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**Progress in
Privatization:
Transforming
Eastern Europe's
Social Housing**

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**OFFICE OF
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Progress in Privatization: Transforming Eastern Europe's Social Housing

April, 1992

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ABSTRACT

Frustration with housing conditions was no doubt a factor in the revolutions that swept the communists from power in Eastern Europe. The region's new governments are considering a number of reforms in the housing sector to change the old system, but the loudest rallying cry has been privatization: selling social (government-owned) housing to private buyers, principally residents, but in some cases investors.

This paper reviews the progress of housing privatization in Eastern Europe through early 1992, focusing on four countries: Poland, Czechoslovakia, Hungary, and Bulgaria. It indicates (a) that the ownership of a significant number of social housing units in each of these countries has already been transferred into private hands, but more will need to be sold to reap the full benefits of privatization. Progress toward an efficient housing sector will also depend on several accompanying reforms: rent increases, ultimately leading to the removal of controls; legal revisions permitting landlords to evict tenants if they fail to honor their obligations; housing allowance programs, focusing assistance tightly on the poor; enabling legislation to permit the sale of social housing in a workable form; the availability of mortgage financing; capacity to appraise properties and record titles efficiently; the encouragement of private building management.

Privatization policies from here on will need to be based on more careful analysis and strategic thinking than has typically been applied to date. Our judgment is that extremes should be avoided; i.e., setting prices so high that the privatization process is stopped or so low that local governments are, in effect, giving the stock away. Instead, a strategic incremental approach, keeping in mind a number of issues described in detail in this paper, should be adopted.

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EXECUTIVE SUMMARY

Frustration with housing conditions was no doubt a factor in the revolutions that swept the communists from power in Eastern Europe in the last few years. The region's new governments are considering a number of reforms in the housing sector to change the old system, but the loudest rallying cry has been privatization: selling social (formerly state-owned) housing to private buyers, principally residents, but in some cases investors.

The purpose of this paper is to review the progress of housing privatization efforts in Eastern Europe through early 1992. We first examine the context of privatization by looking at the other policy reforms needed to support it. We then describe what four countries—Poland, Czechoslovakia, Hungary, and Bulgaria—have done about these reforms, and review the actual progress they have made in housing privatization. Last, we draw lessons from this experience that may help to guide these and other formerly communist countries in the next stages of reform.

The Benefits of and Constraints to Privatization

East European institutions that owned and managed social housing faced no sanctions if they wasted money or ignored tenant complaints. The result was immense inefficiency. The replacement of old institutions with new ones that have powerful incentives to be responsive and spend money wisely will have several benefits. It should deliver a higher quality of housing service while reducing the cost of that service in relation to local incomes. It should stimulate savings, dampen inflation, and have a sharp, stimulative effect on the housing market.

Privatization—selling whole buildings to investors who operate them as private rentals, or selling individual housing units to their residents or others willing to purchase them—would not have been attractive to buyers under the old rules. The policy changes outlined below are designed to make such purchases attractive.

Remedies and Progress To Date

For movement toward a market-oriented housing system, the following changes will be essential.

Rent increases, ultimately leading to the removal of controls. While all four countries examined are moving toward the liberalization of rents in social housing, they still have a long way to go before rents reach market levels and controls are removed. Given the development of housing allowance programs to protect the poor,

it would seem that the pace of rent increases in Eastern Europe's social housing stock should and could be accelerated.

Legal revisions permitting landlords to evict tenants if they fail to honor their obligations. In East European countries, renters of state-owned flats have enjoyed extraordinary protection. The result is a low rate of residential mobility and a disincentive to invest private capital in rental housing. Each of these countries has made changes, some more effective than others, to deal with this problem. But even in Bulgaria, which has gone the farthest in reforming tenant rights, it is doubtful that decades of tradition can be easily overcome.

A housing allowance program, focusing assistance tightly on the poor. Housing allowances are rent supplements paid only to low-income families in which the size of the payment varies inversely with the family's income. Analysis of housing allowances in Hungary reveals that, at least at the beginning of the privatization process, the rent increases for all tenants would be sufficient to finance the allowance payments and leave significant funds to cover improved operation and maintenance of housing units. Analysis for Czechoslovakia is quite optimistic. Poland's housing allowance program will need changes before implementation.

Enabling legislation to permit the sale of social housing in a workable form. For true privatization, the law must not only permit sale but also permit and facilitate the creation of a viable form of private building control to replace government control after the sale. The lack of such provisions has thwarted privatization so far in Poland, and the situation is somewhat similar in Bulgaria. In both countries, ownership of units has been in name only; the government maintains responsibility for managing the units. The most promising alternative form of ownership for multi-unit structures is the *condominium*. It gives resident families more direct control over their living environment, and financial default by one resident does not create problems for the others. In contrast to cooperatives, condominiums' financial and managerial stability has made private lenders much more willing to provide financing for them. In Eastern Europe, only Hungary now provides for conversion to condominium form when government-owned properties are purchased by their tenants, although it is also the form proposed in Czechoslovakia's draft law on units sales, and it is being considered in Poland.

The availability of mortgage financing. Establishing a system of market-oriented housing finance through the banking system requires developing efficient banking institutions operating under market principles, introducing appropriate lending and savings instruments that deal with the inflationary problems associated with economic restructuring, and strengthening foreclosure procedures. An alternative to the banking system providing housing finance is for the governmental body owning the units to provide seller finance. The advantage of this approach is that the seller

can adopt innovative approaches and finance sales immediately while the banks are engaged in more systemic reform.

Capacity to appraise properties and record titles efficiently. The relatively low volume of private transactions and the lack of an institutional structure to share and make public information on sales has made it difficult to assemble data on "comparable properties" in these countries. Using data on comparables is the only feasible alternative to solving the problem of developing price information on buildings and property. Associations of real estate professionals have been established and are growing rapidly in all four countries. Technical assistance has helped to facilitate the process of computerizing sales information. Considerable work needs to be done to streamline the processing of title changes and to develop computerized record-keeping systems.

The encouragement of private building management. There is much scope for cost reduction in the management of state-owned housing. Introducing competition into the market for property management services can achieve these cost savings, and also enable renters who cannot yet "vote with their feet" (by moving) to change management companies. Another advantage of private building management is the opportunity it creates for viable entrepreneurs.

Recommendations

In all four countries, substantial volumes of housing have already been sold. It is likely that many of the worst inequities that were initially feared have already been implemented: units with tremendously high potential market values sold to tenants in the highest income groups for next to nothing. Privatization policies from here on in will need to be based on more careful analysis and strategic thinking than has typically been applied to date.

Our judgment is that extremes should be avoided; i.e., setting prices so high that the privatization process is stopped or so low that local governments are, in effect, giving the stock away. The alternative approach is *strategic incrementalism*. Some specific suggestions follow:

1. The most important and under-recognized opportunity is the implementation of a credible and well-publicized housing allowance program. Such a program is a way to legitimize and gain political acceptance for a massive net reduction in subsidy outlays.

2. While decentralizing much of the housing reform process to the municipal level makes good sense, it is vital to retain decisions about rent controls and housing allowance policies at the national level. Decentralizing those choices

would surely lead to internal inequities that would erode social support for the reform process.

