# Housing Reform In Hungary

## Five Concept Papers

May 1991

OFFICE OF
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W O R K I N G   P A P E R

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# HOUSING REFORM IN HUNGARY:
# FIVE CONCEPT PAPERS

Prepared for
Ministry of Social Welfare, Republic of Hungary
U.S. Agency for International Development

Prepared by
The Urban Institute (Washington)
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## PREFACE

This document contains five short "concept papers" which were prepared in response to a series of requests from the Government of Hungary to the U.S. Agency for International Development for assistance in developing a new national housing policy. These short pieces were designed to expand the range of options under consideration and to stimulate discussion within the Hungarian housing community.

Each of these papers has been translated into Hungarian and distributed to the interministerial committee preparing the new housing act, central and local government officials, academics, and the parliamentary committee dealing with housing issues.

The papers are being made available in this document as it is believed that they may of interest to those working on parallel problems in other countries of Eastern Europe.

The affiliations of the authors of the papers are as follows. Jozsef Hegedüs and Iván Tosics are principals at the Metropolitan Research Institute, Ltd. (Budapest); Jill Khadduri is Director of the Office of Policy Development, U.S. Department of Housing and Urban Development; and, Katie Mark, Jeffrey Telgarsky and Raymond Struyk are on the staff of The Urban Institute (Washington).

The opinions expressed in these papers are those of the authors and not necessarily those of the institutions for which they work or of the U.S. Agency for International Development.

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# RELATIONS BETWEEN THE STATE AND LOCAL GOVERNMENTS IN THE HOUSING SECTOR

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## Relations Between the State and Local Governments in the Housing Sector

Hungary, through the 1990 Act on Local Governments, has established nearly unique legal and fiscal relationships between the State and local governments. On the one hand, the relationship is unusually direct, with essentially no other levels of government intervening between the two. However, at the same time, the relationship is structured so that the State will have very limited direct control over the activities of local governments in many spheres, including housing.

The question addressed in this brief concept paper concerns the desirable forms of interaction between the State and local government in the housing area. The first section of the paper describes certain responsibilities that the State explicitly and implicitly retains for housing. The second section outlines various tools that the State could use to influence local governments to meet national objectives in housing. Importantly, several instruments which are the best-suited to the recently created system of relationships between the State and local governments have not yet been introduced to the Hungarian housing sector. The final section sketches how these tools might be realistically employed to induce local governments to achieve several concrete objectives in the housing sector deemed critical at the national level.

### State Responsibilities in the Housing Sector

The Law on Local Government assigns primary responsibility for housing to local governments (Part II, Sect. 8). Pursuant to the Act, ownership of the stock of state rental units is being transferred to local governments; and these governments will be responsible for these units (including possibly selling them) and for such housing-related tasks as urban planning and provision of necessary infrastructure to support the development of new housing. In general, the housing responsibilities given to local governments are quite comprehensive.

Nevertheless, the State retains two significant responsibilities for the housing sector. First are explicit duties. Under the Act on Local Governments the State has been given the power to regulate the requirements for local public services by decree, and, through the Ministry of Interior, it has the task of coordinating the physical development of adjacent jurisdictions (Part X, Sect. 95-6). Moreover, as additional legislation is passed by the Parliament over the next year or two, more duties are likely to be explicitly assigned to the State.

Second, the State has substantial implicit responsibilities for the sector, which are outlined in Table 1. Some of these flow from the State's responsibility for ensuring national economic stability and growth, a task not possible to evolve to lower levels of government. Hence, regulation of the banking system--including requiring prudent underwriting standards for mortgage loans--is essential. Similarly, protection of employment in some "threatened industries" during the transition to a market economy may be required.

The State must also sustain a legal framework necessary for efficient commerce. Essential is the enforcement of contracts. Among the important contracts in the housing area are mortgages and the protection of tenants rights under leases. With respect to leases, while the private rental sector is developing and State rentals are shifted to private management the State may have to be proactive in the creation and enforcement of leases.

Other duties flow from the State's broad responsibilities for the general welfare--these include the imposition of minimum standards in residential and infrastructure construction to ensure the public health. (Obviously, individual governments can enact more stringent standards, but the State retains the right of protecting all citizens in this area.) A critical aspect of social welfare policy is the provision of minimal shelter for the homeless.

Moreover, social welfare policy encompasses income distribution and the redistribution of resources to a degree that provides all citizens with a minimally adequate standard of living. Because regions of the country have different endowments of natural and economic resources, the State is the appropriate level of government to undertake this function. In the housing sphere, this may, for example, involve housing allowances to increase the effective demand for housing of poor households or the subsidization of the supply of adequate housing services at a price the poor can reasonably afford.

Finally, additional duties fall to the State in its role as the preserver of the nation's wealth--both environmental and physical. Most prominent among the physical assets is the stock of rental stock being transferred from State to local government ownership. This housing is part of the nation's wealth and its use and disposition--while under the direct control of local government--should be subject to the same kind of safeguards as other public assets. It should not be destroyed, deliberately neglected, or sold at unreasonably low prices.

**Instruments Available to the State**

How is the State to discharge the duties outlined above without unduly intruding upon the rights of local governments? We begin the response to this question by first defining the tools or instruments available to the state to influence local governments: issuance of regulations, issuance of guidelines, taxation by the State, direct expenditures by the State, or grants by the State to local governments. Brief comments about the current and future use of these instruments in the housing sector are also presented.

<u>Regulation.</u> The setting of rules which local governments must obey is probably the least attractive of the tools available to the State because such action is so contrary to the spirit and letter of the Act on Local Governments. Nevertheless, there are areas in which this form of control may be appropriate. One example is the establishment by the National Bank

**Table 1**
**National Government Responsibilities and Examples from the Housing Sector**

| Central Government Responsibilities | Housing Sector Example |
|---|---|
| income distribution/ social welfare | protection of the poor from having to spend an excessive share of their incomes on housing: housing allowances or subsidized supply of housing services; provision of necessary assistance to homeless persons |
| protection of health and safety | establishment of minimum building standards (local government can establish more demanding standards) |
| preservation of a community's environmental rights | prevention of one community locating noxious land uses or industries near the border to other communities or routing heavy traffic flows through other communities |
| protection of the national financial system | establishing construction period and mortgage loan underwriting rules consistent with prudent lending practices that cannot be overridden by local governments or the financial institutions |
| preservation of state assets | prevention of the "give away" of state rental units at extremely low prices |
| management of the macro economy | maintenance of high employment levels; support for the construction industry during the transition from the centrally planned to market economy; support for residential construction in tight labor markets to promote labor mobility |
| enforcement of contracts | support of tenants in disputes with landlords over lease disputes; during transition may need special provisions for the creation of leases |

of Hungary of criteria for underwriting mortgage loans to keep defaults at acceptable limits. The prohibition of certain types of building on environmentally sensitive sites may also fall into this category.

In the past issuance of regulations has been heavily relied upon throughout the Hungarian economic and welfare systems. Central government decrees were the standard instrument for implementing policy. In the current environment, however, the State is likely to resort only rarely to using this instrument for areas falling within the competence of local governments, including housing. They will continue, however, to be an important instrument for supervision of economic entities, such as banks and brokerage firms.

Guidelines are a soft form of regulation. These can be issued to inform local governments of the State's view about desirable action on the part of community. Although the guidelines themselves are only advisory, they may carry the suggestion that regulations would be issued or other actions taken by the State if the guidelines were ignored. In the current Hungarian situation, in which the leadership of many local governments is quite uncertain about their options for dealing with various housing and other issues, thoughtful, well-written guidelines might be quite effective for a number of areas.

Taxation. The State could discourage certain actions at the community level by subjecting local governments or specific transactions to taxes. For example, the State could impose a significant tax on communities which transferred locally produced pollution to other jurisdictions--for example, dumping raw sewerage into waterways or location a burning land-fill site next to another community with the smoke entering the neighboring community. Similarly, a tax could be imposed on a local government for each unit of state rental housing sold at a price below some minimum share of market value. For example, the community would have to pay a tax equivalent to half of the difference between the sales price and 60 percent of market value.

There is no history in Hungary of the imposition of "nuisance" or penalty taxes on local government actions that violate national standards. Imposing such taxes would, therefore, be breaking new ground and could be quite difficult.

State spending perhaps holds out the greatest promise for effectively influencing the behavior of local governments in the housing sphere. Two broad options are relevant. First, the State could have spending programs in direct support of improving housing. Such support could include, for example, grants for infrastructure in new residential areas, low interest rate loans for the development of additional rental housing, and housing allowances. The other avenue would be to fund a Housing Block Grant under which State funds are distributed to local governments through a formula and the local government would decide on how to spend this money from within a set of approved housing sector uses, like those just mentioned.[1]

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1 For a complete description of this type of program, see K. Mark and R. Struyk, "Housing Block Grants in Hungary," (Washington, DC: The Urban Institute, 1991).

Either direct expenditures or housing block grants could be conditioned on the local government meeting various types of conditions; examples of such conditions include:

-- some or all of the funds must be spent on certain activities, e.g., housing rehabilitation, housing allowances, infrastructure development;

-- some or all of the funds must be spent so as to benefit certain groups of households, for example, those with incomes in the lower half of the income distribution;

-- the local government would have to match State spending for these purposes in some specified ratio, for example, local governments might have to spend Ft. 50 on the activity for every Ft. 100 given by the State; the matching rate could vary across activities--to continue the example, activities favored by the State might have a 1:10 matching rate, which those not favored have a 5:10 rate.

The second broad spending option for encouraging local governments to undertake certain housing sector activities would be the threat to reduce grants they would otherwise receive if they failed to follow government guidelines. So, for example, either a community's normative grant or its housing block grant could be reduced if it sold state rental units for less than a "reasonable" share of their market value, perhaps 60 percent of the market price. The reduction in the grant would be some share of the difference between the market and actual sales prices of the units sold during the preceding year.[2]

In the past Hungary relied principally on direct spending, without conditions of the type just discussed, to support the housing sector. The most important form has been support for the purchase of units by homeowners; both downpayment subsidies and interest payment subsidies were deep, and they have been administered through the banking system. Other direct spending was also undertaken to support the development and maintenance of State rental housing and provision of residential infrastructure. In the current budget, housing assistance to local governments is provided exclusively through the normative grant program (general revenue sharing); there is no requirement that the funds computed in the formulas for the housing sector be spent in the sector, nor are the grants conditioned in other ways.

The foregoing discussion indicates that the State has a number of options for influencing--rather than mandating--local governments to implement certain policies in the housing sector. The central theme is that under most of the options just reviewed local governments could choose to follow housing policies different from those believed by the

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[2] An important question concerns how such spending programs might be administered under Hungary's two-tier governmental structure. A plan for a central-level Housing Office plus a set of field offices to handle such programs in described in Jill Khadduri, "Relationship Between Central Government and Local Governments in Administering Hungarian Housing Programs and Policies," (Washington, DC: The Urban Institute, 1990).

Parliament to be appropriate. However, they would pay a price in doing so in the form of enjoying a lower level of support from or being taxed by the State. Freedom of choice is preserved, but it is not costless.

Importantly, some of the instruments best suited for indirectly guiding local decisions in the housing sector--housing block grants, conditioned direct expenditure programs, and "penalty taxes"--have not been used in the past in Hungary. As a group they have great possibility for reshaping State-local government relations.

