state company making and assembling panels might remain. A TA strategy similar to the one outlined above for privatization of building material production enterprises might be followed:

- A study of the construction enterprises and their role in the system;

- A team of advisors to draft a strategy and assist with privatization of individual enterprises.

Obviously, carrying out this initiative is contingent upon government resolving a host of issues regarding the sale of SOEs in general.

Create incentives for growth of private sector construction enterprises. This approach would involve removing all advantages enjoyed by the SOEs (this has already taken place in theory) and restructuring the way local councils invest their resources. Small firms while already providing a large share of total production appear to still be operating at distinct disadvantages compared with the SOEs. In addition to assuring them access to credit at market rates (discussed below), a careful analysis of the access of these firms to building materials, equipment, and buildable sites could be undertaken to identify specific impediments that continue to exist despite broad policies to the contrary, and to outline government actions that would end these practices. This could have a major, short term effect on improving sectoral performance.

Other actions to foster the development of private construction and development firms could be undertaken. A specific program might would include:

- Bidding on government funded projects;
- Subdividing projects into small enough packages that new private contractors can compete for them;
- Providing mobilization advances or other assistance with construction period financing as part of bid package.

Short term TA could be provided to assist local councils with these three steps. Training and TA for the newly emerging small contractors would also be helpful. The primary areas for TA would be:

- Project scheduling and construction management;
- Cost estimating and preparation of bids;
- Project accounting and cost control;
- General principles of business planning, organization and management.

Assistance with formulating a regular series of training courses offered under the auspices of an association of general contractors or the National Training Center (now open only to SOEs) may be the most effective way to provide such assistance and training to private contractors.

Other donor actions

Consultations with World Bank staff indicate that restructuring the state construction enterprises is an area of primary concern. The World Bank has also indicated an interest in undertaking a study of the construction industry in

Hungary and has solicited A.I.D. participation. In addition, there are other donor resources that could be used.[12]

Allocation, tenure, and management: Context

Hungary has a very complex system of allocating housing. Rents have not covered maintenance costs in rental units, thereby producing many dilapidated units; and second economy incomes have produced increasing differences in housing consumption levels among households.

Technical assistance

1. Homeownership housing. Transactions costs, in particular the cost of assembling information on current ma rket conditions, are a major impediment to an efficiently functioning market for units and sites to purchase in Hungary (Tosics & Hegedus, 1990). Even though nascent brokerage firms do exist, information on prices of recent transactions is still very difficult to assemble. Word of mouth is the standard way of obtaining these critical data. Yet these data are collected by local registrars when land and units are sold. Moreover, because transfer taxes are low and because registrars study transactions looking for outliers, the figures reported by buyers and sellers are believed to be reasonably accurate. The data are not released, however, because of existing regulations.

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12 The Eastern European Fund created by the EEC has substantial grant funds available to assist industry and credit investments in Hungary; mainly for small- and medium-sized enterprises.

The SEED Enterprise Fund for Hungary can be used to support and strengthen local private building materials firms and to explore joint-venture prospects and opportunities.

TDP can fund feasibility studies for U.S. building products manufacturers interested in establishing joint venture operations with Hungarian firms.

U.S. and European investment funds targeted for Eastern Europe could help capitalize direct U.S. investment in Hungary by U.S. construction tools, equipment, building materials, and building component manufacturers.

The Center for Privatization has grant-funded resources from PRE and could assist in formulating and implementing privatization of the construction SOEs and of specific building material enterprises as an extension of work under way in Hungary. The Center presently has an advisory team in the field working with the newly-formed National Property Agency which is charged with privatization in Hungary. The NPA currently has a goal of privatizing 20 percent of Hungary's SOEs within 3 years.

A prior step to providing technical assistance for setting up an information system would be to change the rules governing access to the data. Some observers believe that officials are unaware that standard practice in the west is for such records to be fully open to the public. Assuming the changes were achieved, then the TA would help set up a system for reporting prices or representative transactions on a periodic basis, extracting information from the data already compiled by the registrars. A key issue would be determining how best to promulgate these reports, and this would require working closely with Hungarian counterparts.

2. Rental housing. The U.S. has acquired an impressive body of experience at both the national and local level in managing low- to middle-income public housing. While the donors have not traditionally been involved in rental housing programs, there are two areas where U.S. expertise could be of particular value in Hungary.

Rehabilitation and sale of dilapidated units. In Budapest alone, about 120,000 units require extensive renovation; the nation-wide estimate exceeds 200,000. Deferred maintenance constitutes a continuing financial threat to government and is a major reason that government is actively promoting privatization of state-owned apartments. The intention of the present policy is to pass on the accumulated deferred maintenance costs to the purchaser. This approach has not been well-received and an alternative is clearly needed. Technical assistance could be provided in the form of a series of short term missions to help local councils privatize publicly-owned housing by developing partnership arrangements with private developers. The developers would rehabilitate the dilapidated units and offer them for sale to individual buyers as condominiums or to investors who would hold them as rental investment properties. A number of foreign companies ae negotiating with the government about rehabilitating and selling large blocks of rental units into up-scale condominiums. Reportedly the negotiations about treatment of sitting tenants, sales prices and other factors are quite complex.

Housing estate management. Technical assistance and training in the form of short courses and short-term consultancv missions could be made available to local council housing bureaus to assist them with the formulation of self-sustaining rental project operations. These programs must be based on full recovery of capital and financing costs.

The U.S. has a cadre of competent managers of large multifamily residential properties who know how to plan and implement efficient programs of property renovation and to design and operate efficient project maintenance programs. The skills of these managers could be used to restructure operations and finances of a few pilot projects, training managers as they did so, and then conduct broader training short-courses.

For either of these initiatives to work would require that it be possible to obtain the essential financing, bridge financing in the case of redevelopment of the dilapidated units and longer term loans to support improvements of the rental properties. For such lending to happen will require that commercial banks become more skilled in underwriting these types of loans and that they price credit in line with the risks to which they are being exposed. In addition, both initiatives would require broader reforms in rent setting, or the exemption of renovated structures from the existing controls.