3. Priority should be given to rapidly reducing the number of buildings for which government has any lingering management and maintenance responsibility. This means actions to convert multi-unit buildings where a substantial number of occupants have bought their units to a true self-ownership form like the condominium as soon as possible.

4. Accomplishing the above will require that some tenants who do not want to purchase their current units be forced to move. Due to entrenched tradition, evictions without the provision of substitute housing will be rare for some time to come. This means that to accomplish privatization, local governments will have to set funds aside to develop some substitute housing in order to permit a larger volume of transfers to take place.

5. One of the easiest reforms to implement may be the institution of competitive contracting for the management of social housing. It appears that private management companies will emerge almost immediately once the opportunity to compete for such work is announced.

6. Deciding what units and buildings to try to sell, at what price, with what financing, and on what schedule, is extraordinarily complex. Different strategies will be required for different quality housing stock and circumstances. There is a great need for technical assistance to help local officials in this work.

INTRODUCTION AND PURPOSE

Eastern Europe's communist governments saw themselves as responsible for providing housing for their populations, and took the responsibility seriously. Soon after assuming power, they confiscated apartment buildings and large private houses to bring them under social control. Then they began a program of building new social housing, much of it in high-rise concrete panel structures. Local arms of the state bureaucracy managed this housing and tightly controlled the allocation of apartments to families. By the late 1980s, government-operated social housing accounted for one-fifth to one-quarter of all housing in most countries in the region, but a much higher proportion in urban areas.¹

There is now little disagreement that the results were disastrous. Tenants paid only a negligible fraction of their incomes for rent and enormous public subsidies were required to cover operating costs. The management bureaucracies had no incentives to be efficient or responsive to tenants. With the mounting inefficiencies of the state enterprises that built new social housing and their drain on national budgets, the volume of new production dwindled over the 1980s. Overcrowding, undermaintenance, and rapid physical deterioration were ubiquitous.

Frustration with housing conditions--probably the lack of freedom and personal control as much as the physical decline--was no doubt a factor in the revolutions that swept the communists from power. The region's new governments are considering a number of reforms in the housing sector to change the old system, but the loudest rallying cry has been *privatization*: selling social housing to private buyers, principally residents, but in some cases investors.

The purpose of this paper is to review the progress of housing privatization in Eastern Europe through early 1992. We first offer a framework that looks at privatization in the context of several other policy reforms needed to support it. We next describe what four countries--Poland, Czechoslovakia, Hungary, and Bulgaria--have done about these reforms and then review the actual progress they have made

1. Unlike the Soviet Union, Eastern Europe's regimes allowed more retention of smaller single family homes in private ownership, and such housing accounts for about half of the stock in most countries. Such family housing, however, is heavily concentrated in rural areas--urban homeownership rates are extremely low by Western standards. The rest of the housing stock is made of cooperatives, housing provided by state enterprises for their employees, and a small but growing private rental sector.

in housing privatization. Finally, we draw lessons from this experience that may help to guide the next stages of reform.

We conclude, overall, that these countries have taken significant steps to create a more market-oriented policy environment and to transfer the ownership of social housing into private hands. However, the process remains fragile--it is far from complete. In some cases, privatization has been a sham. Units have been sold to tenants, but the old management bureaucracies still control the buildings and high subsidies remain. Bolder moves are probably called for and should be politically viable if made in conjunction with supportive policies and adequately explained to the public.

FRAMEWORK

The Benefits of Privatization

The problems of social housing under communism are now understood as an inevitable outgrowth of the nature of the institutions that owned and operated it. With no competition and full control over the assignment of tenants, institutions faced no sanctions if they wasted money or ignored tenant complaints. The extent of the resulting inefficiency is hard to measure, but there are many indications that it was immense. One indicator is the ratio of the median value of a housing unit to median household income. The data (Renaud 1988) demonstrate that costs in market-oriented housing sectors are substantially lower in relation to incomes than is the case in the government-dominated housing sectors of Eastern Europe. In the United Kingdom, the United States, and France--all market economies--median unit values range only from 2.4 to 2.8 times median annual income. The comparable ratio has been estimated at about 10 for Czechoslovakia, and at 12 or higher for Poland.

By the replacement of the old institutions with new ones--institutions that have powerful incentives to be responsive and spend money wisely--privatization should wrench such inefficiencies out of the system and deliver a higher quality of housing service while substantially reducing the cost of that service in relation to local incomes. Other benefits should follow, including the stimulation of savings (motivated by the increased availability of housing as an attractive investment asset), and a dampening effect on inflation (through the absorption of excess cash balances--see Struyk and Telgarsky 1991).

Moreover, privatization of a significant share of the stock could have a sharp, stimulative effect on the housing market, setting off increased mobility and expanding the opportunities for families to improve their housing circumstances.

Constraints and Remedies

Privatization entails selling social housing in one of two ways. In both cases, of course, the buyers must be willing.

- Selling whole buildings to investors who would operate them as private rentals, integrating them into the emerging private rental market;
- Selling individual housing units to their residents or other households willing to purchase them (assuming an association of unit-owners will then be formed to control property management).

Under the old rules, purchase would not have been very attractive for either type of buyer. The main constraints were that: (a) the buildings were operating at a substantial financial loss (operating costs were much higher than the controlled rental incomes); and (b) strong tenant rights built into the law made eviction difficult if not impossible. Normally, tenants who did not pay their rent could be evicted, but the process was cumbersome and, more important, the owner was obligated to find substitute housing for them.

It is easy to see why a private investor would not be much interested in buying a building under these circumstances. But these constraints also dampered the interest of tenants in purchasing their own units. The tenants had something not very distant from the right of ownership to begin with. Why should they pay out capital to buy the unit and then, in addition, face major increases in monthly outlays to cover the full costs of operating and maintaining the building?² For movement toward a market-oriented housing system, then, two policy changes will be essential.

- (1) A program of *rent increases*, ultimately leading to the removal of controls, and
- (2) Legal revisions *permitting landlords to evict tenants* (without the obligation to provide substitute housing) *if they fail to honor their obligations*.

Those who live in single-family housing and cooperatives (the majority of the voters in all countries) should favor such policies where they apply to middle- and upper-income renters in social housing, i.e., those who have inequitably benefited from huge subsidies in the past. But the population at large is not likely to support

2. Katsura and Struyk (1991) discuss these issues further and show how similar circumstances stifled housing privatization initiatives in China in the 1980s.

their application to the poor who simply cannot afford much higher rents. Social justice will appropriately demand a third policy change:

- (3) The implementation of a *housing allowance program* where assistance is focused tightly on the poor. Subsidy payments would cover the gap between a standard rent and the fraction of income it is reasonable to assume families can afford to pay for housing. Thus, subsidies would decline as incomes increase and higher income families would not be entitled to any support.

Unless these three themes are seriously pursued by the region's governments, it is unlikely that a market-oriented system can develop, whether or not privatization of social housing is itself carried out. If the environment does change along these lines, four other facilitating actions will be required to support privatization.