**Achieving National Objectives**

This section presents four examples of possible State incentives to local governments to achieve national objectives in the housing sector plus one instance of the State acting to achieve an objective than transcends local governments. The examples concerning local governments, summarized in Table 2, all employ indirect measures to achieve their objectives: in every case the local government can reject or accept the activity or standard suggested by the State. As noted earlier, however, it pays a price for doing so.

For each of the five examples Table 2 lists the policy objective, the type of instrument with which the State is pursuing the objective, and the specific program or action employed. In all cases, the instrument is "conditional," i.e., the local government or (in example 5) the enterprise receives assistance or avoids a tax only if it undertakes actions consistent with the national policy. The balance of this section briefly discusses each of these examples.

#1. Housing allowances for poor renters. This program implements a State policy of protecting poor renters from having to spend an excessive share of their incomes on housing. It would offer local governments partial funding for its housing allowance program under certain conditions. Specifically, the conditions would be:

> (a) the local program would have to offer support at least as generous as that which poor households would receive under a "standard program design" developed by the State.
>
> (b) the State would pay 50 percent of cost of the total housing allowances in the community, net of some or all of the increased revenues obtained from raising rents. The 50 percent sharing between the State and community recognizes the joint national and local responsibility for social welfare in the housing sector.

If a community failed to offer a housing allowance program or to agree to these conditions in structuring its allowance program, it would not receive State budget support for housing allowances. Additional conditions could certainly be added, such as the community gradually increasing its rents to market levels. However, the two conditions listed above achieve the

**Table 2**
**Pursuing National Housing Objectives Through Incentives to Local Governments and Enterprises**

| Policy | Type of Instrument | Program |
|---|---|---|
| 1. protection of low income renters from excessive housing expenditures | conditional direct spending | housing allowance, payments conditioned on acceptable program |
| 2. enforcement of minimum housing construction standards | loan regulation through the banking system | loans only on properties meeting minimum standards |
| 3. assistance in the production & maintenance of good quality housing for lower income families | conditional multi-purpose grant | housing block grant, receipt conditioned on spending for lower income families |
| 4. selling State rental units for at least a minimum price | conditional tax | reduction in housing block grant or normative subsidies if conditions not met |
| 5. transition maintenance of employment in residential construction SOEs | conditional direct spending | per unit subsidy as percent of actual sales price |

relief of the poor while at the same time preserving very substantial freedom of choice for local governments.[3] Careful consideration should be given to other possible conditions.

#2. Enforcement of Minimum Building Standards. Failure of local governments to adopt and implement building and zoning codes that ensure the safety and health of the population is a national concern. Indeed, many would argue that absolute minimum standards should be enforced nationally through State regulations. However, a number of countries do not have a national housing code, but they give incentives for compliance with minimum standards in various ways. One method--and the one favored here--is through the banking system. Banks would be prohibited by the National Bank of Hungary from making loans for the construction or purchase of residential properties which failed minimum codes.[4] In this instance, even if a household elected to build a low quality unit, it would know that in the future the sales price of the unit would likely be depressed because of the inability of purchases to obtain a mortgage for its purchase. The bank would be prohibited from making the loan unless the local government gave a statement saying the unit met the minimum standard.

In this case the local government could elect to establish building standards at least as stringent as those enforced by the banks. The bank loan regulation would only be in effect in those communities where building standards less stringent than those demanded by the National Bank of Hungary were in effect.

#3. Production and Maintenance of Good Quality Housing for Lower Income Households. This policy recognizes that housing allowances, while an important element in a comprehensive housing policy, are not sufficient to address all of the housing problems of lower income families. Assistance with development of new housing through the provision of infrastructure to housing plots is one example of an additional area where support may be needed. Rehabilitation of existing rental units occupied by lower income households is another.

An appropriate tool in this case is a housing block grant. The funds are distributed to local governments using a formula which takes into account different elements of housing need. Receipt of the funds, however, is conditional upon the locality using these funds to improve the housing conditions of lower income families--perhaps defined as those in the

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3 For a detailed description of a possible housing allowance program see J. Hegedus, R. Struyk, and I. Tosics, Integrating State Rental Housing with the Private Market: Designing Housing Allowances for Hungary. Washington, DC: The Urban Institute Press, 1991.

4 In the United States, for example, the Federal Housing Administration, which insures banks against losses from mortgage loans going into default, has minimum property standards which are widely followed by builders and developers so that the units can be sold using insured mortgages. In addition, all of the secondary mortgage market firms require minimum property standards.

lower two-thirds of the income distribution. One could also consider requiring the locality to match the national funding, perhaps on a 1:2 (local: state) basis.

#4. Charging at Least a Specified Minimum Price for the Sale of State Rental Units. Under a policy of not "giving away" State rental units to their occupants, a minimum sales price--presumably defined as a percentage of the current market value of the unit--would have to be charged by the local government. If this minimum price is not implemented through a decree, how would it be established? In Table 2, the approach indicated is the use of a "conditional tax," which is actually a reduction in State funds received by the community. As suggested earlier, the size of the tax would be related to the size of the foregone income from the units sold. For example, State funds received by the community through the Housing Block Grant or the normative grant would be reduced by one-half of the difference between the minimum and the actual sales prices.[5]

#5. Transitional Support for the Residential Construction Industry. The State as part of its macroeconomic stabilization responsibilities could decide on a policy of assistance to some state-owned enterprises during the period of transition to a market economy, including assistance to some enterprises engaged in residential construction. The structure of such assistance must be such that it encourages the enterprise to respond to consumer preferences (market demand) and to improve its efficiency at a maximum rate so as to be able to compete with private firms, both domestic and international. With the enterprise in a more competitive position, it could be privatized on terms attractive to the State.

Obviously, support of this type does not involve the relationship between the State and local governments, but it rather an element in broader industrial policy.

One way to structure assistance for a two or three year transition period is to grant the enterprise a subsidy equivalent to a percentage of the sales price of the units it sells to private persons. Perhaps this could be 10 percent in the first year, 5 percent in the second, and none thereafter. By making the subsidy conditional on the sales of the unit, the enterprise is required to build the type of units consumers want to buy, price the units to sell and market them effectively. Phasing the subsidy out puts increasing pressure on the enterprise to become increasingly efficient.

[5] Assume, for example, that Parliament determined that the minimum sales price should be 60 percent of market value. For a unit with a market value of Ft. 2 million, the minimum price would be Ft. 1.2 million. If a city sold such a unit for 50 percent of the market value or Ft. 1 million, then its housing block grant would be reduced by Ft. 100,000 (i.e., .2 million*.5). Block grant funds not spent because of such reductions would be reallocated among all cities not penalized using the regular block grant formula.

## Conclusion

The foregoing presentation has illustrated that it is possible for the State to create incentives, sometimes very powerful incentives, for local governments to accomplish national objectives in the housing sphere. It is clear, however, that the necessary tools must be in place for this to happen. It is also clear that some tools--such as a housing block grant--are more desirable than some others because they can be used to encourage local governments to meet several objectives, i.e., different types of conditions can be assigned to the receipt of the subsidy, but the same conditions apply to all communities, the amount of funds received is determined by formula, and the community decides how to spend the funds.

In designing the new housing concept for Hungary it is necessary to simultaneously consider the unique structure of State-local relations, the objectives in the housing sector which the national government deems paramount, and whether the State has the implementation tools necessary to encourage local governments to pursue these objectives.

# RELATIONSHIP BETWEEN CENTRAL GOVERNMENT AND LOCAL GOVERNMENTS IN ADMINISTERING HUNGARIAN HOUSING PROGRAMS AND POLICIES

by

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## RELATIONSHIP BETWEEN CENTRAL GOVERNMENT AND LOCAL GOVERNMENTS IN ADMINISTERING HUNGARIAN HOUSING PROGRAMS AND POLICIES

Hungary is changing from a unitary governmental system, in which there is only one governmental authority with different geographical levels of administration, to a system in which there are two levels of government. The national government and the local governments (called "self-governments" in order to emphasize that they are no longer simply lower levels of administration of the national government) have independent authority deriving from separate elections. This means that the central government will henceforth deal with local governments as independent decision makers. It also means that in many areas, including housing, authority will be shared between two governmental entities.

Another key change in Hungary is the privatization of many functions that were formerly carried out by the state. This means that institutions that in the past were public bodies will not longer be available to implement directly the policies of the central government. Some of their functions will be taken over by private organizations, while others will be absorbed into the administrative structure of the local governments. This is the case, for example, for the state-owned companies that manage publicly owned residential and commercial property, the IKVs.

The counties as administrative entities will remain part of the national government. Historically, these lower geographical levels of central government authority have been delegated substantial power to make decisions -- for example, on the allocation of program resources among cities and other settlements. The decision-making role of the counties has been somewhat reduced in the past several years and the authority of the local councils (i.e., the lowest level of national government administration) to set priorities for the use of funds increased. However, the current administrative role of the counties is still sufficiently strong that it may conflict with the role of the local governments in the new political structure of Hungary.

Especially during the period when the newly elected local governments are building capacity and experience, it may be important to make sure that old lines of authority really are broken and that attitudes and habits of the past are changed. Therefore, it may be important to circumscribe very carefully the role of the county level of national government administration, so that county-level administrators do not usurp the decision-making roles that should belong to local mayors and councils or continue to deal with departments of local governments as though they had line authority over them.

At the same time, for the sake of administrative efficiency, it will be desirable to continue to use a lower level of national government administration rather than having all program administrative functions carried out in Budapest. One way of doing this would be to remove housing functions altogether from the county level and instead create new institutions at the regional level. This would have the advantage of newness -- new organizations, new people, new relationships -- but it does not appear to be compatible with the quasi-judicial rather than administrative role that, in general, appears to be envisioned for the national government's regional representatives under the Local Governments Act. It also could be expensive, as all the start-up costs of new organizations, from office space and equipment to recruitment and training would have to be incurred.

Another option would be to use the county level of national government administration to carry out the day to day work of program administration but to limit the role of counties in two ways:

1) to design the funding programs of the national government for the housing sector so that they are as automatic and formula-driven as possible, minimizing the discretion that needs to be given to program administrators.

2) to set up direct relationships between the national government's Housing Office and local governments so that representatives of local elected officials have an opportunity for direct discussions with the Housing Office and so that policy-sensitive technical assistance goes directly from the Housing Office to local governments.

## Administration of Housing Programs

The housing programs recommended for the national government, a housing allowance and a multi-purpose housing block grant, are particularly suitable for enhancing the authority of local governments and protecting them from arbitrary decision-making by representatives of the national government.

## Housing Allowance

The housing allowance would operate according to well-defined rules with little reason for discretionary decision-making at the county level. Any renter household meeting certain criteria would be eligible to receive an allowance, and the amount of the allowance would be based on rent standards and income criteria established by the national Housing Office in Budapest. Those local governments that represent settlements with more than trivial amounts of rental housing would be eligible for the housing allowance -- perhaps 150 to 200 settlements.

The role of the county level housing office (which could be part of a county-level counterpart of the Ministry of Welfare -- i.e., an expanded Health Department -- or part of the current "Regulations" Department) would be:

-- to review the applications from the local governments for program funds needed each year. These applications would be based on standard procedures for estimating the number and characteristics of households that would participate in the program. The county housing office review the accuracy of the applications and allocate funds to the local governments based on these applications.

-- to review any requests from local governments to vary program rules based on special circumstances and to recommend to the central Housing Office whether those "waiver" requests should be granted. The authority to grant such requests would <u>not</u> be delegated to the county level.

-- to provide assistance to the local government's housing office in understanding the rules of the program and in solving administrative problems.