Other donor actions

The World Bank had identified the need to improve management and pricing of rental housing as a key sectoral issue in Hungary. It is likely that the Bank will undertake a program aimed at restructuring rents on a market basis and targeting housing subsidies in accordance with income. The technical assistance proposal above could significantly enhance such an effort.

2. Housing Finance

Improving Hungary's housing finance system would provide two types of benefits to the country. In terms of macroeconomic implications, if done well, reform in the housing finance system could eliminate or at least substantially reduce the very large subsidies still allocated to the sector through the housing finance system, increase the efficiency with which the financial sector operates, and be an important source of innovation in the sector. In addition, more housing would be produced, responding to a popular demand.

Critically, housing finance offers an area of action which has important macroeconomic implications but which permits many improvements to be made relatively independently of the full transformation of the economy to a market system. At the same time, however, for reforms in housing finance to be successful they must be accompanied by actions in other sectors, as outlined below.

Context

Before discussing specific areas in which technical assistance might be provided, it is useful to recall several key attributes of the current situation in Hungary in financial markets and the housing sector:

- The OTP (National Savings Bank) has had a monopoly on mortgage lending in urban areas, while cooperatives have had the same powers in the countryside. The MHB (Hungarian Credit Bank) since January 1989 has begun significant mortgage lending and several other commercial banks appear to be marginally involved (Parry, 1989, p. 8).[13] Mortgage finance is reported to be readily available.

- In January 1989 Hungary took the critical step in reforming its financial sector of removing impediments to commercial banks doing consumer banking and to OTP expanding further beyond consumer banking than it had in the past. This creates the genuine possibility for competition for deposits and in lending.

- Interest rates charged on mortgages are 18.5 percent plus a point for fees; these are close-to-market rates. A variable rate mortgage instrument has been introduced.

- A complex and pervasive subsidy scheme, involving both up-front grants and below market interest rates, has been put in place to aid home purchasers. In addition, many workers get even deeper subsidies from their employers or Tanacsok.

- The Hungarian banking system suffers from a severe shortage of staff trained in underwriting loans on a businesslike basis.

- Capital markets, while still nascent, are developing steadily and rapid future growth is expected.

Technical assistance

Four types of technical assistance in housing finance could be provided. They include improving loan origination, introducing more appropriate mortgage instruments and eliminating subsidies, tapping new sources of funds for housing lending, and encouraging more competition in mortgage lending.

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13 There appears to be some disagreement about the degree to which other banks besides the OTP are lending for housing. One IMF staff member recently returned from Hungary thought that OTP still had a virtual monopoly, while, as stated in the text, Parry (1990) reports that MHB has been making a significant volume of mortgage loans.

1. Loan underwriting. In Hungary, like Poland, the tradition of directed credit with little regard for the ability of the borrower to repay has left a legacy of banking staff poorly trained to underwrite loans rigorously. This situation is endemic in the banking system, and GOH is taking steps to upgrade these general skills on a crash basis, including hiring consultants from outside of the country.[14] Unclear, however, is the extent to which the general training will extend to consumer lending and to mortgage lending in particular. Moreover, and equally important, it is not clear that reasonable underwriting guidelines are being developed for use by the residential loan underwriters and loan officers. It appears that Hungary could use assistance in underwriting development period loans as well as individual mortgages.

Mortgage underwriting. The surge in default rates on single family mortgages in the U.S. during the second half of the 1980s may hold a lesson for Hungary. In the U.S. both the mortgage insurance industry and the secondary mortgage facilities (Fannie Mae, Freddie Mac) failed to properly understand the risk of the new adjustable rate mortgages (ARMs) and to identify a broad increase in the riskiness of loans with very high loan-to-value ratios. The liquidity of the system itself may also have contributed to lax underwriting practices. The upshot was losses of billions of dollars and the failure of several private mortgage insurance companies. Hungary is in this sense at the same point as the U.S. lending industry was in the early 1980s, confronted with new mortgage instruments and potentially large changes in consumer behavior.

The training necessary should, therefore, begin with a full assessment of the guidelines and standards now in use, measuring them against the risks associated with the new mortgage instruments and the altered risks of lending to borrowers who could become unemployed or suffer significant short-term income losses. Obviously, it would be essential to work with Hungarian bankers in defining the new guidelines. Once these are in place, training for loan officers and underwriters should take place as quickly as possible.

Underwriting construction period loans. The inability of small residential construction firms to obtain financing is widely cited as a serious impediment to the growth of small firms. Financing appears to remain a problem despite 1989

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14 The consulting division of Citibank, for example, has been working with two commercial banks.

regulations instructing banks to make loans to small firms for up to 18 months. One of the reasons for the lack of lending by commercial banks to such firms is bankers' unfamiliarity with this type of lending and their concerns about evaluating the risk associated with these loans. Again, development of underwriting guidelines and assistance in applying the new guidelines to a number of loans of this type could be instrumental in permitting badly needed financing to flow to the small producers.

Consideration should be given to providing a package of assistance for underwriting residential loans—both development period and mortgages. One of the conditions for assistance could be that each participating bank provide loan financing to small and medium sized firms (perhaps as judged by number of employees) for credit worthy developments that would together produce 2,000 to 3,000 housing units. Hopefully, the experience of this initial lending will encourage the banks to continue lending to these firms.

2. Mortgage instruments and subsidies. As described earlier, the current mortgage instrument is an adjustable rate mortgage (ARM) carrying an initial rate of 18.5 percent. This is a close-to-market rate, if one uses the rate at which T-bills are sold at auction as the bench mark—annual rates of around 23 percent. As far as can be determined, the index to which ARMs are to be tied has yet to be defined. A matter of policy priority should be to move the interest rate to the market rate.