- (4) *Enabling legislation to permit the sale of social housing in a workable form;*
- (5) *The availability of mortgage financing;*
- (6) *Capacity to appraise properties and record titles efficiently;*
- (7) *The encouragement of private building management.*

TRENDS IN THE POLICY ENVIRONMENT

Here we discuss the progress made to date in Poland, Czechoslovakia, Hungary, and Bulgaria with respect to each of these seven reforms (the status of several reforms is summarized in Table 1).

Before this review, however, it is important to note a bold step taken recently in three of these countries that, while not essential to privatization, may prove a critical support for it: wresting the ownership of the social housing stock away from the central bureaucracies that controlled it in the past (in most cases, disbanding those bureaucracies in process) and transferring it to popularly elected local governments. Bulgaria is an exception in that local governments there have controlled the social housing stock since 1958. In the other three countries, this transfer has been made since 1989 (Table 1).

Since their livelihood does not depend on it, recently elected mayors do not have the strong incentives of the old bureaucracies to retain the housing stock under government ownership. To the contrary, facing large continuing operating deficits and, at best, uncertainty about the willingness of national government to continue to foot the bill, some mayors have been among the strongest proponents of rapid privatization.

Table 1
POLICY ENVIRONMENT FOR PRIVATIZING SOCIAL HOUSING

	Poland	Czech.	Hungary	Bulgaria
GOVERNMENT OWNED HOUSING				
No. housing units (000)(1)	2,078	1,438	800	255
Percent of total stock	19	24	20	9
TRANSFER TO LOC.GOV'T	5/90 (3)	5/91	10/90 (6)	1958
RENT DETERMINATION				
Controlled by	Cent.govt	Cent.govt	Cent.govt	Cent.govt
Ave.rent pct.of income	3.5	2.4	4.5	4.5
Pct.Rent increase (2)	100 (9/91)	100 (6/92) (4)	35 (1/90)	870 (3/91)
Pct.Inflation (1991)	55	49 (5)	35	470
MODIFICATION TENANTS RIGHTS				
Extent	Major	Modest	None	Major
Status	Pending	Enacted	None	Enacted
LAWS PERMITTING SALE				
Total building	None	1964	None	1958
Individual units	1970	None yet	1982	1958
PERCENT MANAGED BY				
Local government	Almost 100	Almost 100	Almost 100	Almost 100
Private firms	Negl.	Negl.	Negl.	Negl.

NOTES:

- (1) Number of units at start of privatization process.
- (2) Space rent only—excludes utilities.
- (3) Some questions about legal status due to registration problems.
- (4) Significant increases in utility prices were implemented in 1991.
- (5) Full increase occurred from January to June—inflation negligible since then.
- (6) Further clarification of law passed in 7/91.

Phased Rent Increases

As noted, raising rents on state rental housing units to a level equivalent to that commanded by privately owned rentals in a free market is mandatory for integration of the private and public rental sectors. Using free-market rents as a target is important because the development of a market-oriented housing sector implies that the private rental market offers adequate returns to investors and that households face the true cost of their housing in return for the greater freedom to choose the type of housing they desire.³

Increasing rents is equally important for the sale of state rentals at reasonable (market or near-market) prices. Put simply, the value of a unit to a sitting tenant (and other possible purchasers) depends on the unit's net rent. The higher the rent, the higher the value and selling price. Some transitional limits on rents will very likely be retained during the period of large price adjustments associated with the economic restructuring process. However, it should be the aim of policymakers to move as quickly as possible toward market rents as economic restructuring raises household incomes.

The new governments in all four of the countries discussed here have recognized the need for substantial rent increases and have taken some steps to implement them, although the increase in Hungary has only been token (and negative in real terms). In no case so far have central controls on rents in social housing yet been relinquished.

Poland increased rents in its social housing a number of times since 1965, but until recently the amounts of the increases were negligible (it was estimated that subsidies there had to cover 85 percent of operating costs on average in 1990--Matras 1991). A 100 percent increase in both energy costs and base rents, however, did go into effect in 1991 and another major increase is expected in 1992.

In Hungary, it was estimated that in fall 1990 rents in private units were 10 to 12 times greater than the rents administratively set for social housing. Of course, this is not the gap that will have to be covered fully by increasing rents on public units. The supply of private units is also increasing and the effective demand of the majority of occupants of state rentals is well below these levels, i.e., market rents are far too high to be paid. Both factors will drive market rents downward as rents on

3. Rent control remains in effect on all rental properties except for the small private rental sectors in Hungary, Bulgaria, and Poland. Private rentals are just now emerging through restitution in Czechoslovakia but controls for them have not yet been removed.

state units are gradually raised to meet them (Hegedus et al. 1991). Nonetheless, substantial increases in social housing rents will be required and an increase was implemented in January 1991 (although by a smaller amount than in Poland--35 percent on average, 50 percent for higher quality units). Also, importantly, the Hungarian government has stated that social housing subsidies will no longer be paid from the national budget. While they still exist, they will have to be covered from local revenues.

Tenant rents as a share of income remain lowest in Czechoslovakia (2.3 percent, vs. 3.5 percent in Poland and 4.5 percent in Hungary and Bulgaria) and that country has not yet increased unit rents. In fact, rents in Czechoslovakia are still set by a law that has not been amended since 1964. The country did, however, implement major increases in utility prices (including a 300 percent increase for space heating and hot water in mid-1991 that should eliminate the need for subsidies for those services), and eliminate special rent adjustments for families with children. Also a 100 percent increase in rents has been scheduled by directive for June 1992.

In Bulgaria, the fixed base tariff for social housing was increased from 0.19 leva per sq. meter to 1.65 leva per sq. meter in March 1991--an 870 percent increase, clearly the largest in percentage terms.⁴ However, even after that increase rents in social housing were still approximately only one-tenth those of private rentals in Sofia. The difference is reported to be not as great outside Sofia, but still substantial (Hoffman et al. 1992). Inflation reduced the real increase in rents to about half of its nominal value.

In sum, while all countries are moving toward the liberalization of rents in social housing, they still have a long way to go before rents reach market levels and controls are removed. There are anecdotal reports of greater arrearage in tenant payments since the recent spate of increases. However, there are no indications of mass refusals to pay--in most places it appears that tenants by and large are continuing to meet their obligations, even though prices for many non-housing goods and services also have markedly increased. Evidence indicates that in most of the region there are many middle- and high-income tenants in social housing whose rent/income ratios are still extremely low by international standards (see, for example, the analysis for Czechoslovakia in Telgarsky et al. 1992). Given the development of housing allowance programs to protect the poor (see further below),

4. The new rent system does retain 15 "adjustment coefficients" that can be applied by municipalities to alter the base rent depending on the quality and the location of the unit. In addition, to discourage overconsumption, the system calls for a doubling of the rent where floor space exceeds 20 sq. meters per person. Actual rents may thus vary from 1 to 3 leva per sq. meter, but even the higher level remains well below rents for comparable units in the private market.

it would seem that the pace of rent increases in Eastern Europe's social housing stock should, and could, be accelerated.

Dealing with Tenant Rights

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

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

This situation has two effects. First, a lower rate of residential mobility is established than would obtain in a market-oriented system that more evenly balanced tenant and landlord rights. The lower level of turnover provides less opportunity for households such as young families who tend to have the greatest needs for rental housing. Second, this lack of protection of landlord rights implies that there will be little interest by investors in dwelling units already occupied by protected tenants--effectively cutting off a large segment of the housing stock from private resources that could fund repairs and rehabilitation.

