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ABSTRACT

Selling Eastern Europe's Social Housing Stock:
Proceed with Caution

This paper examines efforts to sell state-owned housing to tenants, using the experiences of China, Hungary, and the United Kingdom to draw broad conclusions. It identifies impediments to the sale of state-owned housing and examines ways to facilitate the sale of such units.

The most sought after benefit of selling state-owned housing is a reduction in budgetary outlays for the construction, operation and maintenance of these dwellings. Other commonly cited goals include the desire to: dampen inflation; stimulate savings; increase labor mobility; improve the condition of the hosing stock; transfer wealth; and develop a sense of pride and identity in people.

The paper presents a conceptual framework for analyzing measures to sell state-owned units and encourage homeownership. The means through which policymakers can increase sales are: 1) raise rents, 2) rationalize borrowing terms, 3) clarify and strengthen property rights, 4) stimulate the demand to hold wealth. This framework was used to assess the sales programs of each country.

SELLING EASTERN EUROPE'S SOCIAL HOUSING STOCK: PROCEED WITH CAUTION

by

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EXECUTIVE SUMMARY

SELLING EASTERN EUROPE'S SOCIAL HOUSING STOCK: PROCEED WITH CAUTION

This paper examines efforts to sell state-owned housing to tenants, using the experiences of China, Hungary, and the United Kingdom to draw broad conclusions. It identifies impediments to the sale of state-owned housing and examines ways to facilitate the sale of such units.

The most sought after benefit of selling state-owned housing is a reduction in budgetary outlays for the construction, operation, and maintenance of these dwellings. Other commonly cited goals include the desire to: dampen inflation; stimulate savings; increase labor mobility; improve the condition of the housing stock; transfer wealth; and develop a sense of pride and identity in people.

The paper presents a conceptual framework for analyzing measures to sell state-owned units and encourage homeownership that George Tolley developed for his work in China. The means through which policymakers can increase sales are:

(1) Raise rents. Low rents discourage people from buying existing homes.

(2) Rationalize borrowing terms. To ensure a supply of funding, borrowing terms should be competitive and lending should be at market interest rates.

(3) Clarify and strengthen property rights. Both strengthening owner rights and weakening tenant rights will increase the incentive to own.

(4) Stimulate the demand to hold wealth. The demand to hold housing as an asset can be boosted by: increasing household incomes; improving the attractiveness of housing as an asset by clarifying property rights; and improving the liquidity of housing by allowing units to be freely bought and sold.

This framework was used to assess the sales programs of each country. The United Kingdom has sold over a million units, which has largely been achieved through deep price discounts, homeowner tax benefits, a desirable housing inventory, readily available financing, and comparatively weak tenant rights. The United Kingdom has not, however, adequately addressed the fundamental problem of each of the countries, which is low rents. Sales have been poor in China and

Hungary because of confused property rights and strong tenant protections.

The country analysis led us to the following conclusions:

Some nations have tried to sell their housing stocks without clearly identifying their objectives.

Large price discounts on the units sold are common, and are primarily due to a reluctance to raise rents and to alter property rights.

Large transfers of wealth from the state to buyers have resulted from the price discounts and other subsidies. This represents a waste of a valuable resource.

Sales of state-owned housing depend on the availability of housing finance.

Every country needs a well-functioning rental market to meet the needs of transient households.

A country's social safety net must be extended to include housing. A well-designed housing allowance for renters may be an appropriate tool to ensure that poor households are protected from excessive housing expenditures caused raising rents to market levels.

State-owned properties are poorly managed and maintained because of a lack of resources and accountability. Big state property management enterprises should be broken up. The private sector should be allowed to compete for management contracts, and to purchase projects outright.

There is no simple way to measure the success of a privatization effort, in part, because the goals are often so diverse.

Even if policymakers know what they have to do to increase sales in an efficient and equitable manner, they may lack the political will to carry out the necessary changes.

1

INTRODUCTION

Fundamental to the transformation of centrally planned economies to market-oriented ones is the privatization of the great majority of economic activity that has been subject to central control. Unfortunately, as John Donahue points out in his book, The Privatization Decision, privatization "is not only an inelegant term, it is also lamentably imprecise".[1] In America, where little economic activity has ever been in the public sector, privatization generally refers to public agencies, especially local governments, contracting out with private firms for the provision of services they have traditionally provided. In contrast, privatization in the context of Eastern Europe refers explicitly to changing the ownership (and sometimes management) of enterprises from the public to the private sectors.