-- to monitor the administration of the program by the local governments based on visits to the settlements, reviews of administrative records, discussions with local officials and local citizens, to determine whether the rules of the program were being followed. The results of this program monitoring would be reported to the central Housing Office and only the central Housing Office would have the authority to act in the case of major administrative failures: for example, to withhold funds.

-- to assist the county offices of the Central Statistical Office in obtaining needed information from local governments, such as the case records of households receiving housing allowances.

**Housing Block Grant**

A housing block grant program would be allocated by formula from the national governments to local governments, with local governments making the decision as to how to use funds among a wide range of housing activities. These decisions would be made by local elected officials, and not by either the central Housing Office or by county housing offices.

The roles of the county housing office would be similar to those for the housing allowance program:

-- to review requests for exceptions to program rules and to make recommendations to the central Housing Office (which makes the decision).

-- to provide advice and assistance to local governments in interpreting program rules.

-- to monitor the use of funds to make sure they were used for eligible activities and that any special rules included in the law establishing the program were followed. For example, special rules might involve income targeting; a maximum percentage of the grant usable for administrative costs; and rules to prevent favoritism or abuse in the use of funds -- for example, rules requiring competitive selection or public disclosure of recipients of funds. Where serious problems were found by a county office review, the situation would be reviewed by the central Housing Office, which would have sole authority to withhold funds or to place additional conditions on their use.

A key decision would be whether all 2000 local governments, should receive this grant by formula or whether only those settlements with enough population to receive at least a minimum amount of funds or only those with a certain level of presumed administrative capacity (those over a certain size or with other administrative characteristics) should receive an automatic grant. If funds were allocated by formula only to the larger local governments, a system would need to be set up in which the smaller local governments compete for the share of the total program funds belonging to them. This competition could be held at the level of the county housing office, or it could be held at the central Housing Office. Even though many local governments (1500-1800) would be eligible to apply, a more limited number (perhaps several hundred) would apply in any one year, so it would be feasible for the competition to be held at the central Housing Office.

A model that should be considered is to hold such a competition at the central housing office for the first two or three years and then delegate it to the county level. The advantage of this model is that the guidelines for the competition could be established by the central Housing Office and then could be followed more consistently by the county offices. In particular, the pattern could be established that the competition judges administrative capacity and the feasibility of the planned activity, rather than second-guessing the objectives or priorities chosen by the local governments.

## Direct Relationships between Local Governments and the Central Government Housing Office

It will be important to establish direct communications between the central Housing Office and local governments for two reasons: to acknowledge the independence of the local governments as separate elected bodies that have the larger share of authority and responsibility for housing and to provide sophisticated technical assistance in areas that are new, not just to the local governments, but to Hungary.

## Dialogue between Central Housing Office and Local Governments

One of the responsibilities of the program divisions in the central Housing Office will be to monitor the performance of the county housing offices. An important part of this monitoring, for example during annual visits to the county by central office staff, should be meetings with local elected officials and local housing officials so that any problems in the way the county offices are applying program rules are discovered.

It may also be desirable to set up symposia on a regular basis in which key officials (council members? heads of housing departments?) from a few local governments at a time meet with the head of the central Housing Office.

## Technical Assistance

Technical assistance will be an absolutely key responsibility of the national government's Housing Office. This is not only because of the newness of the local governments as elected bodies and their vastly increased decision-making responsibilities for housing, but also because of the fundamental redirection of housing policy towards privatization, reliance on the market mechanism, and better targeting of subsidies to the needy.

Assistance to local governments in assessing housing needs and developing housing strategies and in bringing about systemic changes in housing delivery systems can be provided effectively only by a national technical assistance effort closely directed by the Housing Office. Technical assistance provided by the county offices should be of the type described above -- assistance in interpreting program rules and in solving administrative problems directly connected with programs.

# HOUSING BLOCK GRANTS IN HUNGARY

by

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# HOUSING BLOCK GRANTS IN HUNGARY

Decentralization is a powerful force in contemporary Hungarian politics, as reflected in the Act on Local Governments which in August 1990 gave local governments full responsibility for housing. This shift in policy direction should lead to significant efficiency improvements and should also foster greater democratically based decision-making, but it obviously entails many changes in the ways policy is developed and implemented and in the roles of the State and local governments. Because active State intervention in the housing sector is now viewed by many as undesirable interference, use of normative grants to support local governments has strong appeal as a means for the central government to influence the housing sector.

The State still retains broad responsibility for certain economic functions such as management of the national economy and redistribution of resources to aid poor regions and poor persons. In particular, the State can maintain an interest in assuring minimum levels of housing -- housing that is affordable and of adequate quality -- and related infrastructure services to all of the nation's citizens. In some rapidly growing areas, meeting this objective may require assistance with the expansion of residential infrastructure, such as water and sewer lines. To exercise its interest, the State can promulgate minimum standards which local governments are required to meet, help local governments provide these service levels by providing financial assistance, or a combination of both.

Housing block grants offer a way for the State to provide assistance ear-marked for the housing sector and at the same time give maximum control to local governments. State involvement assures greater equity between regions, encouragement of minimum service levels, and local government assistance in addressing concerns like the encouragement of citizen participation or compliance with environmental protection guidelines. At the same time, the freedom of choice that block grants afford local governments enables them to deploy resources as needed to either housing production or rehabilitation and support of existing housing, and grants them flexibility not only to differ from other regions but to change their own resource allocation decisions from year to year.

## The Housing Block Grant

A housing block grant is a mechanism through which the State provides financial support to local governments for the provision of good quality housing through a number of actions -- including the development of infrastructure for new housing projects, rehabilitation of existing units, and payment of housing allowances to poor families -- which local government selects from a set of activities defined as eligible for funding by the State.

In order to receive State funds, the local government has to follow a specific and straightforward application procedure, which may include requirements for provision of data, enunciating objectives, or guaranteeing compliance with certain guidelines. Following the satisfactory application of the local governments, these governments receive grants from the State. The allocations will be determined by a formula based on the relative need of different settlements. Hence, there is no central government interference in deciding on the amount each settlement receives; and there is no competition among settlements.

### Eligible Activities for the Block Grant

The list of activities which can be financed by the block grant should be broad enough to allow local flexibility, narrow enough to target the need and to ensure the funds are used to improve housing. Possible activities include:

- housing rehabilitation for homeowners, private landlords, or for government-owned housing to bring the unit up to an adequate level of quality;
- providing infrastructure for new building sites;
- upgrading infrastructure in existing residential neighborhoods;
- assistance with down-payment or through subsidized financing to low-income first-time homebuyers;
- building new units;
- relocation assistance;
- assistance with rent payments for low-income tenants (housing allowances);
- technical assistance to communities -- for example, to train housing managers or cooperative organizers, or to assist in designing innovative financing methods.

Other activities that could be included in a broader conception of the block grant include rehabilitation to promote energy efficiency, building code enforcement, public works, public services, energy conservation, demolition.

### Meeting the National Purpose

Additional requirements may accompany State funds, as a way to ensure that the national purposes of the grant are being accomplished. An important requirement, for instance, is targeting the funds, that is, requiring that a certain percentage of the grant be spent low-income households. Other targeting criteria could include substandard housing or specific disadvantaged localities. The grant could also specify that local governments must match State money with their own funds. For example, local government may be required to contribute an amount equivalent to one third of the grant allocation to the housing projects being funded. The state may also require adherence to various guidelines, such as environmental protection regulations, prohibition of projects that displace people, or encouragement of citizen participation (e.g. through required public hearings and citizen comments).

It is important to note that these conditions would be set by Parliament during the design of the block grant, and would not be left to the discretion of the Housing Office.

**Application and Review Procedures**

In order to apply for state funds, the local government will have to undertake a number of actions. For instance:

1. Prepare a statement of objectives and proposed use of funds, i.e. proposed activities.
2. Outline the settlement's strategy for addressing its housing problems. The strategy should:
    a. survey condition of housing stock, including vacant units;
    b. assess housing assistance needs (especially for low income, elderly, large families);
    c. specify realistic annual goal for the number of dwelling units, or persons of low income to be assisted, and the form the help will take.
3. Present a statement as to how national objectives for use of the funds will be met.
4. After the grant period has elapsed, submit a performance and evaluation report concerning use of funds, and an assessment of success vis-à-vis objectives defined.

The Housing Office would review applications, but this process will be strictly limited in scope and in duration. The review will be conducted over a short period of time -- say, thirty days -- and will be a check for completeness rather than an approval process. The performance report would also be reviewed with the aim of ensuring that objectives, successes and failures are addressed and examined, as opposed to using the review process to approve future funding.

**Allocation**

Allocation is designed to direct funds to the areas of greatest need through a formula based on local conditions relative to the national norms. Useful factors which help determine housing need could include population, the extent of poverty, population growth, or the condition of housing. In each case the factor takes the form of a ratio in which the numerator



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is the number of units, households, or individuals in a particular city that fall into that category, and the denominator is the total number in all cities combined -- for example, (population in City A)/(population in all cities). Different weights are attached to the various factors depending on how important they are judged to be and what the prime objectives are.

Possible factors are diverse and might include:

- population
- population growth
- net in- or out-migration
- number of households below poverty line (or other measures of income)
- number of substandard housing units
- number of state-owned units
- number of units with overcrowding (more than one person per room)
- number of units built pre-1955
- housing shortages
- affordability (number of households paying over 30% of income for housing)
- construction costs for a standard unit

A rationale can be constructed for the inclusion of each of these variables under appropriate circumstances. For instance, when construction costs are high and seem to be a significant problem and one that is unevenly distributed among cities, costs would be a useful factor to consider in allocating funds to areas that will most need assistance for new homebuyers.

Since allocations will be made to individual settlements, the smallest settlements may be allotted amounts too small to be usefully applied to significant housing projects. These small settlements may choose to receive their allocations periodically, for example every three years, so that the amounts would be more substantial. Another alternative they may choose is to join with other small settlements and undertake joint projects.

**Illustrative Allocation Simulation**

As an illustration of the allocation process, we have conducted a simulation, testing five different formulae based on seven variables. The calculations have been done using readily available data for the 22 districts of Budapest, separately, and eight other large cities. The variables are:

POP 1990 population
PUB number of public rental units
SUB number of substandard public rental units[1]

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[1] These are units with "half comfort", "no comfort", or emergency status. That is, units which lack at least one of the following: outlet water collector or warm water supply, and which may also not have a toilet, electricity, heating, or access to water inside the unit.



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INMIG in-migration (1980-1990)
OUTMIG out-migration (1980-1990)
POPINC population increase (1980-1990) [migration plus natural population growth]
POPDEC population decrease (1980-1990)

The argument for including these variables is as follows:

- Population should serve to determine the appropriate magnitude of the city grant.
- The number of public housing units gives information about the level of financial support the local government will need in operating and maintaining their housing stock, a new responsibility for local governments.
- Substandard housing, although the data refers to the social housing stock only, provides information on housing conditions.
- Population change figures include both migration and natural growth. Because the increase of population in general will put more pressure on housing, both population increase and in-migration are weighted more heavily than decreases in population, despite the economic decline that decreases may be indicating.

In addition to using different combinations of the variables, we have assigned different weights to the various factors. The weights should be chosen carefully to best reflect what are judged to be the most important needs, and the goals of the housing grant. Both the choice of variables and the choice of weights will affect the distribution among cities of the total grant amount.