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

In some cases, however, these protections have literally been purchased by the tenants through some payment at the time of initial occupancy. The occupancy rights conferred by the payment of "key money" or similar charges include the ability to transfer occupancy of the unit to one's heirs and nearly absolute freedom from eviction, as long as rental payments are made. Moreover, in some countries it has been possible for tenants to sell their units in the "gray market" as well as to the

housing agency when they move. Thus, these tenant protections are quite different than the basic legal protections offered to all tenants.

In Hungary, tenants have been required to make a key money payment to the government at the time of the initial occupancy of the state-owned rental unit. The occupancy right implied by the key money payment was officially recognized by local governments in 1981. Local councils even purchase back the occupancy right (paying between three and ten times the initial payment, depending on the quality and condition of the unit) in order to have households vacate the unit so that it may be allocated to another household (rather than have the initial tenant privately sell the right to another household). Despite local authorities' attempts to buy back the occupancy right, the majority of households that leave their units do sell the right to another household. It is estimated that 30 percent of the tenants in state-owned housing purchased their occupancy right on the gray market (Hegedus et al. 1991).

Thus, in Hungary occupancy rights are so strong that the distinction between owning and renting is often blurred. These rights are effectively property rights and they cannot be ignored in attempting to reform the rental sector. A proposal put forth for Hungary (but unlikely to be adopted because of the momentum of current privatization policies) attempts to address the problem. The government would offer identical awards to those who purchase their units and to those who elect to remain as renters (Hegedus et al. 1991). In this particular case those electing to purchase would pay 20 percent less than the market value of their unit, and renters would receive a payment equivalent to 20 percent of the value of their units in cash or bonds. After this step, renters could continue to occupy their units as long as they paid the going rent (specified in a lease), but they could not sell the unit or give it to other family members. How to price these property rights is ultimately a political decision, presumably dependent partly on the effective strength of the rights under the old regime.

While compensating sitting tenants who have paid for their current property rights is a necessary step, it will not be sufficient. The overall laws governing tenant rights must be amended. This is likely to be politically difficult and will have to be done at the national level.

In Czechoslovakia, the civil code has been revised to make a start in this direction. The main revisions were: (1) to introduce, for the first time, the concept of a fixed-term lease (eviction would be at the landlord's discretion at the end of the stated term--important for the future, even though this would not affect current tenants); and (2) to give landlords more latitude in the choice of the quality and location of substitute housing that must be provided to a tenant who is being evicted.

But this does not yet represent a marked reform of the old rules. Draft housing reform legislation in Hungary would make broadly similar changes.⁵

A new housing law being considered by Parliament in Poland would go farther, actually eliminating the obligation to provide substitute housing when a tenant is evicted for valid reasons (Merrill et al. 1991). Decision on this act has been postponed several times, however, and it remains uncertain whether such formidable reforms will be enacted soon. Some municipalities are taking stronger action within the existing laws against tenants who do not pay rent. For example, the deputy mayor of Lodz widely publicized his 1991 forcible movement of 16 non-payers into much lower quality substitute housing units. This type of action would have been unthinkable several years ago.

Bulgaria has actually done the most to reform tenant rights, in part because its old protections for renters were never made part of a civil code, and therefore were easier to change. In 1991 the "Rental Relationships Act" was amended in several ways. One provision eliminated the requirement for private landlords to provide substitute housing for tenants being evicted for due cause. Another provision also made it possible for tenants in municipally owned housing to be evicted without substitute housing for a short list of reasons, including non-payment of rent. Even with these changes in the law, it is doubtful that decades of tradition can be easily overcome--landlords are likely to be cautious about evictions for some time, even where they are now clearly sanctioned. Nonetheless, these changes represent an extremely important step in creating the incentives needed for an effective market-oriented housing system.

Housing Allowances

The use of housing allowances permits the reform of the state rental sector to proceed on the middle course between the two administratively oriented solutions often advanced to resolve the current problems of state-owned housing: (a) wholesale privatization of state rental units at deep discounts, which would remove the immediate problem of the costs state rentals impose on the budget in the short term, but would not address the needs of poor households who cannot afford to purchase their unit or rent a unit in the free market; and (b) the retention of the units as special, highly subsidized, rent-controlled housing, which would continue the current pattern of high costs to the public sector with little control over occupancy of the unit once the unit is assigned to the initial tenant. Both of these approaches have the disadvantage of imposing significant costs on the public sector budget by providing expensive subsidies that are difficult to target on the households most in need.

5. For more information on the Hungarian situation, see Heller (1992).

Housing allowances are rent supplements paid only to low-income families in which the size of the payment varies inversely with the family's income.⁶ This is in sharp contrast to rent controls, under which all households benefit, regardless of income. Moreover, allowances are tenant-based rather than project-based, i.e., the recipient can take the subsidy with him when he moves, rather than having the subsidy tied to a unit. All income-eligible households--those living in state and private rentals--could participate. Thus, state rental units would lose their "privileged" status as subsidized housing and would be required to compete with private rentals to attract tenants--a strong motivation for maintaining housing quality and service levels when the state and private rental sectors are fully integrated.

Analysis has been done of introducing a housing allowance program in Hungary under which, at the end of the phase-in period participants would pay between 15 and 20 percent of their income for rents (exclusive of utilities) and with subsidies calculated as the difference between the market-determined rent of a good quality unit of the size appropriate for the household and its mandated contribution (Hegedus et al. 1991).⁷ Subsidies for renters living in units larger than the program standard for a family of their size are computed based on the standard unit--thereby creating a strong incentive to move to a smaller unit. The results show that the majority of current tenants would be income-eligible to receive an allowance payment but the rent increases (for all tenants) would be sufficient to finance the allowance payments and leave significant funds to finance improved operation and maintenance of these units. Note, however, these results are for the distribution of households at the beginning of the privatization process. Assuming the better units (occupied by families with higher incomes) have been disproportionately privatized, the "revenue surplus" will now be much less. Housing allowances were included in the draft legislation submitted to the Hungarian Parliament in April 1992.

Analysis for Czechoslovakia yields quite optimistic findings for housing allowances (Telgarsky et al. 1992). The income distribution in rental housing there is very similar to that for the nation as a whole, i.e., in contrast to conditions in Western economies, the tenancy of social housing is not dominated by low-income

6. For a general description of allowances and their expanded use in Western Europe and North America, see Howenstein (1986).

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

groups. While a sizable share of the total 1.8 million renter households⁸ are poor (18 percent have incomes below Kcs 30,000 per year), a surprisingly large number are in the higher income range (360,000 households, or 20 percent, make more than Kcs 100,000 per year). This suggests that most renters should be able to pay much higher rents without significant strain on their family budgets.

A simulation model based on these data assumes high market rents (four times the current levels) and a fairly pessimistic economic outlook. The results indicate that only 17 percent of all renters could not afford such increases without paying more than 20 percent of their income for rent. It should be possible to increase rents as needed to cover adequate building operations and maintenance while, at the same time, reducing total government subsidy outlays for social housing by at least 85 percent (from Kcs 4.7 billion to Kcs 0.6 billion), and avoiding the creation of true budgetary hardships for any family. Prospects are brighter for implementation in Czechoslovakia as well, because the government already has an income-based social payment program. It will be necessary only to build the housing allowance concept into the framework for that program.