The shift to the ARM is certainly a very important improvement. However, it may be possible to do better. The Hungarian economy will likely undergo significant stress in the years ahead, with wages lagging price increases episodically and perhaps for extended periods. In this environment introduction of the dual-indexed mortgage (DIM) would provide an added measure of protection to both lenders and borrowers, and its adoption should be strongly suggested to the Hungarians. (The DIM is outlined in the discussion for Poland.)

In addition, the simple shared appreciation mortgage (SAM), described above, could also be introduced in conjunction with DIMs as a method of eliminating (or at least greatly reducing) the need for subsidies in Hungary. Under a SAM the lender buys part of the home and shares in the house's appreciation over time. So, for example, if the bank bought 30 percent of a home, it would receive 30 percent of the sale proceeds when the unit was sold. The bank is betting that house appreciation will be a good investment, as real estate usually is in economies at this stage of development. (Of course, the property supporting each loan would have to be carefully evaluated.) A lien is placed on the title to enforce the bank's claim. As suggested for Poland, the household might be required to buy back the bank's interest in the house—possibly through another loan—when it had paid off its mortgage (assuming the bank found the household a good credit risk for the second loan). The current interest rate subsidies reduce monthly payment by about 33 percent for a household of three. (The up-front subsidy cuts costs by another 5 percent.) Thus, under a SAM in which the bank held a 30 percent interest the home would nearly wipe out the subsidy and hold affordability constant. Because a maximum 70 percent loan-to-value ratio is standard and often the ratio is substantially lower in practice, the household would still have a very strong interest in maintaining the unit and making its payments.[15]

If SAMs were adopted, the funds generated through the bank's purchase of part of the home should go to eliminating the interest rate subsidies. Although the interest rate subsidies are reported to have been transferred to the budget (IMF, 1989, p.39-40), having any remaining subsidies in the form of up-front equity contributions makes their magnitude absolutely clear and eliminates the temptation to assign the interest subsidies back to the banking system.

Obviously, these are new instruments for Hungary and they would need to be introduced with great care. Assuming government approval of the instruments and the implied policy changes associated with SAMs (if they were included in the package), the broad technical assistance elements are clear: bankers would have to understand them fully, proper software must be installed for changing monthly payments and tracking payments, legal procedures for placing liens on the property would be developed, and borrowers would have to be educated about the terms and conditions of such instruments. Each of these tasks can be done with moderate effort, but the package together is a substantial undertaking.

3. Funds mobilization. The basic choice in a funds mobilization strategy is whether to pursue small depositors or large blocks of funds. The second

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15 Under the SAM with a 70 percent L-T-V the household would have a loan for 40 percent of the value of the unit. The other 60 percent would be split between the borrower's downpayment and the bank's interest in the property. The example in the text is based on data in Parry (1989).

approach is facilitated by well-functioning financial markets. Traditionally, OTP has generated its funds through deposits from households, for which in urban areas it had a virtual monopoly. Since January 1989, however, the situation has changed dramatically, with the elimination of the segmentation between banking services for enterprises and the traditional network for savings institutions for households. The integration of the two banking sectors was contingent upon reforming the housing finance system. Simply, because OTP and cooperatives had huge blocks of mortgage assets paying very low interest rates, the overall banking system could not be permitted to compete for household deposits until some arrangement was made to rid OTP and the coops of their low-yielding assets. As interest rates on deposits had been raised in recent years, this problem became increasingly acute. In the event, the state transferred the outstanding stock of concessional loans to a newly created housing fund in exchange for bonds with market-related yields. The losses of the housing fund were covered by budgetary transfers (IMF, 1989, p.39-40). This action created a level playing field on which financial institutions could compete for deposits, and such competition appears to be occurring.

With competition developing for deposits, it may make sense for OTP and other major housing lenders to look to other sources of funds (although they should continue to compete for deposits). There have been important developments in the nascent capital market in this regard. The ground work for establishing a stock market has been completed and a stock exchange is about to open; a number of enterprises have sold bonds and shares; at least one brokerage house has opened. In addition, the dozen small financial institutions created by government in the early 1980s, which have now evolved into commercial banks, and the half dozen insurance companies have increased the number of players in the financial market (Friedlander, 1988).

However, as noted earlier, the market for bonds has flagged since the beginning of 1987 when government stopped guaranteeing bonds issued by enterprises and price volatility made fixed rate bonds unattractive investments (Antal, 1989). In this context, the issuance of mortgage-backed debentures might be very attractive because investors would be able to readily evaluate asset quality for debt explicitly backed by pools of mortgages; asset quality could be strengthened further by the pools being overcollateralized. These instruments could be sold to institutional investors, but at least in the short term they would probably have to be marketed to the public as well, given the small institutional base. If this type of instrument were offered, it would be a genuine financial innovation.

Substantial technical assistance would likely be needed to design the securities to be sold and to work out internal procedures for the lenders offering them. Particular attention must be given to design issues. Variable rate instruments are probably a necessity. And it may well be that a mutual fund type instrument like that sold by Fannie Mae in Japan which has semi-annual payments and a bullet repayment of principal would be necessary for consumer acceptance rather than the standard type of pass through securities most common in the U.S. that produce uneven monthly payments. Bonds issued by banks might not be attractive to Hungarian investors, if they were not assured that their payments were explicitly tied to a specific pool of mortgage assets. Because one or two major housing lenders would be issuing the securities, the task of creating these instruments would be modest relative to trying to establish an actual secondary mortgage market. Therefore, only a matter of months may be required before debt could be issued.

4. Increasing competition. Banks other than OTP were permitted to do mortgage lending beginning in January 1989. One bank, MHB, has moved with alacrity into this market and other banks may be doing a small volume of such lending. Moreover, Parry reports that MHB is considering spinning off a real estate subsidiary that would do mortgage lending among other things. In short, there is evidence of the beginnings of competition among lenders, although it is not clear that they are now able to compete on price terms.