In the planned economies of Eastern Europe the state has owned and managed a large share of the housing stock, particularly in urban areas. This stock has been rented to families at often nominal amounts, and units have been allocated according to complex rules. To date, privatization of the state rental stock has meant selling the units to their occupants. Since the overwhelming majority of units are in multifamily structures, most countries have rules regarding the share of unit occupants who must want to purchase a unit before units in the building can be sold. Thus, upon the sale of units, buildings shift from rental to condominium status.

Many of the issues which arise in determining the conditions under which to sell housing units are parallel to those which are confronted in selling state owned enterprises (SOEs). Most obviously, the housing stock, like the stock of industrial assets, is extremely valuable and represents a major resource under control of the state. These assets are so valuable that if sold at or near full value, they could provide the state with substantial funds to help during the economic transition. For example, Buckley, et al. (1990) have estimated that the market value of the

[1] Donohue (1989), p. 5.

state-owned housing stock in Hungary exceeds the value of the assets contained in the country's entire financial system. Difficult issues arise as to who owns the state rental stock and what rights sitting tenants have. Moreover, if units are sold for less than their market value, the critical issue of the distribution of the benefits between the purchaser and the state, i.e., the balance of taxpayers, arises.

In carrying out a privatization effort, the need for a rental sector should not be overlooked. Because private rental housing was not permitted in Eastern European countries, the state rental units constitute the rental housing stock. Success in selling all of these units would mean the elimination of rental housing. Obviously, a rental sector is needed--to provide housing for newly forming families, to permit geographic mobility and other reasons. Hence, the general privatization objective must be refined to be realistic.

This paper assesses the experience of several countries that have tried to sell state-owned housing to their citizens.[2] Specifically, it identifies impediments to the sale of state-owned dwellings and examines ways to facilitate the sale of such units. We stress at the outset that there may well be conditions under which the sale of units may not be economically rational. The real problem is to define the "right" conditions. The experience of these countries shed light on the problems that Eastern European nations are currently facing and others are likely to face in their housing sectors as their economies become more market oriented.

As the conditions of centrally planned economies of Eastern Europe have worsened, there has been a growing interest in privatizing the social housing sector. One of the primary benefits of privatization is a reduction in budgetary outlays for the construction, operation, and maintenance of housing. Receipts from the sale of units can be recycled back into housing or, alternatively, be used for the reduction of budget deficits or other purposes. Privatization of housing is also viewed as a way to improve labor mobility and reduce inflationary pressures by soaking up excess demand and encouraging households to save more.

Importantly, the promises of privatization may not be realized. It is possible, for example, to sell units at such low prices and with loans so heavily subsidized that the sale of units actually results in an additional drain on government finance.

By focusing on the sale of units, either to current tenants or others, this paper

[2] State-owned housing is also known as state housing, public housing, social housing, and council housing. We will freely interchange these names throughout this report.

takes a narrow view of housing privatization. Although the construction, financing, and management of units are also candidates for "privatization," they are not the main concern of this report. Examples of these other kinds of privatization include: reforms that force housing finance institutions to compete with commercial banks for deposits; the breaking up and selling off of a state construction monopoly; and the contracting out of the management and maintenance of state-owned housing.

The paper begins with a review of a conceptual framework for analyzing measures to sell state-owned rental units and encourage homeownership developed by George Tolley in his comprehensive analysis of privatization in China. His framework provides a useful way to think about the central problem of how to sell rental units when nobody wants to buy them. He identifies the tools that are available to policymakers to encourage sales, and offers illustrative examples--based on China's housing reform experiments--of the potential impact of these mechanisms.

After this analytical framework is presented, it is used to assess the experiences that Hungary and the United Kingdom have had in selling their state-owned rental housing stock.[3] The United Kingdom has had modest success in selling units, but not without controversy. Most of the units sold have been large semi-detached dwellings and row houses. Hungary, on the other hand, has had problems selling units--problems likely to be encountered by other Eastern European countries. Wherever units have been sold, purchasers have paid far less than the market price.

The final section of the paper presents some conclusions based on the country analysis. In addition, it considers a number of related actions that should accompany the sale of units. This section also reexamines the goals of privatization and offers some criteria for judging the success of a privatization effort.

[3] We examined other privatization cases before settling on these countries. Of those not included, the best documented case is that of Algeria. Algeria has had experiences similar to those of the countries included in this report. For more details, see, for example, Strauss, et al. (1990).

2

A POLICY FRAMEWORK

This section presents some of the key features of Tolly's framework for analyzing housing reforms in China.[4] It begins with an overview of China's progress so far. Next, it discusses the main analytical issues that form the basis for the framework, and then brings these points together to explain how to sell more housing.