Poland's Ministry of Labor and Social Affairs has already announced the establishment of a housing allowance program, but the program is not yet an operational reality and changes and improvements will be needed (Kingsley et al. 1992). First, the formula should be adjusted to provide realistic incentives. Under the present formula, the subsidy payment is to make up the difference between the full rent and eight percent of the tenant's income regardless of the level of the rent. The figure of eight percent is unreasonably low. Also, in a proper housing allowance program, a standard rent is set (based on reasonable costs to operate a modest unit) and the subsidy covers the gap only between a reasonable fraction of tenant income and that standard. This is an important difference that discourages overconsumption and puts sensible limits on total subsidy outlays.

Second, the Polish program is now quite small and not well publicized. Administrative capacity building is a high priority to enable it to efficiently handle the substantial growth in workloads it is likely to face over the next few years. Important in this is an adequate quality control procedure to assure that data on applicant incomes (used as the basis for the assistance formula) will be accurate. Once housing allowance programs have been adopted in the other countries, these administrative themes are likely to be high priorities over the next few years in Poland.

8. This includes tenants in housing operated by state enterprises for their employees as well as social housing.

Legislation Enabling Sales and Condominium Ownership

Obviously, privatization cannot proceed if it is prohibited by law. Among the four countries reviewed, only Czechoslovakia does not yet have legislation permitting the sale of individual social housing units to tenants (Table 1), although its Parliament is now reviewing a law that would allow such sales. Only Hungary does not have a law permitting the sale of government-owned apartment buildings, as a whole, to private investors, and in this case, revision to the laws in this direction do not appear on the current policy agenda.

A point often missed with respect to the sale of individual units, however, is that for true privatization, the law must not only permit sale but also permit and facilitate the creation of a viable form of private building control to replace government control after the sale. The lack of such provisions has thwarted privatization so far in Poland. Most units sold there remain in government-controlled buildings. The new unit owners can freely sell their units at prices they negotiate, but they do not have freedom of choice in, or responsibility for, management decisions and they typically continue to benefit from operating subsidies, just like the renters in the building.

The situation is somewhat similar in Bulgaria, where unit ownership has been legally permitted since 1958. But ownership there has been in name only. Until 1991, owners were not allowed to sell their units freely on the market. Management responsibility still remains with the government.⁹

The most promising alternative form of ownership for multi-unit structures is the *condominium*--over the past few decades, the fastest growing form of ownership for such structures in Western Europe and North America. The reasons for its success are: (1) it gives resident families more direct control over their own living environments because they have clear ownership of their own apartments and share a vote on building management; (2) unlike the situation in cooperatives, financial default by one resident in a condominium does not create problems for the other residents; and (3) partly because of this, condominiums have proven financially and managerially more stable over time--private lenders are much more willing to provide financing for them, and do so on reasonable terms.

9. In practice, building management responsibilities are ambiguous. Local governments actually focus their management and maintenance activity on rental housing and leave buildings dominated by owners relatively unattended. The owners sometimes initiate and finance repairs and improvements through informal agreements, but there are no formal owners' associations with clearly defined authority for ongoing operations and maintenance. In other words, no one is in charge.

In Eastern Europe, only Hungary now provides for conversion to the condominium form when government-owned properties are purchased by their tenants (under legislation adopted in 1924), although it is also the form proposed in Czechoslovakia's draft law on unit sales (Schreiberg et al. 1992) and is being considered in Poland (Kingsley et al. 1992).

In cooperatives, residents only own a share of the assets of the organization as a whole. In condominiums, residents receive independent title to their own units, clearly defined in space. They can freely sell their units without approval from any governing body. Condominium purchasers can also independently take on a private mortgage to finance the purchase of their units. In the West, private financing for condominiums is generally easier to obtain than it is for cooperatives (and on better terms) because there is less risk for the lender. If the individual family in a condominium does not make its required mortgage payments, the lender can foreclose and take over ownership of that particular unit.

This also protects the other residents of a condominium--if one resident defaults, there is no effect on the financial position of the building overall. In cooperatives, by way of contrast, it is the cooperative entity as a whole that must make the mortgage payments. If several residents default on their payments, the whole entity is threatened. Lenders see greater risk in getting their money back when the whole cooperative has financial problems.

Condominium owners also own a share of the common spaces (hallways, lobbies, elevators) and other assets of the development, usually in proportion to the amount of floor space in their own units. They are obligated to form a Condominium Association to be responsible for policy and management. Voting rights are in proportion to ownership shares. The Condominium Association elects some of its own members to serve as its board of directors. The board usually meets monthly to review the performance of full-time management and maintenance staff, and give them revised instructions and set revised policies as may be appropriate. Because provisions in the Association by-laws permit the removal of board members if the overall membership is not satisfied with their performance, the board has strong reasons to act in a responsible manner.

Almost always, the Condominium Association contracts with a separate professional management organization to handle the day-to-day work of building management and maintenance. After looking over the property, the firms present estimated budgets for costs and fees. The Association board then selects the firm that looks best from the standpoint of both qualifications and price, and enters into a contract with it, probably for a one-year period. The important feature of this arrangement is that the firm knows that if it does not perform well, the residents can terminate the contract and select another firm. The board uses the budget of the

winning firm as a basis for setting the payments all residents have to make each month to cover operations and maintenance (normally after having shared information on the firm's proposed budget with the full membership).

Mortgage Financing

Without adequate finance, effective demand for housing will be limited, as households will have to rely on alternative strategies beyond typical mortgage financing to purchase a unit. In particular, would-be purchasers are limited to housing with prices equal to or less than the amount the household has saved and can borrow from friends and relatives. Households without access to outside sources of capital will be forced to save for several years in order to purchase a unit.

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

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

There are two distinct avenues for providing finance: through the banking system or through "seller-financing" by local governments. Establishing a system of market-oriented housing finance through the banking system requires overcoming three key problems faced by reforming Eastern European economies:

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

Banking systems in Eastern Europe are only now making the transition from reliance on public resources to private funds for their lending activities--a change which requires more careful evaluation of borrowers and their requests. In the case of housing finance, the change is further hindered by the previous monopolistic structure whereby housing finance was channelled through a specialized bank, usually the state savings bank. This bank often acted merely as a credit allocation agent for the state, disbursing highly subsidized credits, and was not required to make any assessments about the riskiness of its loans. Steps are being taken in most East European countries to move the savings banks onto a commercial footing by removing the subsidy-distribution function from their operations and moving new housing lending toward market terms.¹⁰

A second problem to be overcome is how to structure long-term lending in an inflationary environment. The initial response in most East European countries has been to deepen subsidies to maintain the financial affordability of housing loans. However, in the cases of Poland and Hungary, the experience with this approach has proven to be extremely costly to the government. As a result, these countries are now planning to implement appropriate lending instruments--in the case of Poland, dual index mortgages (DIMs); in Hungary, probably a form of graduated payment mortgage; in Bulgaria, probably the Price Level Adjusted Loan (PLAM)--that help maintain affordability for the borrower while ensuring adequate returns for the lender.¹¹

Finally, attracting newly established private banks, which can bring needed technical underwriting skills and competition into the housing finance market, will require additional reforms beyond raising interest rates to market levels. Enforceable collateral guarantees and foreclosure procedures, which are still lacking in most East European countries, are also needed to provide security to lenders.¹²

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

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

12. Heller's (1992) discussion of these problems in Hungary gives a good overview of the general problems and some pointers on how they might be mitigated. The most serious difficulty is the right of the borrower to remain in the unit unless substitute housing is provided.