Fostering further competition might be done by assisting an institution new to housing lending with strengthening its internal operations and raising funds. It would be particularly desirable to assist a fully or mostly private bank to begin pulling the banking system from its nearly exclusive state ownership. However, it is not clear that this should be a very high priority compared with the actions listed above. The Hungarian banking system appears to be evolving fairly rapidly toward a competitive model, and the project team is not privy to GOH plans for increasing competition and diversifying ownership further. If the is a desire to move forward in this area, then the first step should be detailed consultation with government.

Complementary actions required. Several actions are necessary for the development of housing finance to continue unabated. First, various actions outlined above to increase the supply of affordable housing should be pursued; without them excess demand could result from expanded credit. Second, while there has been remarkable progress in the past several years in the development of the banking system and capital markets, more definitely needs to be done. For example, for the capital market to expand will require better information about the financial condition of firms offering debt issues and shares. Creation of a rating agency may be essential. Government should also work to create a real secondary market in its own debt, to pave the way for further trading. On the banking side, further loosening of interest rate controls is needed, and mortgage rates in particular should move to market rates. Indeed, it is likely that mortgage-backed debt issues will only be saleable if they carry competitive rates.

Other donor actions

The situation for Hungary appears to be quite similar to that for Poland in that the World Bank appears to be the only donor with a stated intention of working in the housing finance area. The Bank's there initial focus is on the introduction of the dual index mortgage.

3. Technical Assistance Summary

From the foregoing it is clear that numerous elements of the housing system in Hungary could profit from some form of technical assistance. Even for Hungary, however, it is difficult to specify priorities in assistance at this time: because the intentions of the other donors are still evolving, because A.I.D. has not determined the likely scale of the assistance effort, and because there remains much ignorance about key facts needed to design assistance in several areas. On the other hand, the pervasiveness of the sectoral problems suggest that there are many opportunities for successful intervention. It will likely be necessary, however, for the donors to remain flexible so as to be able to respond to distinct opportunities that arise.

Table 3.4 presents a summary listing of the areas discussed above and assigns to each a rough, qualitative estimate of the size of the commitment which assistance would entail and an indication of the "next step" in pursuing each. For reasons stated in the introduction to this section, we have not attempted at this stage to assign priorities to these opportunities.

There are, however, a couple of "opportunities" that may be worthy of early consideration. There may be a high return in terms of housing output and constraining price increases to analyzing remaining impediments to small contractors acquiring building materials, equipment, and sites on which to build. Similarly, improving the underwriting skills of bankers for making residential construction period loans may have a major effect on building activity by small producers. Importantly, the efficiency of the homeownership market could be sharply increased just by improving information flows. In addition, an early, in-depth examination of the planning and regulatory framework for housing development at the local level would pave the way for determining how large the task will be of streamlining current procedures. All of the actions (indicated by a "#" in the table) are candidates for quick action that could yield visible short-term improvements in the sector, since none of them is dependent on significant other actions within the sector or at the macroeconomic level.

Table 3
Summary of Potential Technical Assistance to Hungary

INITIATIVE	COMMITMENT LEVEL*	INITIAL STEP**
Planning, Land and Infrastructure +		
o Review and revision of planning and regulatory instruments	2	mission to identify constraints to private sector housing development and to recommend changes
o increase local government understanding of public/private partnerships	1	send key officials for special training course in U.S.
o design and implementation of program of public/private partnerships	2	mission to identify potential projects and to define TA and training program
Construction and Building Materials Industry +		
o identify remaining barriers to small builders producing efficiently	2#	study of impediments; recommended administrative actions
o design and implementation of programs to privatize state-owned building material industry	3	study of building materials production and distribution to identify candidate enterprises for privatization and to outline TA program
o design and implementation of program to privatize construction SOEs	2	mission to analyze the operations and structure of construction SOEs and to outline a plan for privatization and a TA program
o design and introduction of incentives for growth of private sector construction enterprises	1	mission to outline a specific plan and to define TA program
o design and implementation of training program to upgrade skills of private contractors	2	mission to define specific training needs and identify target institutions to delivery courses
Allocation, Tenure and Management		
o design and implementation of program to rehabilitate and sell dilapidated rental units	2	(see public/private partnership initiative above)
o improve housing estate management capacity of local housing authorities	3 #	mission to define TA needs and to organize management and training courses
Finance		
o strengthen underwriting of construction loans and mortgage financing	2 #+	exploratory mission defining specific TA program
o design and introduction of more suitable mortgage instruments	3	exploratory mission defining specific TA program
o design and introduction of new mortgage-backed bond to mobilize additional funds	2	exploratory mission defining specific TA program
o support to nascent housing lenders to increase competition	3	mission to analyze current situation, identify target institutions, and design TA program

* Commitment Level: 1--short duration, modest cost (<$75,000); 2--medium duration and cost ($75,000-250,000); 3--longer duration, more substantial cost(>$250,000).

** Following expression of interest by government.

+ Possible major constraint to expanded production

Activity with high short-term pay-off

4

SUMMARY OF SECTOR CONDITIONS AND TECHNICAL ASSISTANCE NEEDS IN POLAND AND HUNGARY

We have presented an enormous amount of material in the preceding chapters. Here we provide a comparative summary of the current situation in the housing sectors of Poland and Hungary as a way of unifying and clarifying the previous discussion. We first outline the current conditions and then give an overview of technical assistance opportunities.

A. CURRENT STATUS

Table 4.1 gives a summary of conditions in the two countries on a topic-by-topic basis. Viewed in this way, important similarities and contrasts are evident.

In terms of housing finance, both countries need to take steps to increase the availability of construction financing for contractors. Other issues require different approaches in the two countries. Hungary's more developed financial institutions and markets are a fundamental advantage which makes it possible for Hungary's housing finance institutions to consider raising funds by selling debt instruments in the capital market. In contrast, the underdeveloped Polish financial system precludes this possibility. Rather, emphasizing contract savings schemes may be appropriate for Poland for the next few years. Finally, neither Poland nor Hungary has yet to achieve market interest rates in their housing secotrs. Hungary may have come closer to nominal market lending rates but these have been eroded by a host of subsidies. On balance Poles are actually paying closer to market rates than their Hungarian counterparts.