The five formulae used in this simulation are:

A. $G_i = (.50)POP + (.50)SUB$
B. $G_i = (.50)POP + (.50)PUB$
C. $G_i = (.30)POP + (.40)SUB + (.20)INMIG + (.10)OUTMIG$
D. $G_i = (.30)POP + (.40)SUB + (.20)POPINC + (.10)\ POPDEC$
E. $G_i = (.40)POP + (.30)SUB + (.30)PUB$

where $G_i$ is the share of the total grant received by city i. As described above, each variable is a ratio of the form POP = (population of city i)/(population of all jurisdictions included in the analysis).

As can be seen in Table A, the five different alternative formulae result in very different results. Settlements with large proportions of substandard housing -- mostly in Budapest -- clearly fare least well with formula B, which does not include that variable, whereas the non-Budapest cities which tend to have relatively large proportions of public housing in good condition, receive larger allocations under that formula. Conversely, Budapest receives larger allocations under Formulae C and D which reflect the much greater population changes that affect the capital city.



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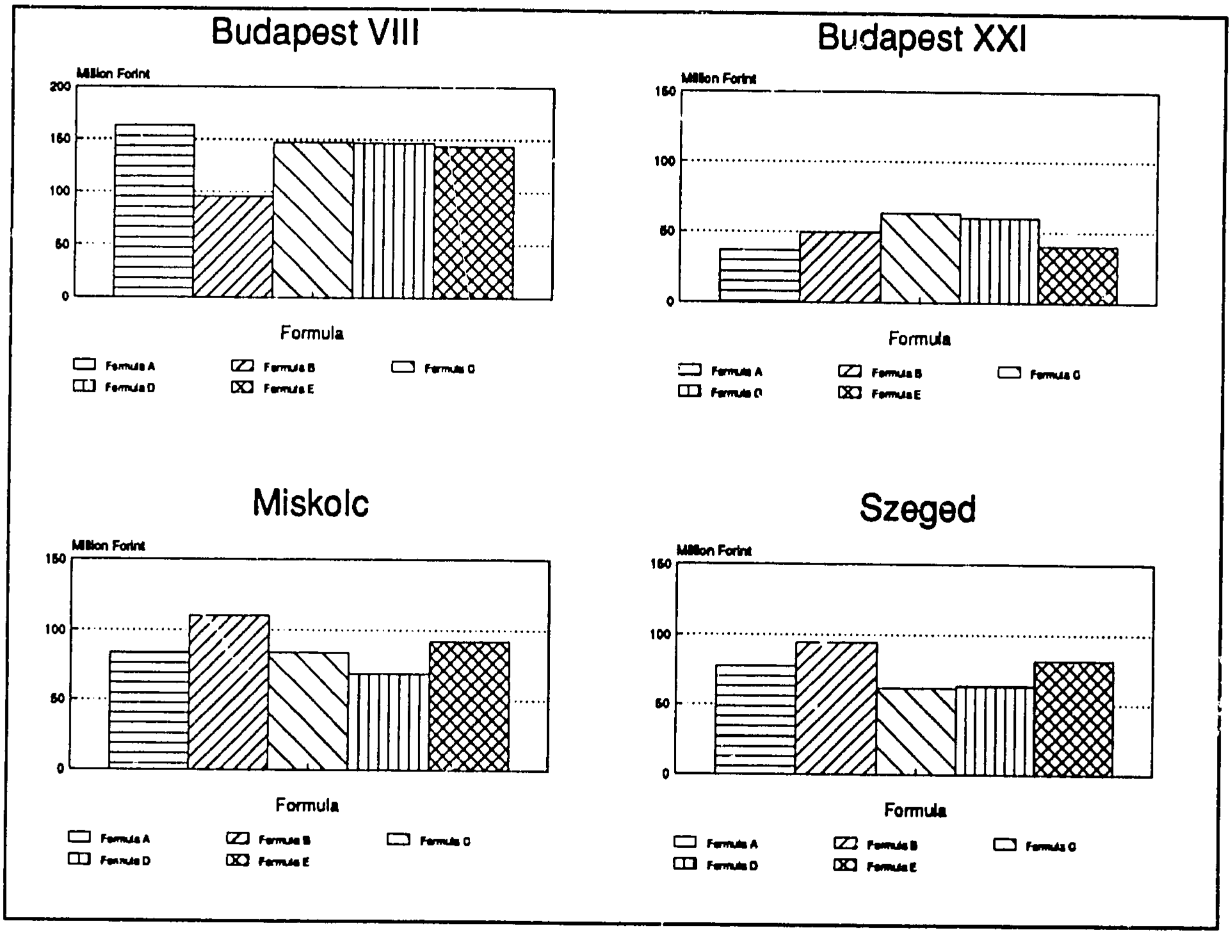
Figure 1 graphically depicts the allocation results for four settlements: two Budapest districts and two other cities. The sizeable variations among the results of the five different formulae emphasize that there may be fundamental distinctions between various regions (in this case the capital and other cities) with respect to the nature of housing problems, and hence they underscore the importance of choosing both the variables and the weights carefully to be sure that the most important needs are being targeted, and that equity among cities is maintained.

## Figure 1: SHARE OF A FORINT 2 BILLION BLOCK GRANT RECEIVED BY FOUR SETTLEMENTS UNDER FIVE ALTERNATIVE FORMULAE




Formula A: $G_i = (.50)POP + (.50)SUB$

Formula B: $G_i = (.50)POP + (.50)PUB$

Formula C: $G_i = (.30)POP + (.40)SUB + (.20)INMIG + (.10)OUTMIG$

Formula D: $G_i = (.30)POP + (.40)SUB + (.20)POPINC + (.10)POPDEC$

Formula E: $G_i = (.40)POP + (.30)SUB + (.30)PUB$

## TABLE A: ALLOCATION FACTORS AND RESULTS
## (based on a Ft. 2 billion total grant)

| LOCATION: | POPULATION (1990) | MIGRATION ('80-'90) | POP'N CHANGE ('80-'90) | PUBLIC HOUSING UNITS | SUB-STD UNITS |
|---|---|---|---|---|---|
| District I | 34976 | -2960 | -6121 | 10784 | 1376 |
| II | 103204 | 1227 | -4209 | 16881 | 2769 |
| III | 148466 | 28218 | 26043 | 23704 | 2780 |
| IV | 108064 | 28388 | 25551 | 19958 | 4008 |
| V | 43944 | -1424 | -6184 | 18438 | 2447 |
| VI | 59742 | -4888 | -11462 | 25559 | 7596 |
| VII | 78508 | -4664 | -13842 | 33961 | 11513 |
| VIII | 91729 | -10136 | -18803 | 36471 | 15527 |
| IX | 78400 | -5048 | -11695 | 28889 | 10513 |
| X | 96899 | -5369 | -7757 | 19771 | 5536 |
| XI | 176607 | 3167 | -2353 | 29742 | 3902 |
| XII | 76738 | -2650 | -6644 | 12446 | 2440 |
| XIII | 131777 | 4502 | -4112 | 36724 | 12669 |
| XIV | 142902 | -17020 | -25118 | 33297 | 6419 |
| XV | 95627 | -13390 | -17183 | 16146 | 2269 |
| XVI | 69979 | -345 | -2779 | 1800 | 536 |
| XVII | 72562 | 17772 | 16283 | 4172 | 128 |
| XVIII | 98075 | 9509 | 7458 | 6331 | 1063 |
| XIX | 73561 | 18483 | 14829 | 12365 | 3092 |
| XX | 90743 | -8014 | -11263 | 8894 | 3356 |
| XXI | 90272 | 15207 | 13580 | 11581 | 1003 |
| XXII | 53357 | 3468 | 2566 | 3695 | 1206 |
| Total Budapest | 2016132 | 54033 | -43215 | 411609 | 102148 |
| | | | | | |
| Debrecen | 212247 | 8044 | 14052 | 20892 | 2467 |
| Gyor | 129356 | 3302 | 5209 | 15040 | 1410 |
| Kecskemet | 102528 | 3012 | 5700 | 5460 | 608 |
| Miskolc | 196449 | -13145 | -11654 | 27173 | 2641 |
| Nyiregyhaza | 114166 | 690 | 5931 | 7503 | 519 |
| Pecs | 170119 | 2035 | 985 | 23648 | 2567 |
| Szeged | 175338 | 4023 | 4544 | 21776 | 2680 |
| Szekesfehervar | 108990 | 1521 | 5419 | 11500 | 696 |
| TOTAL | 3225325 | 63515 | -13029 | 544601 | 115736 |

.25'

TABLE A (cont'd)

| LOCATION: | FORMULA A (m Ft.) | FORMULA B (m Ft.) | FORMULA C (m Ft.) | FORMULA D (m Ft.) | FORMULA E (m Ft.) |
|---|---|---|---|---|---|
| District I | 22.7 | 30.6 | 22.7 | 23.6 | 27.7 |
| II | 55.9 | 63.0 | 41.6 | 43.6 | 58.6 |
| III | 70.1 | 89.6 | 120.8 | 117.2 | 77.4 |
| IV | 68.1 | 70.2 | 122.2 | 116.8 | 69.6 |
| V | 34.8 | 47.5 | 28.3 | 32.8 | 43.9 |
| VI | 84.2 | 65.5 | 74.6 | 77.8 | 82.4 |
| VII | 123.8 | 86.7 | 104.7 | 111.4 | 116.6 |
| VIII | 162.6 | 95.4 | 147.2 | 147.7 | 143.4 |
| IX | 115.1 | 77.4 | 98.6 | 101.8 | 105.8 |
| X | 77.9 | 66.3 | 68.4 | 65.9 | 74.5 |
| XI | 88.5 | 109.4 | 68.1 | 62.7 | 96.8 |
| XII | 44.9 | 46.6 | 37.1 | 39.4 | 45.4 |
| XIII | 150.3 | 108.3 | 123.9 | 117.2 | 138.8 |
| XIV | 99.8 | 105.4 | 109.2 | 102.1 | 105.4 |
| XV | 49.3 | 59.3 | 63.5 | 54.8 | 53.3 |
| XVI | 26.3 | 25.0 | 17.5 | 20.2 | 22.1 |
| XVII | 23.6 | 30.2 | 61.0 | 58.3 | 23.3 |
| XVIII | 39.6 | 42.0 | 50.5 | 45.7 | 36.8 |
| XIX | 49.5 | 45.5 | 83.5 | 75.1 | 47.9 |
| XX | 57.1 | 44.5 | 58.1 | 54.1 | 49.7 |
| XXI | 36.7 | 49.3 | 63.6 | 60.4 | 40.3 |
| XXII | 27.0 | 23.3 | 27.4 | 25.2 | 23.6 |
| Total Budapest | 1507.7 | 1380.9 | 1592.3 | 1553.7 | 1483.1 |
| | | | | | |
| Debrecen | 87.1 | 104.2 | 77.6 | 94.5 | 88.5 |
| Gyor | 52.3 | 67.7 | 42.5 | 47.9 | 56.0 |
| Kecskemet | 37.0 | 41.8 | 31.2 | 38.7 | 34.6 |
| Miskolc | 83.7 | 110.8 | 84.3 | 69.3 | 92.4 |
| Nyiregyhaza | 39.9 | 49.2 | 26.6 | 40.8 | 39.3 |
| Pecs | 74.9 | 96.2 | 54.7 | 52.1 | 81.6 |
| Szeged | 77.5 | 94.3 | 61.7 | 63.4 | 81.4 |
| Szekesfehervar | 39.8 | 54.9 | 29.1 | 39.7 | 43.3 |
| TOTAL | 2000.0 | 2000.0 | 2000.0 | 2000.0 | 2000.0 |

Formula A: $G_i = (.50)POP + (.50)SUB$

Formula B: $G_i = (.50)POP + (.50)PUB$

Formula C: $G_i = (.30)POP + (.40)SUB + (.20)INMIG + (.10)OUTMIG$

Formula D: $G_i = (.30)POP + (.40)SUB + (.20)POPINC + (.10)POPDEC$

Formula E: $G_i = (.40)POP + (.30)SUB + (.30)PUB$

# INTEGRATING STATE RENTAL HOUSING WITH THE PRIVATE MARKET: DESIGNING HOUSING ALLOWANCES FOR HUNGARY

by

József Hegedüs
Raymond J. Struyk
Iván Tosics

THE URBAN INSTITUTE

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**INTEGRATING STATE RENTAL HOUSING**
**WITH THE PRIVATE MARKET:**
**DESIGNING HOUSING ALLOWANCES FOR HUNGARY**[1]

Between the fall of 1990 and the spring of 1991 the Hungarian government will very likely make decisions that will fundamentally determine the shape of the nation's rental housing market for at least the next several years. These months are obviously when new ideas should be considered, especially those which realign the rental sector with the market principles guiding adjustments in the rest of the economy. Yet most of the debate is focussed on two administratively-oriented solutions: a wholesale privatization of rental units by selling them at deep discounts to their tenants, or retaining them as a special, highly-subsidized rent-controlled housing stock. This paper analyses a third alternative--reforming the rental sector along market lines while protecting lower income families from high rent payments through the implementation of a housing allowance program.