The alternative to the banking system providing housing finance is for the governmental body owning the units to provide seller finance. The principal advantage of this approach is that the seller can adopt innovative approaches and finance sales immediately during the period that the banks are engaged in more systemic reform. One example of such innovation is Budapest's District VII where the mayor proposed to the district council that future sales be financed using a PLAM with a *real* interest rate of 3 percent. Importantly, all subsidies would be in the form of price discounts. Thus, it is likely that after a couple of years' seasoning, these loans will be saleable to other investors at par, thereby giving the district use of more of its funds in the relatively near term than if it held the loans until maturity.¹³

It is also possible for seller financing to play a pivotal role in modernizing the financial system. By using a bank to originate and service loans made with seller financing, the bank will gain valuable experience with the new mortgage instrument, which should encourage it to adopt the instrument for its own lending.

Property Appraisals and Titling

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

There are several approaches to solving the problem of developing price information on buildings and property. Our assessment is that using data on comparables is the only feasible alternative. Over the past two years, it has been difficult to assemble data on "comparable properties," mainly because of the relatively low volume of private transactions and the lack of an institutional structure to share and make public information on the sales that do take place. Associations of real estate professionals, however, have been established and seem to be growing rapidly in all four countries reviewed here. The association in Prague is already developing a computer network as a basis for sharing information about properties on the market and sales transactions. Technical assistance has helped to facilitate the

13. See Struyk, Heller, and Mark (1991) for a further description of the options considered by District VII.

process, as demonstrated by the training of over 100 Bulgarian real estate brokers in the second half of 1991.

Another potential barrier to privatization is inadequate capacity to handle the legal recording of sales transactions. The maintenance of accessible and authoritative records on property titles is essential to an efficiently functioning private market. In all East European countries, considerable work needs to be done to streamline the processing of title changes and to develop computerized record-keeping systems.

Private Management of Social Housing

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

The introduction of competition among housing suppliers is especially critical for another reason: 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 (Mayo and Stein 1988); in Warsaw, as an extreme, moving is nearly impossible.¹⁴ Hence, there is a need for renters to be able to change management companies more readily than is the case in the countries of Western Europe and North America. Eventually, as more private rental housing is developed, competition will be generated by households being able to move to better managed buildings.

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

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

routine operations and local governments could work with commercial banks to help newly formed companies gain access to credit.

Recent experience in District 2 of Prague shows that, if given the opportunity, a pool of entrepreneurs can form rapidly to enter this market. After abolishing the state management company for the district, the council received 38 responses to its request for proposals from private firms to provide management services for its social housing stock. Of course, not all of the responding firms had adequate organizational and financial management skills, but 22 of them were retained. After six months of experience, it appears that four of these firms have not been performing satisfactorily and the district plans to replace them. Tenant and local government reactions are very positive about the others, however.¹⁵ Clearly, the approach works, although it could no doubt be further enhanced by additional training for the municipalities on the best methods of contracting with and monitoring the performance of private firms, and wider availability of training in modern housing management techniques for would-be entrepreneurs.

THE PROGRESS OF PRIVATIZATION

With these circumstances in the policy environment, how much privatization has actually taken place in Eastern Europe in recent years? Below we attempt to answer that question for each of the four countries. Fully reliable data on sales are not yet available for any of them, but there is enough evidence at hand to paint a general picture of what has occurred so far.

Poland

Sales of government-owned housing units to their occupants were first permitted in Poland in 1970 but the national housing survey indicates that by 1986, tenants who purchased their units then represented only about three percent of all residents in communal buildings. The most frequent explanation for the lack of volume is the lack of incentive: there was no clear indication through that point that the system as a whole was going to change. Anecdotal reports are consistent on one point: sales seldom led to private control. The new unit owners were normally in the minority in their buildings and government management agencies found it impossible to deprive them of the operating subsidies that continued to benefit their fellow residents.

It appears that the volume of sales did pick up dramatically for a few years, although by 1991 sales had almost stopped because sales terms were made much

15. Interview with the Deputy Mayor of District 2, Prague, March 1992.

Table 2
PROGRESS OF PRIVATIZATION

	Poland	Czech.	Hungary	Bulgaria
TERMS/CONDITIONS OF SALE				
Price basis	Govt. Formula	None yet	Apprais. Mkt.	Est. Cost
Price discount	95% (1)	None yet	60-85%	(4) Significant
Source of financing	St. Sav. Bank	None yet	Seller	St. Sav. Bank
Loan term (years)	35	None yet	35	30
Mortgage interest rate	1.3%	None yet	3.0%	49.0% (5)
Market interest rate	45.0%	16.0%	39.0%	54.0%
HOUSING UNITS SOLD				
Period of sale	1986-90	NA	1990-91	1985-90
Est. Units sold (000)	312 (2)	0	160	176 (6)
In pipeline for sale	NA	0	300	NA
PRIVATIZATION THROUGH RESTITUTION				
No. of Units (000)	0	400 (3)	0	0

NOTES:

- (1) Estimate for Krakow. Actual percents vary in different locations.
 (2) Rough estimate based on data in Matras (1991).
 (3) Estimated maximum subject to restitution.
 (4) 60% if rehabilitated in past 5 years, 85% if not.
 (5) 2% loans before 1/91 converted to 10%; now floating rate (49% if housing savings account).
 (6) Rough estimate based on data in Hoffman et al. (1992).

more stringent (discounts reduced to 15-20 percent of market value). An estimate based on the 1989 household budget survey indicated that the ownership share by then had grown to around ten percent nationwide. The Ministry of Construction has estimated that the share may have reached around 18 percent by 1991. Independent data for Krakow indicates that 17 percent of that city's social housing units were sold to their occupants between 1985 and 1989 (Matras 1991). This increase in sales was no doubt motivated by expectations of reform. In particular, many tenants wanted

to obtain clear security of tenure and take advantage of the old, highly favorable terms and conditions of sale before they changed.

Prices of units sold from 1986 to 1990 were set by pricing formulas developed by the Ministry of Construction, adjusted by time-series data provided by the Central Statistical Office. Formula prices for older buildings were discounted depending on their age (1.25 percent depreciation per annum). Buyers could pay back the purchase price to government in 80 quarterly installments (no interest is charged), but they are offered an additional 20 percent discount if they pay the full amount in cash. Other factors could yield other discounts adding to yet another 20 percent. The resulting sales prices were far below market value--so low in fact that most purchasers were able to pay in cash. For example, the average 1989 price in Krakow was 107,770 zl. per sq. meter, estimated at about 5 percent of market value in the area.