Turning to the real side, the most striking difference is the current status of the residential construction industry in urban areas: in Poland private sector participation is nascent, while in Hungary it is dominant. One has some confidence that Hungarian contractors can respond to increased demand for units

Table 4.1

Current Status and Constraints Effecting the Housing Sectors in Poland and Hungary

Area	Poland	Hungary
Finance		
Construction finance to small & medium-size firms	Constrained by lack of underwriting skills and familiarity; loans are at market rates	Constrained by lack of underwriting skills and familiarity; loans are at market rates
Mortgage lending		
(a) interest rates	Lending still somewhat below market	Difficult to judge but lending appears at below market rates, and major subsidies remain
(b) mortgage instruments	ARM instituted in 1990; DIM would be better	ARM adopted in 1989; DIM would be better
(c) competition	PKO with near monopoly; more competition needed	OTP clearly dominant but competition developing gradually
Funds mobilization	Limited competition for deposits; positive real rates on deposits; contract savings schemes may be appropriate	Limited but increasing competition for deposits; interest rates on deposits equals the inflation rate; mobilizing funds with debt instruments may be appropriate
Real-side		
Construction industry	Very small private sector capability; major effort for removing impediments still in place may be necessary; restructuring SOEs required	Private sector quite capable, although may be still disadvantaged; restructuring of SOEs required

Area	Poland	Hungary
Building materials industry	Chronic shortages have been the rule; what the situation will be following the "shock" of the 1990 reforms is unclear; SOEs have a monopoly in both production and distribution	Current situation for both production and distribution is unclear, except that SOEs are heavily involved in both; private sector participation is emerging
Planning, land, and infrastructure	Process geared to providing sites for huge housing estates developed by kombinats; wholesale change needed, but details are unclear with available information; user fees may be appropriate for financing infrastructure	Significant bottleneck to housing production; local government responsibility; more analysis to define problems fully is required
Housing allocation		
(a) rental units	Situation changing very rapidly but at moment very deep rental subsidies and allocation appears to be by regulation	Rental subsidies are deep but major part of stock is being allocated through market mechanisms informally
(b) ownership units	Market allocation	Free exchange
Estate management	Insufficient maintenance a clear consequence of low rents; quality of managers is unclear	Insufficient maintenance is a clear consequence of low rents; quality of managers is unclear

(perhaps with difficulty because of the remaining vestiges of the earlier system), while this is not the case in Poland where the past dominance of the kombinats precluded the emergence of all but very small-scale contractors. (Of course, as a result of the shock administered to the Polish economy in January 1990, the residential construction industry is now in a very deep depression.)

The situation regarding the availability of building materials and construction equipment also appears to differ sharply between the two countries. Shortages have been a greater problem in Poland, either because of absolute shortfalls in production or because of poor distribution on the part of the SOE which monopolizes the industry. We are constrained, however, from saying anything more specific about this situation by a lack of information and any concrete idea of how the January 1990 reforms will ultimately effect the sector. In Hungary, SOEs appear to dominate the industry but private suppliers and distributors have been expanding.

Similarly, while we know that shortages of serviced sites--especially for small builders--are a major constraint in both countries, we do not understand the local planning process, land transfer laws and administration, and infrastructure provision processes sufficiently to offer more specific contrasts between the two.

Importantly, owner-occupied housing now appears to exchange openly and at market rates in both countries--a major change in the past two years. The efficiency with which the market operates can clearly be improved, but this is likely to happen in due course as more brokerage services and better information develop. Moreover, mortgage finance, at least with moderate loan-to-value ratios, appears to be generally available, although it is expensive and competition among lenders is very limited.

The rental market offers both similarities and differences. In both countries deep subsidies to the sector remain, although both are moving to reduce them. As to the allocation of units, in Poland the bureaucracy remains in control, while in Hungary a large and increasing share of units are being transferred under market processes--often outside of "official procedures". In both countries fundamental restructuring of the allocation systems is needed. Another similarity in the rental sector is the large stock of state-owned under-maintained projects which need to be repaired. It appears that estate management is generally weak and that major infusions of training and professionalism as well as cash will be required to save these projects from eventual early retirement.

B. Technical Assistance Needs

Any plan for providing technical assistance to these countries must divide the possibilities into two sets: those areas requiring additional study of the problem before any assistance, beyond some possible pilot projects, can be meaningfully suggested; and, those in which assistance can go forward more directly. Some large topics, unfortunately fall into the category of those for which more information must be developed before comprehensive assistance plans can be formulated. For both Poland and Hungary these include:

-- the privatization of SOEs engaged in residential construction

-- improving the supply and distribution of building materials and construction equipment

-- streamlining the process by which serviced sites are available to contractors, i.e., the whole urban planning, land transfer and administration process, and the financing and delivery of residential urban infrastructure.

Some of these essential studies are being launched by multi-lateral donors, some are in the planning stages, and others are yet to be addressed.

There are other areas in which technical assistance efforts could be launched in the near term with greater confidence. These include:

-- increase construction period and long term housing finance, strengthening underwriting capabilities, improving the mortgage instruments in use, enhancing the funds mobilization capabilities of housing lenders;

-- removing the impediments still faced by small residential construction firms in gaining access to credit, building materials and equipment, and buildable sites and formulating concrete steps for eliminating them;

-- improving the allocation and pricing of state-owned rental units; and

-- strengthening the capabilities of estate managers and assisting in pilot efforts to improve the quality of existing rental housing projects, with concomitant increases in rents to cover the improvements.