Under the third option, rents on social rental units are gradually increased to levels determined by the market. For the great majority of units this will be more than enough to cover fully operating and maintenance costs; services should actually improve. Occupants would still be permitted to purchase their units--but now at or near their market values, which would be greater because of the higher rents and better conditions. Those who would have to pay an unreasonable share of their incomes for rents would be protected by a housing allowance program which would subsidize the difference between what they can reasonably afford to pay and the rent of a good quality unit large enough to meet their needs. Those receiving the allowances, like other households, would be free to move from one social housing unit to another or into private rental housing: the allowance would travel with them. The management of social housing would be privatized and services improved--to give tenants something in return for their higher rents.

Key advantages of this system are that the rental sector is largely preserved, its value is enhanced, and subsidies are restricted to only those households who truly need them. The total subsidies, defined to include the value of rents not paid under controlled rents plus actual government expenditures, are very sharply reduced.

Thus, establishment of a housing allowance program, along with complementary actions, holds the promise of a fundamental and sustainable reform of the rental housing system. Obviously, however, adopting this program would be a very large step; and government officials, members of Parliament, and citizens would want to see a detailed analysis of such a system before embracing it.

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1 This is the Executive Summary of a paper of the same title, published in November 1990 by The Urban Institute for the Office of Housing and Urban Programs of the U.S. Agency for International Development.



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This paper is designed to fill this void by presenting a careful description and analysis of a housing allowance system proposed for Hungary.

## Simulation of a Housing Allowance System

Using a data set especially developed for this study by the Central Statistics Office a large number of alternative housing allowance designs have been simulated. All of these designs, however, employ the same "housing gap" formula under which each household whose income is low enough to qualify for these benefits receives a subsidy payment equal to the difference between the cost of a good quality unit of a reasonable number of rooms for a family of different sizes and the share of the household's income that it can reasonably be expected to spend on housing (values of 10 to 20 percent of income were explored). The subsidy is computed independently of the actual rent of the unit. Therefore, households who occupy smaller or lower quality units than the program standards get the same grant as those in the opposite circumstances and in effect pay a lower share of their incomes for housing. Low income renters living in private rentals as well as those in state-owned units could receive a housing allowance (although our data set only includes state rentals).

Two sets of simulations were undertaken: one for the first year in which housing allowances are introduced and one for the third year--the point at which rents paid on state rentals should be approaching market levels. These "years" may in fact turn out to be longer periods, depending on administrative and political problems encountered.

## Principal Findings

In Year One the administered rents in effect are increased by 100 to 200 percent. In Year Two, rents are shifted to a set percentage of market-determined rents, and in Year Three they go to a higher share of market rents. While the study did work with real estate brokers to develop estimates of current (summer 1990) market rents, these rents are for the very small private sector and the rent structure is expected to change dramatically over the next few years as more rental units are made available and as the lower income families in state rentals, with less purchasing power than current renters of market-rate units, enter the market.

The main findings for the Year One simulations are:

- Participation rates (i.e., the percentage of renters who are eligible to participate), the size of subsidy payments to participants, and total program costs are all quite sensitive to the share of income which households must contribute to rent.

- Program costs are not high. In the most extreme case--imposition of a 200 percent rent increase above 1990 rent levels, and a household contribution rate of 10 percent of income--program costs amount to Ft.4.7 billion or 19 percent of the



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total rental revenue from the stock. Under a 100 percent rent increase, total subsidies are only Ft.1.3 billion.

- Nevertheless, because the subsidies are focussed on the poorest renters, they make a significant difference on the economic situation of participants. Typically, payments account for 25-30 percent of unit rents.

- Subsidy payments are distributed among participants in ways that show a very strong targeting on need. Eighty percent of the subsidies go to households in the lower half of the income distribution; half go to those with eight or fewer years of schooling; and two-fifths are received by households without a working family member.

- The share of income which households not eligible to receive a housing allowance must spend on rent is not extreme, even for those who are "overhoused". Under a 200 percent rent increase, such households would spend about 15 percent of income on housing.

The cases simulated for Year Three differ principally in the share of income participants must spend on housing (values of 10 to 20 percent were used) and where rents on state rentals are set in relation to 1990 private market rents (values of 10 to 30 percent were tried). The case of rents set at 10 percent of 1990 private market rents involves, on average, the same rent increase as the case of a 100 percent increase in rents in Year One, although the structure of rents by location and quality level is quite different. We believe that in 1990 prices by Year Three the overall structure of rents will be about 30 percent of 1990 private market rents. In other words, our best estimate--which is subject to great uncertainty--is that if rents on state units are raised to the 30 percent level they will be near the market level, because a likely increase in the supply of rentals over the period will drive rents down and because the much more limited purchasing power of families living in state rentals will limit the extent of the rent rise on these units.

The results for Year Three can be summarized as follows:

- Participation rates in the models with market-type rents are generally high--in several cases around 90 percent--and are sensitive to both the share of income participants must contribute to rent and to the level of rent; but after a point, and holding participants' contributions constant, increasing the rent level has only the effect of increasing subsidies, i.e., net-of-subsidy rent revenues do not increase.

- Program costs are much higher than in Year One as the gap between actual rents paid and market rents is closed. However, under the program designs more likely to be adopted, housing allowances remain self-financing in the sense that the increase in total revenues is greater than the total subsidy.



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- Generally, targeting has the same patterns as in the Year One models, i.e., more needy households participate at higher rates and receive larger subsidies than more affluent households. But, as participation approaches 100 percent and higher income renters become participants in greater numbers, target efficiency is diminished. But even in these cases, the subsidies remain well-targeted on the poor.

- Overhoused households have very strong incentives to move to smaller units. These incentives increase with the share of income which households must contribute to rent ("t") and the rent level.

Our overall conclusion is that housing allowances are a key element in the solution to the problem of reforming the state rental sector so that it operates more efficiently and subsidies are reduced and provided only to lower income households. We also think that the transition process we have outlined offers a workable model. Nevertheless, while a simple increase in administratively set rents of even 200 percent coupled with allowances poses no special problems, enormous uncertainty surrounds introduction of the market rent-housing allowance system. The uncertainty encompasses administrative procedures, the responses by households and suppliers of additional rental housing to higher prices, and the political acceptability of introducing market rents.



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# PRIVATE MANAGEMENT FOR EASTERN EUROPE'S STATE RENTAL HOUSING

by

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## EXECUTIVE SUMMARY


State-owned rental housing constitutes 20 to 50 percent of the housing stock in the countries of Eastern Europe. It is characterized by a host of distortions and problems, including low rents and poor management. Options for the future of the sector include selling off the state rental stock or maintaining the current system. However, each of these approaches will force the state to bear large costs, either through large discounts required to make the units attract to buyers or in high levels of operating subsidies if current below-market rents are continued. Raising rents over time to market levels while protecting low-income tenants with a "social safety net" offers the best opportunity for reform, with the potential for both lowering the amount of subsidy required for the state rental stock and making purchase of state units at near-market prices more attractive to prospective buyers.

As rents are gradually increased to eliminate broad-based rent subsidies and to generate additional revenues, tenants will demand improved services. While it may be possible for the monopolistic state-owned enterprises who now manage this housing to deliver these improved services as their operating revenues rise, greater gains are likely if management is shifted to private firms. The need for such a shift will remain even in those countries where strong attempts are made to sell state rental units to their tenants. Many buildings are in poor condition and their occupants have little motivation to buy them because of low rents, worries about rehabilitation costs, and strong occupancy rights.

The introduction of competition among rental housing service-providers is critical in Eastern Europe for another reason—because of the limited scope for renters to express effective demand. In particular, significant housing shortages limit the possibility for dissatisfied renters to "vote with their feet" by relocating to another unit. Hence, renters need to be able to change management companies more readily than tenants in Western Europe and North America. Eventually, as more rental housing is developed, competition will be generated by households moving to better managed buildings.

Agency theory about the control of management agents by the owners of real estate suggests mixed possibilities for compatible owner-manager relations (and the efficient management of properties) in the private management of state rental housing. Managers will not have an ownership interest in the properties, which usually causes a divergence in the interests of owners and managers. On the other hand, concentrated ownership is typically associated with stronger control of management agents; in all cases the government is certainly the majority owner of the properties. Also on the positive side, governments should be able to create significant competition among management agents and the cost of shifting management companies will generally be small. Finally, the potential of interpreting signals about the management agent's activities (such as the state of the property and reports from tenants) and the use of non-price conditions to limit actions by the agent which might be against the government's interest as a property owner both suggest the possibility of developing owner-agent contracts which can adequately protect the owner and motivate the agent.




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There is limited experience generally with the private management of public facilities, and this is particularly so with housing. The only case we have identified of private companies managing publicly owned housing is in the United States, where there has been some contracting by local Public Housing Authorities (PHAs), who own the projects, with private non-profit and for-profit entities. The one major evaluation of the efficiency of private, for-profit management compared with PHA management did not find significant differences between the two. However, the applicability of these findings to Eastern European rental housing should be tempered by two considerations. First, the analysis—although the best available---is clearly limited, as it mixes the results for situations with differing contract provisions, different working arrangements between the PHA and contractor, and different degrees of competition in acquiring management services. Second, the very existence of a competitive market for property management agents is likely to lead to a greater degree of professionalism and efficiency in the field.

We propose a comprehensive reform in the management of state rental housing which would have four main elements.

1. A management contract for each building or project (a group of buildings) would be given by the local government to a firm. Each project would be large enough to make its management economically efficient; perhaps a minimum size of 100 units.

2. Local government would select three or four firms to compete for the management contract for each project (possibly through a bidding process). Representatives of these firms would appear at a meeting of the tenants and outline their management plans for the project. The tenants would then vote on which firm to hire. The management fee to be paid to the company would be fixed in advance of the competition for the short-listing, and all competitors would be given an estimate of the operating budget for the project and the actual expenses of the previous few years.