A new "Land Use and Expropriation" bill is now before the Polish Parliament that would give the newly established local authorities more autonomy in privatization, in particular, allowing them to set prices above those determined by the Ministry's formulas. It would also revoke a prior restriction prohibiting resale within five years of the initial purchase. Sales volumes have slowed down dramatically of late, reportedly because municipalities are holding back applications pending action on this bill. The bill has been under discussion for some time, however, and its passage appears far from certain. There has been discussion of another bill that would restore the titles to previously confiscated buildings now in the social housing stock to their original owners, but no drafts have yet been submitted to Parliament.

Czechoslovakia

Czechoslovakia is the only one of these countries that does not yet have a law permitting the sale of individual social housing units.¹⁶ To date there has been little interest in sales of whole buildings, although a 1964 law does allow such sales.

A draft condominium law that would permit the sale of individual apartments has been presented to Parliament, however, and prospects for its passage appear

16. A law permitting unit sales did exist in the late-1960s, but only a small number of units were sold under it and the practice was terminated shortly after it began. The most common view of the reason for its failure is that it did not provide for a new entity to take over building management after the units were sold. Except in the few cases where all tenants in a building wanted to purchase their units, there would have been no change in government control and it was viewed that government would be unable to prevent new unit owners from receiving the same operating subsidies afforded to the remaining tenants in the building.

high. The law adopts the U.S. condominium model whereby an association of unit owners is formed to control management, with an individual owner's voting weight and ownership of common spaces proportional to that unit's share of the floor space in all units (Schreiberg et al. 1992).

Since the law has not yet been passed, little can be said about what will happen when sales become possible. However, it is worth noting that: (1) many municipalities do have tentative plans to sell units quickly as soon as the law permits; and (2) most of these plans anticipate deep price discounts and seller financing at rates much below market.

Yet even without sales, Czechoslovakia may be privatizing its social housing at a faster rate than any other country through another mechanism: *restitution*. In 1990 the government passed a restitution law promising to transfer ownership of apartment buildings confiscated by the state after World War II back to the original owners or their heirs, providing that prior ownership could be adequately documented. Although as noted above, Poland is considering doing so, Czechoslovakia is the only East European country to actually implement this approach to date. Claims started to be submitted soon after the law was passed. Final deadline for submission was September 30, 1991.

National data on the number of claims submitted are still not available, but officials responsible suggest the process is proceeding rapidly and more smoothly than originally anticipated. An informal survey of district officials in Prague conducted by The Urban Institute in January 1992 indicated that of the 18,569 residential buildings owned by governments in the districts reporting, restitution was already complete for 7,460 (40 percent).¹⁷ The buildings subject to restitution are older and much smaller than more recently built social apartment buildings, so the share of all units restituted is undoubtedly well below 40 percent. Also, a few selected calls indicate that the pace of restitution in smaller cities and towns has been slower. Still, this represents an impressive transfer in such a short period of time. About 30 percent of all social housing units nationally (420,000) are in buildings old enough to be subject to restitution, and the current view of the officials is that a fairly high percentage will actually be transferred back into private hands. We estimate that 300,000 units is the minimum to be expected.

It must be remembered that the restituted buildings are still occupied by tenants under rent control and with strong tenant rights. Law requires the new owners to provide adequate maintenance regardless of rental revenues received. The

17. Prague has a total of 53 districts and sub-districts with a total of 80,370 buildings of all types; data on restitution noted above were reported by 32 of these units (accounting for 79 percent of the city's total building stock).

fact that so many private individuals have been willing to reclaim their properties in these circumstances suggests considerable optimism that a more complete reform process will eventually succeed.

Hungary

As noted earlier, legislation permitting the sales of government-owned units was passed in Hungary in 1982 and sales have become active, particularly over the past two years. A recent survey indicates that 20 percent of the units in Budapest were sold in 1990 and 1991, and that another 20 percent of the tenants would be interested in buying on the terms currently being offered (Hegedus, Mark, and Tosics 1992). Hard data on national experience are not yet available but it is reasonable to assume a similar 20 percent sold over this two-year period, i.e., about 160,000 units in all, representing about 20 percent of public rentals.

Sales prices are based on an appraised market value, but a standard 85 percent discount has been given on prices for government-owned units being sold (60 percent if the building has been rehabilitated in the past five years). Governments have provided seller financing under a standard agreement--the loans have carried a 3 percent interest rate for 35 years with a maximum loan-to-value ratio of 90 percent. Market interest rates, in contrast, are around 35 percent. Thus, as in Poland, the local governments have almost been giving away their housing stock.

Provisions of the Transfer of Property Act, which came into effect in September 1991, have made an extremely important change in this system. Local governments are now free to determine the size of the discount to be provided. Also, the government has reviewed a draft decree that would permit local governments to determine other financial terms under which they will sell units. This proposal was recently rejected, and has been replaced in April 1992 by draft legislation with modified mandated financing terms.

Bulgaria

Bulgaria represents a strong contrast to the other three cases in that it: (1) permitted the continuing existence of private rentals; (2) has always relied primarily on local governments to own and operate social housing; and (3) has allowed the sale of individual units to residents since 1958. Government-owned rental housing is now proportionately much smaller (only 9 percent of the total stock) because much of the housing in multi-unit structures produced by state enterprises has been sold to the inhabitants on a unit-by-unit basis.

In 1985, the state rental sector had represented about 15 percent of the total stock, but because the elimination of operating subsidies and increases in sales

prices were anticipated as that decade drew to a close, many households took advantage of their right to purchase their rental units at the old prices and loan terms. It has been reported that, in the larger cities and towns, over half of the rental units were sold in 1990 and the first quarter of 1991 (Hoffman et al. 1992).

Sales of state rental housing have traditionally been highly subsidized. In 1989 and 1990, government units were selling at a price ranging from 136 to 170 leva per sq. meter, substantially below the private sector averages of about 400 leva per sq. meter in 1989, and 950 leva per sq. meter in 1990. Mortgage loans were available from the State Savings Bank at a 2 percent fixed rate over a 30-year term.

In March 1991, the government dramatically altered its policies to reduce the direct and implicit subsidies in these sales. Sales prices were substantially increased to a level that is supposed to be based on production costs--the typical figure is 1,200 leva per sq. meter, much closer to market values, now estimated in the range of 1,800 to 3,000 leva per sq. meter in September 1991. The State Savings Bank also increased rates for these mortgages to the market rate, now 54 percent, or 49 percent for families with housing-linked savings accounts. Given current incomes and liquid asset holdings, these increases have all but terminated further purchases of social housing units by their occupants.

IMPLICATIONS FOR THE FUTURE

Given all of this experience, what should we expect (and advocate) concerning the future of privatization in Eastern Europe's social housing stock? It is important to recognize at the start that we cannot approach the question as if we faced a clean slate. In all countries, substantial volumes of housing have already been sold (or, in Czechoslovakia, transferred into private ownership via restitution). It is likely that many of the worst inequities that were initially feared have already been implemented, i.e., units with tremendously high potential market values sold to tenants in the highest income groups for next to nothing.