In considering action in each of these areas, one must be careful that the necessary preconditions are met. Rationalizing the pricing of state-owned rentals, for example, will have to be coordinated with incomes policies. Similarly for strengthened estate management to be productive it will have to possible for projects to obtain bank financing for improvements and to raise rents to cover the new debt. A blend of "quick start" technical assistance efforts along with the donor community sponsoring the studies necessary to create the foundation for further assistance in the future.

ANNEXES

OTHER DONOR PROGRAMS

1. IMF

The IMF Executive Board approved the Standby Agreement for Poland on February 6 1990. This will provide an amount equivalent to SDR 545 million (approximately $723 million) for the period February 5, 1990 to March 4, 1991 for balance of payment support conditioned on GOP progress related to its five-point stabilization program.

An IMF team returned from Hungary in mid-February with a reform package designed to reduce subsidies, depreciate the exchange rate by 10%, raise interest rates, increase revenue through taxes on housing loans as well as higher rents, and restructure 50 state enterprises or allow them to go into bankruptcy. The target for reducing the budget deficit is from $1.4 billion in 1989 to $550 million in 1990, equivalent to about 4% of GDP. In mid-February 1990, Hungary submitted a Letter of Intent to the IMF for a new agreement.

2. THE WORLD BANK

The World Bank approved two loans for Poland on February 6th, 1990, for Agro-Industry Export Development ($100 million) and for Industrial Export Development ($260 million). These first two World Bank loans are part of a package of more than $2.5 billion that the Bank is preparing over the next three years to help break economic bottlenecks and support reforms of the Solidarity-led Government. An appraisal team for a Structural Adjustment Loan (SAL) arrived in Warsaw on February 5. The SAL is not expected to be approved prior to June. The agreed level is $300, although the Polish Government is pressing for an increase to $500 million. The World Bank is planning a SAL of $200 million to support the Hungarian economy.

The Infrastructure and Urban Development Division (INURD) of the Europe, Middle East and North Africa Department (EMENA) of the World Bank sponsored missions to Hungary and Poland in January 1990 to evaluate the long-term implications of market-oriented reform of the housing sector. For both countries, the World Bank found that the main obstacle to reform of the housing sector is the structure of the construction industry itself, dominated by monopolistic, state-owned construction enterprises concerned more with the number of units produced each year than with responding to consumer needs. Preliminary conclusions were reached regarding the focus of future project preparation studies and likely priorities for technical assistance in the housing sector.

As part of a short-term strategy to stabilize the housing sector in Poland, the INURD favors an emphasis on fostering completion of units currently under construction by:

- Identifying ways of relieving various bottlenecks, particularily removal of arbitrary administrative and procedural restrictions that delay construction; and,
- Targetting subsidies or financing on a selective basis for completion of some of the unfinished stock of housing.

Priorities identified for further study to guide longer-term housing sector assistance in Poland include:

- Re-organization of the building materials supply and distribution system,
- Adjustments in land use regulation and infrastructure provision, and,
- Development of new financial instruments and new financial institutions to replace the housing subsidy system.

In Hungary, key sectoral issues tentatively identified by INURD for further study include:

- Improving the availability of urban land and infrastructure for housing construction by strengthening local government administrative structure and resource mobilization,
- Restructuring state construction enterprises,
- Improved management and pricing of rental housing, and
- Targetting housing subsidies in accordance with income, replacing the current subsidy based on family size.

The World Bank will be sponsoring a conference on housing in Eastern Europe on April 18th and 19th, 1990.

3. EUROPEAN ECONOMIC COMMUNITY

Responsibility for coordinating the West's aid to Poland and Hungary was given to the European Commission (EC) Executive (the Commission, in the strictess sense, comprises the 17 individuals who represent the 12 member countries of the EEC), based in Brussels, at a July 1989 summit conference of the seven major industrial democracies in Paris. Since then, the EC Executive has been designated coordinator for Eastern European assistance by all 24 democracies in the Organization for Economic Cooperation and Development as well as by the World Bank. In addition to its coordinating role for Western pledges of aid, the EC has created the Eastern European Fund with contributions from the 12 EC member countries. The 1990 Budget includes ECUs 300 million (US $360 million) in grant money for Poland and Hungary. Western governments have agreed to coordinate grant support in four areas:

- Environment
- Agriculture and Food Aid
- Industry and Credit Investment, mainly for small and medium sized enterprises, and,
- Training.

The EC faces a major constraint in that the ECU 300 million must be disbursed in 1990. Thus, it will be difficult to fund long-term projects. This may lead the EC to establish several institutes or special funds in Poland and Hungary to screen proposals and disburse funds. Small enterprise development for construction materials is one of 40 projects proposed for Poland. The 1991 budget is expected to total ECUs 100 million (US $120 million). The EC funds are now specifically allocated for Poland and Hungary, but will probably to be made available to all of Eastern Europe by the end of the year.

In addition to grant funds, loan money will be available separately. Large infrastructure loans may be administered by the Eastern European Development Bank or a new bank specifically established for Eastern Europe.

4. FRANCE

French President Francois Mitterrand announced in January 1990 that France will provide 4 billion francs (approximately U.S. $700 m) over three years in aid to Poland. France's bilateral assistance to Poland will be targetted as follows:

- Export Credit Guarantees - 2 billion francs

- Treasury loans - 900 million francs in low-interest loans to promote investment by Polish-French joint ventures
- Technical Assistance and training - 90 million francs (plus expected contributions from various ministries, municipalities, and individuals). Approved projects include training in municipal management/democractic processes in local government and a center for banking system modernization.

In addition to the above, France is contributing to the EEC-coordinated złoty stabilization fund, food aid, and the creation of a Bank for European Reconstruction and Development.

France's bilateral support for Hungary consists of 2 billion francs in export credit guarantees, 2 billion franc over thre years to finance projects proposed by Hungarian officials, and 15 million francs for technical assistance and training.