3. For the first two or three years, there would be a new competition each year, with the winning firm receiving a one year contract. The short duration of the contract is to keep the pressure on the firm to provide good services; if it does not, the tenants will not select it the following year.

4. Management contracts should be phased-in over a several year period, beginning with a demonstration project in a middle-sized city and one or two districts of the capital city where most state rentals are typically concentrated. Prior to that phase there would have to be an aggressive campaign to inform potential entrepreneurs of these opportunities and the chance for both staff of the state enterprises now managing the housing and others to attend workshops on efficient housing management and financial control.

The primary reason for using the "project" as the basic unit is to encourage small entrepreneurs to compete for these contracts. Some managers of the state enterprises now operating these projects might be among those beginning new firms. Because management companies require little capital equipment for routine operations, this is an ideal "incubator" for small firms. If necessary, the local council could work with commercial banks to make market-rate loans to the new firms for equipment, with loan payments deducted from the management fee.

Compared to the structure of present rental housing management Eastern Europe, the foregoing is indeed a radical transformation. The upgrading of technical skills of both the owners and managing agents as part of the implementation of a private management system is clearly desirable if not absolutely essential.

There is probably a substantial number of individuals who have the necessary knowledge about building systems to be able to manage maintenance and related operations in multifamily housing buildings. On the other hand, there is likely to be deficiencies in other skills, particularly those for efficiently organizing and deploying staff resources and for financial planning and control.

Clearly local government agencies have a pivotal role in the reformed system. The staff of these agencies must have a strong working knowledge of the cost of maintaining projects, be able to recruit management companies and negotiate realistic management fees, judge the quality of services being delivered by the management companies, and enforce contract provisions as necessary. These are demanding tasks and new tasks for local government. Obviously, the training for new firms and for local government officials is a responsibility which the donor community could discharge efficiently.

In the countries of Eastern Europe—Poland, Hungary, Romania, Czechoslovakia, Yugoslavia, and Bulgaria—the state rental sector typically accounts for 15 to 20 percent of the overall housing stock and over half of housing units in some major cities. State rental housing is typically built by state-owned construction enterprises, using large-scale, prefabricated concrete panels to construct multi-storey apartment blocks. Management of the state rental stock is carried out by state-owned management enterprises, with individual entities often being responsible for tens of thousands of units.

Hallmarks of this stock include:

- Low rents, usually only a fraction of rents for comparable private rental units (where a private rental market exists) and often accounting for less than 5 percent of occupants' income;
- Large on-budget subsidies for construction and maintenance (and massive implicit subsidies to renter households in the form of below-market rents);
- Substantial deferred maintenance, with rental revenues and subsidies barely keeping up with operating costs;
- Allocation of units by bureaucratic regulations rather than through market forces and the price mechanism;
- The holding of implicit property rights by tenants, through the payment of up-front charges for occupancy and the low mobility imposed on households by chronic housing shortages;
- Inefficient management, as state management enterprises lack both the incentives and resources to run their properties efficiently.

Through the fall of 1990, no Eastern European country has introduced significant reform to the state rental sector, although private rentals have again been permitted. In contrast, the owner-occupied sector in these countries is generally shifting with alacrity to market principles; but important efficiency gains are still to be realized through improvements in information on sales prices, reduction in impediments to private housing production, and increasing the availability of market-rate housing finance and the introduction of more suitable mortgage instruments (Telgarsky and Struyk, 1990).

## Options for Reform of the State Rental Sector

In shifting the housing sector further to market-oriented principles, realigning the state rental sector is consistently posing the greatest challenge to the architects of reform. There are three options for dealing with the future of the state rental sector which have been widely discussed:

1. Sell off as many units as possible, either to their current tenants or other investors.



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2. Maintain the *status quo* in the sector, with continued low rents and subsidies for construction and maintenance.

3. Raise rents in a phased manner to gradually achieve market levels, employing a "social safety net" (such as a housing allowance) to protect households which cannot afford higher rents.

We examine each of these options below.

*Selling Off State Rental Housing*

The seemingly simple solution of privatizing the state rental stock has the strong attraction of being politically popular and quickly eliminating the operating and maintenance subsidies which currently burden government. Receipts from the privatization effort can be recycled back into the housing sector to alleviate shortages or improve the quality of the stock, or the resources can be used to reduce the existing budget deficit. The sale of state units is also a way to improve labor mobility and reduce inflationary pressures by absorbing excess demand and encouraging households to save. However, this approach also raises a number of problems.

First, the need for a rental sector should not be discounted. Rental housing is needed households in transition—newly formed and older households, those who require geographic mobility—and those who do not desire homeownership for other reasons. The private rental sector is not yet in a position to meet these needs. In most Eastern European countries, the private market for rental housing is still small and expensive and will only develop slowly. Landlord-tenant law is undeveloped, making it difficult to implement enforceable leases that adequately protect the property owner and his investment. Thus, any privatization effort must be realistic in preserving enough rental housing to meet demand.

Second, the state rental stock is a valuable asset and could provide substantial funds if this value could be captured by the state through sale of units at market prices. For example, Buckley et al. (1990) have estimated that the market value of the state-owned housing stock in Hungary exceeds the value of assets contained in the country's entire financial system. However, the experience of several countries indicates that this potential value is difficult to capture through privatization. Katsura and Struyk (1990) found that most sales of state-owned units took place at large discounts, primarily due to a reluctance to raise rents or alter tenants' property rights and because of potential buyers' lack of purchasing power and poor access to financing.

The need to use large discounts to make the sale of state rental units feasible raises two problems:

- First, the present distribution of housing units is the result of bureaucratic allocation, not market forces. Often those in the best units are members of the old



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ruling elite. Selling the units to their tenants at deep discounts represents a transfer of wealth from the state to the purchaser, and the greatest beneficiaries may be those whom society wishes to profit the least.

- Second, assuming a methodology can be applied to accurately calculate the market price for the sale of state rental units, past experience indicates many tenants would be unwilling to purchase their units even at very deep price discounts. Deferred maintenance and below-market rents in state rental units imply that purchasers will face significantly higher housing costs when they become responsible for maintaining their units and no longer benefit from the implicit subsidies of artificially low rents.[1]

If the sale of units to their occupants on a wholesale basis is at best problematic for the reasons outlined, the sale of projects to investors hoping to earn a market rate of return in the near term is even less likely to succeed given the substantial deferred maintenance costs and the lack of adequate laws defining landlord-tenant relations.

*Maintaining the Current System*

Keeping the current regime of low rents and large subsidies to the state rental sector would prove to be politically popular (at least with sitting tenants). It would also avoid the problems associated with reform of the state sector by protecting existing tenants from adverse developments associated with higher rents or loss of property rights. These modest gains, however, are more than offset by the problems associated with the current system.

First, the subsidies required under the present system are enormous and poorly targeted. In Hungary, on-budget subsidies for state rental housing construction and maintenance were equal to 1.4 percent of GDP in 1989. Implicit subsidies, based on rental income foregone from rents set below market levels, amounted to further 2.0 percent of GDP (Buckley et al., 1990). In Poland, subsidies for operations and maintenance of the state rental stock accounted for 1.6 percent of GDP in 1989 (World Bank, 1990). These subsidies are usually associated with particular units, not households, and tend to be distributed regressively—households with larger units receive the larger benefits, almost regardless of their income level.

In addition, reversing the deterioration of the state rental stock would require an increase in spending in the sector, with a corresponding increase in subsidies. Sitting tenants in state rental housing would continue to show low mobility rates because moving would mean the potential loss of these deep subsidies. Production of private rental housing would be discouraged, as demand for rental accommodation at market prices would be dampened by the possibility of obtaining a state unit with highly subsidized rents.

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1 For a more detailed discussion of these reasons see Katsura and Struyk (1990).



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Finally, in many Eastern European countries, control over the state rental stock is being turned over to local government. However, local government lacks both the experience and the resources to take on many new functions. The inability of local government to support the current level of subsidies implies they might be forced to either sell off the stock at very large discounts (with all of the problems noted above) or to reduce maintenance expenditures even further, with a consequent decline in the condition of the stock.

*Raising Rents with a "Social Safety Net"*

A third model is to move rents on state rentals to market levels over a period of several years, with low-income renters protected through a "social safety net", such as a system of housing allowance payments. For most units in the state rental stock, such rent increases would be more than enough to cover fully operating and maintenance costs. Both the quality of the stock and the level of housing services enjoyed by tenants should increase. Households that would have to pay an overly large share of their income to meet these higher housing costs would be protected by a support program which would subsidize the difference between what they could afford to pay and the cost of a unit suited to their needs. The subsidy would be linked not to the unit, but to the household and its income, ensuring proper targeting and progressivity. Analysis by Hegedüs, Struyk, and Tosics (1990) for Hungary shows that such an approach could very sharply reduce the level of subsidies required by the state rental sector.

This approach also makes it easier to carry out a program of privatization which fully captures the market value of the housing units being sold. Tenants face the full cost of their housing, and eliminating subsidies reduces the incentives to households to retain their state rental units when their incomes are high enough to make purchase affordable. With state rents at market levels, both tenants and investors should find purchase of units a profitable option.

This third option appears to us to offer the most beneficial course of reform for the state rental sector, combining both the efficiency of moving toward market pricing for rents (and facilitating the use of market prices for privatization of the units where desired) with the improved targeting of subsidies. This approach is not without its difficulties, however. Two key questions arise: how to handle sitting tenants' property rights and how to improve the management of state rental projects during the period of transition to a market-oriented system while the stock remains under state ownership.

Tenants of social housing in Eastern Europe currently have strong property rights very like those of an owner, due both to the low mobility imposed by housing shortages and (in some cases) to actual payments—for example, in Hungary payment of "key money" (worth up to 10 percent of the value of the unit) is made to the government at the time of initial occupancy. These "rights of occupancy" can frequently be inherited by children, or sold or exchanged. In Hungary, for instance, it is estimated that 30 percent of state housing occupants "purchased" their unit on the grey market (Hegedus and Tosics, 1990). As rents



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are increased towards market levels, these rights make it difficult to evict tenants unable to pay the higher rents. Moreover they reduce the incentive to purchase housing or to move to more appropriate units.

The best way to deal with this problem is to recognize explicitly the value of these property rights and to buy out tenants' share of ownership. A recent Hungarian proposal gives occupants a two-year period in which to buy their unit for 70-80 percent of its market value. Alternatively, they can continue to live in the unit as ordinary tenants and will receive 20-30 percent of the market value in cash or in the form of a bond. At the end of the two year period, tenants lose their property rights, including the right to transfer the unit to an heir.

Because rents are likely to increase by several hundred percent during the transition to a market-oriented system,[2] tenants will demand genuine improvement in services in exchange for the higher rents. It is, however, an open question whether the monopolistic and openly disparaged state-owned management companies, such as the IKVs (*Ingatlankezelo Vallalat*) in Hungary, will meet this challenge, even with a sharp rise in the financial resources available for maintenance and operations.

The introduction of competition among housing suppliers is especially critical in Eastern Europe for another reason—because of the limited scope for renters to express effective demand. In particular, in situations of significant housing shortage, the possibility for dissatisfied renters to "vote with their feet" by relocating to another unit is highly constrained (for example, Mayo and Stein, 1988); in Warsaw, as an extreme, moving is nearly impossible.[3] Hence, there is a need for renters to be able to change management companies more readily than is the case in the countries of Western Europe and North America. Eventually, as more private rental housing is developed, competition will be generated by households being able to move to better managed buildings.