A. THE CHINESE HOUSING REFORMS

To date, China's housing reforms have almost exclusively been concerned with selling units. Broader goals of achieving greater economic efficiency in the delivery of housing services and of improving equity have taken a back seat to more immediate goals such as stimulating savings, dampening inflation, and generating resources for more housing.

Tolley was primarily concerned with the problem of selling apartments to households that are not accustomed to paying much for housing--the typical situation in centrally planned economies where housing is provided on an in-kind basis rather than giving households the additional income to purchase housing services. His work focused on urban areas because work units and housing bureaus provide over 80 percent of the housing in these areas. Households in rural areas generally provide their own housing.

Rent and wage adjustments have thus far been the key features of China's plan to stimulate housing sales. Rents have been so low that housing has been a type of in-kind compensation for households living and working in urban areas. By raising rents and increasing wages to cover the increase in rents, China hopes to reestablish a normal rental market. Although a household's economic position remains unchanged by these adjustments, households have been given the new option of buying their units. The government hopes that the desire to avoid paying rent combined with the availability of special financing arrangements will induce

[4] This section draws heavily from Tolley (1990).

households to buy their units.

The results from rent and wage adjustment experiments being conducted in eleven small and medium sized cities have been discouraging. Tolley notes five indicators of lack of progress.

> First, not many households have been induced to buy dwellings.
>
> Second, despite higher rents, an effective rental market has not developed in the sense that households overconsuming housing have not reduced their consumption. No reallocation of housing appears to be taking place.
>
> Third, housing appears to be inadequately maintained; this is partly due to the lack of sales, but may also be due to uncertainty over who is responsible for maintaining units.
>
> Fourth, the lack of demand for purchasing homes means that weak signals are being sent to suppliers who, in any case, are subject to state allocations. The supply response has been weak.
>
> Finally, financial instruments have not evolved in a direction that encourages homeownership. The benefit of low-interest loans is being offset by short repayment periods which necessitate large downpayments.

B. ANALYTICAL ISSUES

Tolley's analysis focused on three main areas: tenure choice; rent and wage adjustments; and the problems of a mixed housing economy. The analysis of tenure choice involves taking a closer look at the incentives and disincentives to purchase a unit. Rent and wage adjustments can be thought of as prerequisites for selling units. The final area is concerned with problems resulting from moving only part of the way towards a market-based system of allocating housing.

Tenure Choice

The factors underlying the decisions of households to own or rent determine how many apartments will be sold. There are four main conditions--capable of being influenced by policies--which can have an impact on the number of households desiring to own housing: (1) the price of renting relative to the price of owning; (2) lending terms; (3) property rights; and (4) savings-portfolio decisions.

Each of these items is discussed in turn below.

The relative price of owning. One of the first things a household will consider in deciding whether to rent or buy is the difference between the price of renting and the price of owning. This comparison is made difficult by the fact that cash outlays by homeowners do not present an accurate picture of expenditures. Although maintenance expenditures are observable outlays, depreciation and the foregone interest on the downpayment and accumulated equity are not. The user cost of ownership can be defined as the sum of the interest component of the debt used to purchase the home, foregone earnings on equity, maintenance expense, and depreciation expense.[5]

In a free housing market, households compare their user costs of ownership to cost-based rental rates[6] in deciding whether to be an owner. However, if markets are controlled--as they are under the Chinese housing reforms--and low preferential rents are used rather than cost-based rents, then a household will only choose to buy if the user cost of owning is reduced by lowering the price of the unit. An important point demonstrated by Tolley is that <u>a reduction in rent causes a more than proportional decrease in the price that a household is willing to pay to buy a home</u>.[7]

Lending terms. Another factor that figures prominently in a household's decision to buy or rent involves the terms for borrowing money. Simply put, lower downpayment requirements, lower interest rates (such as subsidized interest rates), and longer repayment schedules increase willingness to pay. Conversely, high downpayment requirements, high interest rates, and short repayment periods discourage households from buying homes.

In at least some of the Chinese housing experiments, finance terms consist of 30 percent downpayments, repayment periods of 5 to 15 years, and heavily subsidized interest rates (as low as 3 percent when the market rate is probably in excess of 10 percent). While the net effect of these terms on buying behavior is unknown, the short repayment periods and large downpayments have undoubtedly

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[5] This term could be extended to include capital gains and tax consequences.

[6] In a free market, suppliers will not build new rental units if the rents they can charge will not cover costs.