5. SWEDEN

The Swedish Government has authorized 1 billion Swedish Crowns (US $150 million) for a three-year program of assistance to Eastern Europe beginning July 1990. While the program is still being formulated and is scheduled for discussion by the Swedish Parliament in April 1990, Cabinet staff report that SC 900 million (approximately U.S. $150 m), to be funded from the aid budget, have been allocated as follows:

- SC300 million to Poland, primarily for environmental purposes, training/institution-building, and education;
- SC375 million for multilateral assistance to Eastern Europe;
- SC225 million for bilateral assistance to other Eastern European countries, mostly the Baltic states.

Housing is not among the priorities for technical assistance identified to date. The Swedish Agency for International Technical and Economic Cooperation (BITS) will implement the program for Eastern Europe, rather than the Swedish aid agency (SIDA) responsible for long-term grant assistance to developing countries.

Distinct from the new initiative for Eastern Europe, Sweden has an ongoing bilateral assistance program for Hungary. Current funding for Hungary is SC 30 million for environmental protection, NGO cooperation, training/institution-building, and public administration..

Sweden's Export Credit Guarantee Board (EKN) provides export insurance for Swedish exports to all Eastern European countries except Poland. EKN will insure up to SC 900 million in exports to Hungary in FY 1990.

6. NETHERLANDS

The Government of Netherlands will provide an estimated 87 million guilders (approximately U.S. $48 million) this year for Eastern Europe. Roughly half, or 45 million guilders will be made available as bilateral assistance and the remainder in support of multilateral assistance to Eastern Europe. A Cabinet decision on the sectors designated for bilateral assistance is expected by end-March, but Embassy officials indicate that infrastructure and the private construction sector will be supported. The Foreign Economic Relations Office of the Ministry of Economic Affairs will implement the program, rather than the Dutch assistance agency DANIDA.

8. UNCHS (HABITAT)

UNCHS has no plans at present for advisors or direct programming in Eastern Europe. Their main activity is to sponsor a seminar/workshop to be held September 3-7, 1991 in Minsk, USSR, on the formulation of national housing strategies for Eastern Europe. UNCHS officials indicate that one contribution which they can make will be a "housing indicators" monitoring system.

9. WEST GERMANY

West Germany (FRG) is not now providing housing sector assistance to either Poland or Hungary, and there are no discussions underway about doing so. The Government of West Germany is somewhat pre-occupied with developing assistance for East Germany (GDR). This year support to the GDR will be very low. Next year it is possible that as part of a major housing reform in which rents are raised to market rates that a housing allowance will have to be introduced to protect pensioners and low income households. It appears that the FRG may simply pay the subsidies involved in this program.

SUMMARY OF U.S. ASSISTANCE TO POLAND AND HUNGARY RELEVANT TO SHELTER SECTOR SUPPORT

1. ANE POLAND-HUNGARY TASK FORCE ENTERPRISE FUNDS

These funds have been established to provide direct assistance to the private sector in Poland and Hungary, including small business and joint ventures between U.S. and host country partners.

Planned appropriation levels for the funds are as follows (in US$ millions):

	FY90	FY91	FY92
• Poland	45	100	95
• Hungary	5	30	25

Examples of eligible transactions include:

- Direct lending to privately owned firms;
- Support for privatization of state owned enterprises;
- Capitalization of venture capital funds, mutual funds, or unit trusts for private investment;
- Support for the establishment of credit unions that lend to members of cooperatives, trade unions, or other associations; and,
- Support for private investment banks and retail banks.

Appropriations for FY91 and FY92 are subject to change due to an amendment to the SEED legislation under consideration involving an expansion of U.S. assistance to include other Eastern European countries.

2. ANE TRADE CREDIT INSURANCE PROGRAM (TCIP)

Under this program, A.I.D. guarantees trade credit for Poland issued by the Export-Import Bank. The maximum contingent liability for Poland for loan principal during any fiscal year is $200 million.

3. PRE/PD INTERIM ASSISTANCE TO POLAND AND HUNGARY

First Tranche	Poland	Hungary	Total
Wall Street Service Corps	60,000	60,000	20,000
Financial Sector Development	100,000	0	100,000
Privatization Grant	100,000	0	100,000
Divestiture & Privatization	0	250,000	250,000
Subtotal	260,000	310,000	570,000

Second Tranche				
IESC	(for eligible countries in Eastern Europe)			200,000
IESC-TIS		(Hungary & Poland)		130,000
IESC-BDF		0	100,000	100,000
Subtotal				430,000

Briefly, these programs include:

- Wall Sreet Service Corps - volunteers to make diagnosis of technical needs and recommend remedial actions by mid and junior level bank executives and attorneys.

- Financial Sector Development Support - Pricewater House financial sector analysis, stock market framework, banking system regulatory requirements, and training plan.

- Privatization Grant - IESC subgrant to the Polish Foundation for Privatization.

- Divestiture and Privatization - Scientex (Center for Privatization contract) technical assistance to establish the National Property Agency in Hungary, training of government staff in valuation and marketing, and technical assistance to establish Employee Stock Ownership Plans (ESOPs) to allow workers to acquire shares of newly privatized firms.

- IESC - volunteer executive services to Eastern European private enterprises, educational institutions, and producer associations.

- IESC Trade and Investment Support (TIS) - establishment of investment promotion office(s) to support U.S. and host country joint ventures, in coordination with OPIC and ExIm.

- IESC Business Development Foundation (BDF) - the start-up program of the center established by private Hungarian businessmen addresses technical and information needs of newly privatized retailers.

4. CENTER FOR PRIVATIZATION ADVISORY SERVICES

Poland

- Investigating with the IFC technical assistance options for industrial restructuring.
- Expressed interest in preparing, if requested by the Government, concept paper on "shredding" specific privatization functions of construction kombinats.