We argue that greater increases in housing services delivered are possible if private firms are responsible for managing state rental projects (in a competitive environment and with a properly constructed contract) than if they remain managed by state-owned companies operating in the current manner, and we outline a practical proposal for implementing the shift to private management. In brief, it appears very likely that effective competition can be created among management firms, that these firms will be more responsive to tenant demands, and that incentives can be redirected through contractual specifications to increase services while minimizing costs. Logically, such arrangements should also result in a more efficient delivery of housing services.

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2 Estimates for Hungary are in Chapter 4 of Hegedus, Struyk, and Tosics (1990).

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



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The next section of the paper briefly discusses agency theory and some of the principles involved in constructing appropriate contracts between actors with differing incentives. Next we review the limited experience of private management of public assets, and in particular, of publicly owned housing projects. The proposal is then presented and discussed, followed by observations about the type of technical assistance that could be instrumental in successfully implementing the shift to private management. The paper closes with some conclusions about the potential efficiency gains from adopting the proposed system.

**Management Incentives**

Agency theory explains how the separation of ownership and management of a set of assets can lead to a conflict between owners and managers because of differences in the economic incentives they face whenever management does not fully own the property. The main issue is how to determine the compensation for the building manager while protecting the interests of the rental property owner.

In the simplest cases—where owners are solely concerned with profits, all relevant information about the agent's actions is complete and costless, and there are no temporal concerns (such as contract renewals)—agency theory shows that it is possible to design an optimal contract based solely on price.[4]

In practice, however, it is unlikely that the strict conditions which the simplest case requires will obtain. In cases which more accurately reflect reality, relying solely on pricing is not sufficient to achieve an optimal solution. Under these more complex conditions, the management agent has incentives to pursue his own interests to the detriment of the welfare of the owner. Other "optimal" contracts may be possible[5], but these contracts will not be as efficient as the solution in the simple case. The costs to the owner from this difference in incentives include those of monitoring the efforts of the management agent and reductions in the value of the property from under-maintenance, poor selection of tenants, and the like. The challenge in designing efficient contracts in this environment moves beyond simply determining the fee structure of the agent and must now include other means of monitoring and influencing the agent's actions to protect the owner while minimizing the costs associated with these agency constraints.

One approach to bring the owner's and the agent's interests together is to give the agent some ownership in the property. In general, agency costs decline as management's ownership share increase. However, spreading ownership between different parties is not

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4 See Barnea, Haugen, and Senbet (1985) for a more detailed discussion of these results.

5 These contracts are "optimal" in the sense that the welfare of neither the owner or the agent can be increased without decreasing the welfare of the other. However, it is not necessarily true that such a contract can be achieved under all conditions.



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costless. Agency costs tend to be lower when ownership is more concentrated (Lease, McConnell, and Michelson, 1983).

Allowing the market to impose discipline on management agents is another method for reducing agency costs. These should be lower the greater the degree of competition among management agents and the lower the cost of changing management agents (Jensen and Meckling, 1976).

Another possible avenue for improving the contract is for the owner to observe "signals" which provide information on the effort of the agent. To the extent that these signals provide accurate information and have low costs, the observability of the agent's actions is increased. (Perfect signals—which are costless to observe and provide fully accurate information about the agent's efforts—allow the owner to specify the first-best forcing contract defined above.) In the usual case where signals are imperfect, the fee for the agent will depend not only on the owner's profits, but also on the informational content of the signals (which may be difficult for the owner to interpret).

An alternative which is more frequently incorporated into agency contracts is the use of non-price conditions to limit the freedom of action of the agent. Studies on financial contracting have shown that non-price provisions can efficiently control conflicting incentives between actors, even when contracting costs are positive (Smith and Warner, 1979; Smith, 1980). Similarly, non-price provisions in management contracts can be used to ensure that managers do not take actions detrimental to the longer term interests of the owners.

Judged against these lessons from agency theory, the possibilities for harmonious owner-manager relations (and the efficient management of properties) in the private management of state rental housing receive a mixed review.

Managers will not have an ownership interest in the properties and ownership concentration will differ among countries. In some, ownership will be fully concentrated in government—perhaps typically local government.[6] In other countries, ownership will be split between the government and occupants until steps are taken to buy out tenants' "ownership rights" as described above. Even in cases of split ownership, however, the government certainly remains the majority owner. In short, ownership is reasonably concentrated. This is

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6 The distinct trend in Eastern Europe to judge by Hungary and Poland is for the national government to transfer ownership of the state rental housing to local governments as part of a very broad decentralization program. In Hungary the law effecting this transfer was passed in the summer of 1990, while it is at this writing still pending in Poland.

There has been some suggestion that in reforming rental housing sectors socialist economies should assign ownership of the housing to new local foundations which would be responsible for their management. In terms of agency theory it is difficult to see the gain in efficiency of management from this arrangement compared to local governments being the owners. One potentially strong argument for the foundation model, however, is that the foundations may be less subject to political pressure in selecting management agents, setting fees, and enforcing contracts. Whether this would be true in practice is unclear.

important as results of a recent analysis of agency costs for privately owned U.S. multifamily rental properties found that greater concentration of ownership reduces narrowly defined operating costs by about 5 percent (Rosenberg and Corgel, 1990).[7]

Other factors suggesting gains from shifting to private management are that the governments should be able to create significant competition among management agents and the cost of shifting management companies will generally be small. Under some circumstances higher switching costs might be encountered, such as when the owner elects to change management in the middle of major rehabilitation of the property while the managing agent is providing oversight of the improvements on behalf of the owner. We have not, however, found explicit empirical support for the "competition" argument in the literature; the study by Rosenberg and Corgel (1990) referred to above found no impact on costs of a greater degree of competition in the market for property management services—as very roughly measured.[8]

There are also a variety of signals which owners can observe to monitor the efforts of the management agent. For example, the physical condition of a property as revealed by visual inspection can be used as a relatively costless signal for the efforts of a management agent. However, the signal may be inaccurate to the extent the condition of the building is influenced by factors outside the control of the management agent, such as vandalism and differences between tenants in the care of their units. Owners may also be able to take advantage of some commonality of view with their tenants. Regardless of the status of a tenants' ownership rights, because of chronic housing shortages and lack of mobility tenants are likely to have monitoring incentives similar to those of owners. Thus, tenants may offer the property owner a low-cost and accurate signal on the performance of the management agent.

Finally, it seems likely that non-price conditions can be developed to impose limits on actions by the management agent that may be against the owner's interests. Such conditions are often found in mortgage contracts, for example. These agreements often contain clauses which restrict the use of the property (no rental without lender permission), supervise certain activities required to maintain the value of the asset (escrow accounts for insurance and property taxes), and require the borrower to pledge collateral against non-performance in the contract. Thus, the specifics of the contract between the owner and management agents will be an essential determinant of the success of the private management approach.

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7 Operating costs were defined to include all operating costs except real estate taxes, utilities, casualty insurance expenses, replacement reserves, and capital expenditures that are not generally under the control of property managers and are subject to wide variations across properties.

8 The variable measuring competition was a simple one which indicated that distinguished situations in which there was apparently some competition from those where there was none.

## Private Management of Public Assets

*Overview*

The literature on privatization yields few examples of private management of publicly-owned assets (for example, Donahue, 1989; Vuylsteke, 1988). The most prominently cited examples are of privately managed publicly-owned water distribution systems, particularly in France and French West Africa. Under the *affermage* system, the public authority constructs the system and then contracts with a single firm for operation and maintenance, collections, and relations with consumers. The firm discharges these duties at its own risk, and under prices for water set in the contract (Roth, 1987).

**Table 1**
**Distribution of SOEs Placed under Management Contract by Type of Activity**
(percent)

| | |
|---|---|
| Hotels | 22 |
| Manufacturing | 17 |
| Agri-business, forestry | 17 |
| Airlines, shipping | 17 |
| Cement | 7 |
| Mining, oil refining | 7 |
| Other | 13 |

Source: Authors' tabulations of information in Candoy-Sekse (1988).

A recent World Bank survey of privatization of state-owned enterprises (SOEs) in about 70 countries identified 728 cases in which privatization was underway or completed and which contained sufficient information to classify the type of action—for example, public or private offering of shares, new private investment in the SOE, management contract. Of the identified cases a surprisingly large seven percent of the SOEs had been handed over to private management. Table 1 shows the distribution of the type of activities placed under contract, and the range is quite diverse. Despite this recent increase in experimentation with management contracts, there has been limited experience to date with the private provision of services using publicly-owned assets.

*Housing*

The only case we have identified of private companies managing publicly-owned housing is the United States, where there has been a limited amount of contracting by local Public Housing Authorities (PHAs), who own the projects, with private non-profit and for-profit entities, usually for specific housing projects.[9] In the early 1980s the U.S. Department of Housing and Urban Development sponsored an evaluation of privately-managed public housing. One explicit objective was "to examine the direction and extent of differences in cost and performance between sites or projects managed primarily by private firms and those managed by conventional PHA personnel" (Granville Corporation, 1983a, p. 1). Nineteen sites were included in the analysis, all of them managed by for-profit firms. Of these, thirteen were individual urban *projects* (owned by four PHAs) and six were rural *authorities* (that is, all the units managed by the private firm regardless of the number of projects). A control project or authority operated under conventional PHA management was carefully chosen for each of the projects operated by a private firm under contract.

Importantly, there was considerable variation among the responsibilities for which the PHAs contracted. In rural areas more services were contracted, which is logical given that the firm was managing all units. At these sites the contractors selected tenants (following federal guidelines), collected rents, enforced leases, performed routine and non-routine maintenance, managed staff, and processed disbursements as well as other tasks.

In contrast, the following illustrates the variation among contractor responsibilities at urban projects:

- Three PHAs allowed contractors to select tenants.

- All four PHAs used contractors to pursue delinquent rents, but only two used them to routinely collect rents.

- All four PHAs contracted out management of maintenance and operations services.

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9 In recent years, the British government has promoted a "Tenant Choice" program under which tenants can vote for a one time switch from management by the local housing council to a private company, usually a non profit housing association. Such a change in management also involves a negotiated sale of the property to the new manager. Note that the management change is a one-time only affair; hence, the new management agent appears to be under little pressure (competition) to be efficient. To date, however, there has been very limited experience with the program. For more, see Institute of Housing (1988).



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- Three PHAs used contractors to prepare project-level operating budgets for submission to the PHA for approval.

In addition, the basis for computing contractor compensation varied considerably in both rural and urban sites. While a usual (but far from universal) provision was payment of a fee computed as a percentage of rent collections, there were also various performance incentive fees that varied substantially. For example, one contractor was to receive a 4 percent fee if rental income increased by 7 percent, accounts receivable decreased by 5 percent, and the contractor adhered to the PHA's energy conservation program (Granville Corporation, 1983a). Lastly, the report for this work states that at several sites contractor fees were not established competitively and at some sites contracts were not subject to rebidding when the contract expired.[10] Non-price contract provisions (for example, requirements for tenant participation or limits on procurement) also appear to have varied widely although the reports do not provide much detail on those points (Granville Corporation, 1983a).

The analysis of costs and performance differences between contracted and PHA managed projects consisted of simple t-tests of differences and analysis of variance. These techniques did not permit sorting out the effects on performance of different contracting practices and provisions. Hence, the results should be taken as broad indicators of differences in the average performance of the two forms of management.