In fact, there is considerable opinion in all countries that many of the better quality and better located apartments have already been purchased by their occupants (or, in the case of Czechoslovakia, restituted). Increasing sales prices could be more difficult now as much of the housing that remains to be sold is less attractive in market terms. The point is that present policy opportunities are, at best, mid-course corrections, and the range of true opportunities will be limited in various ways by precedents set over the past few years. *Our first conclusion is that privatization policies from here on in will need to be based on more careful analysis and strategic thinking than has typically been applied to date.*

Yet, there are considerable reasons for optimism in this history. While it can be criticized as timid in a number of respects, the process of market-oriented reform (privatization plus all of the supporting policies we have discussed) is clearly moving forward everywhere. There are no signs of stoppage or reversal. And, apparently, the citizens of East Europe do indeed respond to market and policy signals. Examples include surges of unit purchases (based on the expectation of change even before the laws were passed), and private housing management firms forming virtually overnight when Prague's District 2 announced the opportunity.

Avoiding the Extremes

Our second conclusion relates to the most basic question of all: what pace and sequence should be expected in privatization at this point? The experience we have reviewed does not suggest any simple and fail-safe answer. It appears that the path is likely to be messy. Our basic judgment, however, is that extremes should be avoided.

On the one hand, it would be a serious mistake for any of these countries to immediately raise sales prices so high that the privatization process stops cold for a prolonged period of time (Bulgaria may have succeeded in doing this politically only because the remaining public housing stock is so small). We think it is unlikely that *all* of the current social housing stock ever could, or should, be privatized.¹⁸ But we do believe a significantly larger share must be transferred out of government control if the ultimate objectives are to be achieved: that is, the creation of a true market system that will yield the delivery of much higher quality housing services at a reasonable cost. Preventing or even substantially slowing down further sales in this or any other manner could diminish popular expectations about the certainty of the evolution to a market system, and that, in itself, would retard the positive adaptations of past behaviors that now seem to be taking place.¹⁹ While higher sales prices can enhance municipal treasuries, those benefits must be offset against the economic cost of perpetuating an intrinsically inefficient system--of postponing the day when a new and workable framework of incentives is in place. Privatization warrants a continued sense of urgency.

18. While this point may hold in general, about 80 percent of the units in Slovenia and Lithuania were privatized in a few months' time.

19. We do not mean to imply that Bulgaria's recent large increase in sales prices was necessarily a mistake. It has halted privatization temporarily, but that will not be a problem if the market catches up and sales begin again in the reasonably near future. Similarly, we would advocate that Czechoslovakia (the only country that has not yet begun unit sales) open its program with sales prices substantially above the extremely low levels implied by traditional valuation schedules. Those prices should not be so high that they stifle sales for a long period, but it is likely they could go well above the traditional levels without doing that.

On the other hand, there are likely to be grave social consequences if the responsible governments continue to charge prices so low that they are, in effect, "giving the stock away." Municipalities that are strapped for resources needed to renovate infrastructure, deal with environmental deterioration, and address a host of other pressing issues, are throwing away extremely valuable public resources by such significant underpricing. More fundamental, perhaps, may be the erosion of public confidence due to the inequities in the process as it stands. It may be possible to allocate substantial windfalls for a time without recrimination, but the more the public understands what has occurred and the longer the practice continues, the more resistance that could frustrate the progress of overall reform will grow.

Three obvious steps that could be taken, besides cutting price discounts are: (a) put housing finance on a market basis (but use indexed mortgages where needed); (b) restrict sales at discounts to households in social housing as of a set date (e.g., January 1990), and (c) recapture the value of the discount if a unit is resold soon (e.g., within three years) after privatization.

Strategic Incrementalism

The alternative to extreme approaches could be termed *strategic incrementalism*: (1) take noticeable steps to further privatization and the supporting policies discussed earlier while remaining within (although perhaps close to) today's bounds of social tolerance; (2) let things settle out for a time; (3) carefully examine the way things have settled out; and then (4) design the timing and composition of the next package of actions based on what has been learned. Key actions in any phase would include rent increases, rapid and equitable allocation of housing allowances to make the rent increases palatable, and ratcheting up of prices (and lending rates) on unit sales in privatization.

Even with incremental implementation, however, the government should clearly announce its intentions at the outset: that it will continue to raise rents until they approximate market levels, and then abolish controls; and that it will move to a point where sales will be based on full market values. During the phasing, attention should also be paid to the privatization policies in other sectors: price discounts in housing should be kept within a reasonable range of those for other sales to avoid distorting investment. Based on the recent history noted in this paper, several other suggestions are warranted.

1. Perhaps the most important and most under-recognized opportunity at this point is the implementation of a credible and well-publicized housing allowance program. Rent increases have been implemented so far without major trauma, but there could well be problems farther down the line. Public certainty about the existence of equitable housing allowance support for those who need it could

probably do more than anything to make the rent increase agenda acceptable. Considering present fiscal problems in these countries, it is understandable that some macroeconomic reformers may have taken a position against virtually any new "subsidy" program. They miss the point, however. They should read the Hungary and Czechoslovakia analyses noted earlier, which show that a housing allowance program is a way to legitimize and gain political acceptance for a massive net reduction in subsidy outlays.

2. While the decentralization of much of the housing reform process to the municipal level makes a great deal of sense, we believe that it is vital to retain decisions about rent controls (as long as they exist) and about housing allowance policies at the national government level. Decentralizing those choices would surely lead to sizable internal inequities which, again, would erode social support for the reform process.

3. Significant priority should be given to eradicating the type of "in name only" privatization that has developed in the sales of social housing in Poland and Bulgaria. This means actions to convert multi-unit buildings where a substantial number of occupants have bought their units to a true self-ownership form like the condominium as soon as possible. The point is to rapidly reduce the number of buildings for which government has *any* lingering management and maintenance responsibility.

4. Accomplishing the above will require that some tenants who do not want (or cannot afford) to purchase their current units be forced to move. This is perhaps the most difficult element of the reform process. We believe that a market-oriented housing system will never develop if, in the reasonably near future, landlords are not legally able to evict tenants who fail to pay rent without having the responsibility to provide them with substitute housing. We doubt, however, that even when enabling legislation is passed, traditions can be changed over night. Evictions without the provision of substitute housing will be rare for some time to come. This means that to accomplish privatization, local governments will have to set funds aside to develop some substitute housing in order to permit a larger volume of transfers to take place.

5. One of the easiest reforms to implement may be the institution of competitive contracting for the management of social housing. It appears that private management companies will emerge almost immediately once the opportunity to compete for such work is announced. This does not mean that all of the old government housing management entities have to be disbanded. They should be encouraged to compete as well, but with the full understanding that they will have to compete effectively to remain employed.

6. The task that lies ahead for mayors--deciding what units and buildings to try to sell, at what price, with what financing, and on what schedule--is extraordinarily complex. In most municipalities the social housing stock is far from uniform. Buildings may range from attractive older structures downtown, tenanted mostly by pensioners, to enormous complexes of recently built (but poor quality) high-rise concrete panel structures at the urban fringe, inhabited by a mix of income groups. Different strategies will probably be required for different sets of circumstances. Within each, financial and economic considerations will have to be carefully balanced against questions of political and administrative feasibility. There is a great need for technical assistance to help local officials in this work, including efficient strategies for collecting relevant data and computer-assisted models for testing the impacts of alternative courses of action.

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