Hungary

- National Property Agency advisor Charles Twyman to assist NPA planners on the formation of the agency and in initiating studies leading to the prioritization of SOEs for privatization.
- Legal expert Thibaut de Saint Phalle to advise Deregulation Board on banking system legislation.
- Senior consultant A.C. Tomlinson to advise as necessary with respect to the National Property Agency planning, to conduct a capital market survey to determine prospects for the sale of securities of companies being privatized, and to examine feasibility of proposed national investment trust to determine whether future work is appropriate.
- Information for Investment Decisions, Inc. training course for NPA staff.
- Possible advisor on tax concessions and other inducements for foreign investment.
- Possible arrangements for securities regulator to visit Securities and Exchange Commission in Washington.
- Advice on Employee Stock Ownership Plans (ESOPs)

5. TRADE AND DEVELOPMENT PROGRAM ACTIVITIES

The Trade and Development Program (TDP) is an independent U.S. Government agency of the International Development Cooperation Agency (IDCA). Established in 1980, TDP became independent of A.I.D three years ago. TDP currently has annual budget of approximately $30 million, with about $27.5 million in program funds. Roughly 85% of TDP program funds are allocated for public sector projects financed by the World Bank or regional development banks, and only 15% for private investor assistance.

TDP Functions: TDP will provide grant funds to foreign governments for feasibility studies, ranging from $200,000 to $500,000 per study, which are intended to assist U.S. companies to participate in the early stages of major development projects which offer large export potential. The rule of thumb for leveraging exports is that TDP will invest one dollar in funds for a feasibility study for every $100 in anticipated exports if the investment moves forward. TDP will only support projects that are already a top priority of the host government and will be implemented if proven feasible, but are not completely determined as feasible. TDP also has a very small program which provides funds for feasibility studies directly to U.S. companies which can demonstrate the ability as well as a strong interest in investing in a venture abroad which will generate U.S. exports. Those funds are available on a reimbursable basis as low interest loans. Generally TDP avoids projects for which the U.S. does not have a comparative advantage, such as in housing and infrastructure.

TDP Projects in Poland and Hungary:

- FY 1989

  Poland:
  --$25,000 Telecommunications (Global Electro-Comm, Inc.)
  Hungary:
  --$500,000 Borsod Steel Restructuring (USX Engineers and Consultants, Inc.)
  --$25,000 Digital Overlay Network (Culbertson and Associates)

- Under consideration (Poland only)

  --solid waste and hazardous waste management
  --coal and energy sector
  --civil aviation safety technologies

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Annex 4

LIST OF ORGANIZATIONS AND INDIVIDUALS CONTACTED
(January 22 - February 28, 1990)

U.S. GOVERNMENT AGENCIES

U.S. Agency for International Development

David Carr
Asia and Near East Bureau

Penelope Farley
Private Enterprise Bureau

Mark Swartz
Office of AID Representative to OECD

U.S. Department of Commerce

Russell Johnson
Hungary Desk Officer

Max Miles, Leonard Heimowitz
Construction Machinery Division

Barbara White
Capital Goods and International Construction

Patrick Cosslett
Domestic Construction Division

Eastern European Business International Center (EEBIC)

U.S. Department of Housing and Urban Development

John Geraghty
Office of International Affairs

U.S. Department of State

David Hughes
American Embassy, Budapest

Victor Kowalski
American Embassy, Warsaw

International Development Cooperation Agency

Fred Eberhart
Trade and Development Program

Federal National Mortgage Association (FNMA)

Gary Perlin, Senior Vice President for Finance

FOREIGN MISSIONS IN WASHINGTON, D.C.

Bazyli Samojlik
Embassy of Poland

Dr. Komaromi
Embassy of Hungary (New York)

Denis Tersem
Embassy of France

Joanna Vanvliet
Embassy of Sweden

FOREIGN MINISTRIES OVERSEAS

Pascal Berracha
Ministry of Foreign Affairs, France

Dr. Eugen Dick
Bundesministerium fur Raumordnung, Bauwesen, und Stadtebau, West Germany

Mats Karlson
Cabinet Staff, Sweden

Brian Thomson
British Overseas Development Agency

THE INTERNATIONAL MONETARY FUND

Anthony Boot (H)*

Castor Bartholty (H)

OECD

Joseph Wheeler

EUROPEAN ECONOMIC COMMUNITY (EEC)

Karen Fogg, Coordinator
Training Program
East European Fund, Belgium

Pierre Mirel, Coordinator
Industry and Credit Investment
East European Fund, Belgium

* discussion limited to Hungary

THE WORLD BANK

Alain Bertaud (P)**

Ann Elwan (H)

Michael Lav (P)

Steve Mayo (P)

James Wright (H)

UNITED NATIONS

Mark Hildebrand
U.N. Center for Human Settlements (HABITAT)

NON-GOVERNMENT SECTOR

Marta Goldsmith
Curtis International
Indiana

Roger Kodat
Manufacturers Hanover Bank
New York

Andrew Lemer, Executive Director
Building Research Board
National Academy of Sciences
Washington, D. C.

David Levintow, Assistant Director
Center for Privatization
Washington, D. C.

Zbigniew Niemczycki, President
Curtis International-Europe
Poland

David Parry, Professor of Finance, Real Estate and Law (H)
California State Polytechnic University
Pomona, California

James Rosebush, President
James Rosebush Company
Washington, D. C.

Catherine Sokil, Assistant Professor
Department of Economics, Middlebury College
Vermont

** discussion limited to Poland

Timothy Smith **(P)**
International development consultant
Washington, D. C.

Paul von Ward, Chairman **(P)**
Delphi International Group
Washington, D.C

Robin Winchester, Director
Citibank Budapest RT
Hungary

James Upchurch, President
Cooperative Housing Foundation
Maryland

Allison Wey, Chief Underwriter
First Hungary Fund
Bear Stearns & Co. Inc.
New York

Martin Milpole, President
International Division
Enterprise Development Corporation
Columbia, MD

Nelson Warfield, Assistant to Ronald Lauder
East European Development Corporation
New York