The main findings with respect to costs are for a single fiscal year (1981-82) for: (a) total routine expenses per unit month (p.u.m.) less utilities and payments in lieu of local property taxes; and (b) administrative costs p.u.m. No significant differences in total routine expenses were identified; but administrative expenses (including management fee) in urban projects managed under contract were found to be about 20 percent lower than for conventionally managed projects. Analysis was also done of the comparative performance in the areas of rental and occupancy, maintenance, crime and social problems, and tenant relations to test the hypothesis that private contractors were providing superior services at the same cost and conventional managers. No evidence was found of private for-profit management, on average, out-performing conventional PHA management (Granville Corporation, 1983a). Importantly, this finding applies to rent collections, a function sometimes subject to contract incentives; but even here responsibilities were mixed between the PHA and contractor on occasion.

Taken as a whole the results of this limited analysis suggest that simply contracting with private for-profit firms will not automatically lead to lowered expenses and improved services. But the strength of this judgment as it applies to Eastern European rental housing should be tempered by two considerations. First, the analysis, although the best available, is clearly limited, as it mixes the results for situations with differing contract provisions,

10 The report is no more precise on the points in this sentence than we have stated. More detail on some of these provisions is contained in Granville (1983a).

different working arrangements between the PHA and contractor, and different degrees of competition in acquiring services. Second, the very existence of a competitive market for property management agents is likely to lead to a greater degree of professionalism and efficiency. Short courses are routinely available from trade associations and the trade press constantly promotes new techniques and products. These activities can reasonably be asserted to improve the self-management of public housing in the U.S. by local housing authorities compared with the current monopolistic situation in Eastern Europe.

**The Proposal**

The reform in housing management would have four main elements.

1. A management contract for each building or project (a group of buildings) would be given by the local government to a firm. Each project would be large enough to make its management economically efficient; perhaps a minimum size of 100 units.

2. Local government would select three or four firms (through an open pre-qualification process) to compete for the management contract for each project (possibly through a bidding process). Representatives of these firms would appear at a meeting of the tenants and outline their management plans for the project. The tenants would then vote on which firm to hire. The management fee to be paid to the company would be fixed in advance of the competition for the short-listing, and all competitors would be given an estimate of the operating budget for the project and the actual expenses of the previous few years.

3. For the first two or three years, there would be a new competition each year, with the winning firm receiving a one-year contract. The short duration of the contract is to keep the pressure on the firm to provide good services; if it does not, the tenants will not select it the following year.

4. Management contracts should be phased-in over a period of several years, beginning with a demonstration project in a middle-sized city and one or two districts of the capital city where most state rentals are typically concentrated. Prior to that phase there would have to be an aggressive campaign to inform potential entrepreneurs of these opportunities and the chance for both staff of the state enterprises now managing the housing and others to attend workshops on efficient housing management and financial control.

The primary reason for using the "project" as the basic unit for which management companies are selected is to encourage small entrepreneurs to compete for these contracts. It might well be that some former managers of the state enterprises now managing these projects would be among those beginning new firms. Because management companies require little capital equipment to perform routine maintenance and operations, this is an ideal "incubator" for small firms. If necessary, the local council could work with commercial banks to make market-rate loans for equipment to the new firms, with loan payments deducted from the management fee.

*The Contract: Price and Non-Price Provisions*

The local council will enter into a contract with the management company. The local council sets the fee that the company will receive as a percentage of the gross rents collected at the project. Because the firm's fee is based on rent collections rather than on the rent roll it has an added incentive to collect rents.[11] Another option, argued strongly by Jaffe (1979) and others, is to base the fee on net operating revenue on the grounds that it gives managers incentives to control costs as well as to maximize rents. On the other hand, cost cutting may be achieved at the expense of project maintenance and upkeep which can have a strong negative impact on the owner's rate of return over the life of the project. Especially in the Eastern European context, where publicly-owned housing has been allowed to deteriorate for many years, it is probably important to ensure that incentives encourage maintenance.

In a fully developed system, the management company would set the rent for vacant units. It would try to set the rent at the market level: setting it too high would leave the unit vacant for some months, and the company would lose money (its percentage of rents not collected); in setting the rent too low would also "lose" money because the company's fee is computed as a percentage of actual rents. During the transition to a market-oriented rental system, rents could be subject to various controls.[12]

The percentage of rents going to the management fee is expected to vary among projects. For projects in poor condition, which command lower rents, the fee would be a higher percentage of rents. Similarly, for higher rent projects and projects in better condition (which therefore require less maintenance) the fee would be a lower percentage of rents.[13]

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11 Note that there is the possibility for conflict between the owner and manager on rent collections, because the managing agent will have a strong incentive to minimize vacancies and charge maximum rents. While in principle this is good, the managing agent may spend excessively on advertising and other inducements to achieve the high gross rent roll.

12 Rents on commercial space pose a potential problem because the ratio of maintenance costs to rent may differ sharply from that for residential space. One option would be to adjust the overall management fee in light of the percentage of commercial space; another option is to use different fee rates for residential and commercial space.

13 This flexibility deviates from standard practice in the U.S. where management fees are set at 5 percent of gross rent collections as an industry standard.

The management company negotiates its annual budget for each project for running and maintenance costs with the local council in advance of taking over management but after winning the competition. Since the management agent will have seen the operating statements prior to the competition, it should be exceptional for the agent and owner not to be able to agree on the budget. At this stage, and after a year or two of experience with private management, additional incentive fees for reductions in operating expenses for a given level of services could be negotiated.

The fees paid to each company for each project should be a matter of public record so that unusual amounts can easily be identified and questioned.

A series of non-price controls would also be imposed on the management company to protect the local council's interest in the property. These controls would include:

- Minimum required maintenance standards as ascertained by visual inspection, to prevent the management company from underspending on maintenance and repairs in order to keep operating costs low;

- Prohibitions on the sale or lease of assets associated with the managed property by the management company without the approval of the local council;

- Limits on procurements which do not require owner approval (both in terms of individual procurements and spending ceilings for various types of activities) to prevent the management company from undertaking large projects solely to respond to tenant concerns.

In addition, the required periodic re-election of the management firm by tenants also acts as a form of control, providing incentive to companies that wish to continue as the management contractor to provide the level of service as specified in the management contract.

*Profits and Short-falls*

The local council, as the owner, receives all revenue above running and maintenance costs and the management fee.

The foregoing envisions a situation in which rents are sufficient to cover the costs of operation and maintenance and the company's fee. If rents were less than this amount, then local government could either fix a lower budget (but presumably not fee) with the company or make up the shortfall in income from its own resources; that is, it could subsidize the project. A strong incentive for providing a fully adequate budget, aside from protecting the property from deterioration, is to be able to hold the management company accountable: when the company is told at the outset that its resources are insufficient to do the job, it may be very difficult to criticize poor performance. If rents are moved to market levels over a few year period, only a small share of projects should not have rent rolls large enough to cover these costs; indeed, rents should generally be greater than these costs, since there is no payment for capital costs in the negotiated budgets.

A more serious concern is that once market rents are being charged, managers of public properties will be subject to a rather soft budget constraint because of the lack of debt on the property (since the competitor private properties will have such debt); and this may cause general inefficiency in the public sector since governments' net incomes will still be high despite less than efficient management. More generally, if there is a "soft budget constraint," the excess could be captured either by the managing firm in inefficiency or by the tenants in the form of increased services. If tenants are successful in controlling management companies through the annual voting procedure, then the latter is expected; publicly-owned buildings will be popular among renters. Ultimately the problem of the "soft budget constraint" may be solved by the sale of the properties to private owners.

As the owner of the property, the local government would make the decision about which properties to rehabilitate. In principle, these decisions should be based on financial calculations with post-rehabilitation rents being sufficient to cover amortization of the investment.[14] Similarly, local government should decide to retire those projects from the stock which are in very poor condition and whose rehabilitation is not economically feasible. Such retirements, however, would have to be done in the context of a broader strategy of providing additional rental housing.

*Tenants' Choice*

We anticipate that the tenants would choose among three or four competing firms. While tenant interest in selecting the firm should be high in general, it should be especially so because tenants have low mobility. State-owned management companies would be permitted to compete for the contract on any project. The contracts awarded to the state enterprises would be the same as those given to other companies; and, hence, the state enterprises would be subject to the same incentives as other firms.

As part of the process of selecting the management company, the tenants might also have a direct voice in deciding on whether certain services would be included in their rents. These would typically be labor-related services and small improvements (such as installation of a buzzer or visitor announcement system) that could be easily priced and implemented. Services could be added or deleted to the package offered by the management companies. (The budget of the management company would have to be negotiated on the basis of the services actually to be provided by the company, if the service package were changed.)

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[14] It would be important for there to be demand-side subsidies, like housing allowances, available to protect lower income families from severe rent increases in these cases. If such assistance is not present, it is very likely that decisions will not be based on market parameters.

After a few years, with the agreement of the tenants, longer-term contracts could be given by the local council to firms that had proven to be competent and efficient managers. Longer-term contracts might be especially desirable for projects undergoing moderate rehabilitation in order to provide continuity during the construction phase. In such cases the contracts could be modified to assign the management company some of the oversight responsibilities for the rehabilitation work.[15] In all cases, however, the contracts would contain a clause permitting the owner to cancel the contract upon minimum notice, but with some penalty.

## Technical Assistance

Compared to the structure of rental housing management present in Eastern Europe in 1990, the foregoing is indeed a radical transformation. The upgrading of technical skills of both the owners and managing agents as part of the implementation of a private management system will greatly facilitate the process.

There is probably a substantial number of individuals who have the necessary knowledge of building systems to be able to manage maintenance and related operations in multifamily housing buildings. On the other hand, there is likely to be a deficiency in other skills, particularly those for efficiently organizing and deploying staff resources and for financial planning and control.

Clearly local government agencies have a pivotal role in the operation of a mixed public-private system of management of the social housing stock. The staff of these agencies must have a strong working knowledge of the cost of maintaining projects, be able to recruit management companies, design appropriate contracts and negotiate realistic management fees, judge the quality of services being delivered by the management companies, and enforce contract provisions as necessary. These are demanding tasks and new tasks for local government. Obviously, the training for new firms and for local government officials is a responsibility which the international donor community could discharge efficiently.

## Conclusions

On balance, what are the prospects for improved services and greater efficiency in management? Based on agency theory, there are several reasons to expect relatively good performance: ownership will be fully concentrated in local government; it appears possible to create substantial competition among property management firms; the costs of switching firms is small; sources of information on management efforts are available; and conditions can be

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[15] Other alternatives also exist for dealing with the conflict between short-term management contracts and long-term rehabilitation projects: a separate manager could be engaged for the rehabilitation work (like the supervising architect on a construction project); the work could be managed by the owner's supervisors (similar to the function of building inspectors); or the rehabilitation work could be carried out in phases coordinated with the contracts of the management agents.

included in the contract that limit the ability of the management agent to act against the owner's interests. In addition, further gains should result from the provision of technical assistance—improved financial management skills on the part of management agents, and better contracting and monitoring practices for city officials. Nevertheless, there is still concern whether city officials will in fact exercise due diligence in contracting and monitoring. (Indeed, one can argue that the collective ownership implied by city ownership is a highly diffused ownership form, not a concentrated one.) While laxity by city officials could produce an entire cadre of inefficient firms, where management firms are responsive to tenants—due to the re-election procedure—the benefits may actually accrue to unit occupants. In short, there are some grounds for optimism for a positive near-term outcome from shifting to the private management of the state rental stock. The shift is nonetheless something of a gamble—a gamble in which carefully constructed contractual arrangements and concentrated and effective technical assistance can improve the odds of success.

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