[7] See Annex A for more details.

suppressed effective demand.

Heavily subsidized interest rates increase willingness to pay, but can be inflationary if they are not financed by higher taxes. Charging market interest rates would reduce this inflationary pressure and make it possible for housing lenders to attract funds on a competitive basis. Market interest rates also provide an incentive for all financial institutions--not just those serving as conduits for subsidies--to be interested in making housing loans.

Property rights. Property rights constitute a third critical factor that influences tenure decisions. In short, the existence of rights held by tenants that resemble those commonly reserved for owners, and the presence of constraints on an owner's ability to sell, rent, or otherwise use his or her property, both serve to reduce the gains from homeownership. For example, in China tenants have the right to transfer the right of occupancy to relatives and are only subject to eviction if they leave the work unit providing their homes. This provides a very secure living arrangement for tenants. In Hungary, tenants can even sell their right to occupy a unit.

Factors that weaken ownership rights include restrictions on who an owner can sell to and the resale price, restrictions on renting units (including rent control), unclear responsibilities for maintaining units, and uncertainty about property rights in the future.

In the Chinese reform experiments two types of owner property rights were offered; as a result, a "full property rights" housing value was established along with a "limited property rights" value. In Yantai, the limited property rights value--which was set at about 70 percent of the full property rights value--gives the owner inheritance rights, but restricts the owner's ability to rent out the unit, use the unit as collateral, and transfer the ownership of the unit to others. The owner can only sell the unit back to the work unit or agency that originally sold the unit. In Shenyang, an owner with limited property rights cannot sell his or her unit for five years. The organization originally providing the unit has the right of first refusal, and any capital gains are shared by the organization and the owner according to their equity shares.

Through a crude example, Tolley tried to estimate the value of property rights by comparing willingness to pay under a limited rights situation with the willingness to pay under a full rights situation in a freely-functioning market economy. He demonstrates that China's property rights situation may decrease willingness to pay for the purchase of housing by over 40 percent. This number is not meant to be taken as a fact, but rather serves to illustrate the potential order of magnitude of the impact of property rights. In Hungary, it is estimated that the "rights of occupancy" sell in the gray market for about 50 percent of the value of unrestricted rights of ownership.

Savings-portfolio decisions. The desire to own a home as a form of wealth is the fourth and final factor influencing tenure choice. Reasons for accumulating assets include the desire to earn income, save for retirement, have resources available to protect against short-term job loss or illness, and transfer wealth to heirs. An additional reason would be the desire to hold a hedge against inflation.

Households living in countries where high levels of social welfare services are provided and private property is relatively scarce will generally have a lower incentive to hold wealth. The availability of financial instruments and assets that provide returns to investors and the availability of funds to invest are prerequisites for increasing the demand to hold wealth, including wealth in the form of housing.

Higher income households tend to hold more assets and thus are more likely to become homeowners. This statement is more than simply a statement that rich people can afford to buy homes; it is a statement that households which hold assets will consider the possibility of adding housing to their portfolios, and that among these households, the richer ones are more likely to buy housing. The lumpiness and relative illiquidity of housing makes it an unattractive asset to households with relatively small asset holdings.

A household's life cycle position also affects its desire to buy a home. Compared to younger persons, older persons at or near the age of retirement are less likely to want to tie up their resources in a home. Housing is a long-term asset better suited for younger households. An implication of this is that efforts to increase homeownership rates will take a considerable amount of time. Everything else equal, the overall homeownership rate in a country should rise over time as younger home buying cohorts age and replace the older cohorts who chose not to buy.

Thus far, in the Chinese housing reform experiments in Yantai, young households (purchasers under 35 years old) with low incomes have been buying the most homes. The age of the purchasers is consistent with the life cycle hypothesis outlined above; however, the low incomes of these households is surprising. The outcome may reflect a correlation between age and income. Another possibility is that the market which has been captured is simply made up of lower-income households. This would help explain why about 89 percent of the units were sold with limited property rights.

Rent and Wage Adjustments

If anything, China represents an extreme case of housing reform in the sense that the majority of urban housing is provided essentially free of charge by work units and housing bureaus; only about 17 percent of units are privately owned. This contrasts, for example, with Hungary where rents typically account for 5 to 7 percent of occupant incomes and where, even in Budapest, half of the stock is privately owned. Because in China cash outlays for rent are trivial and security of tenure strong, there is little reason for a household to want to purchase a unit. Higher rents, which are made possible by corresponding wage increases, are expected to provide an incentive to purchase apartments.

China has encountered several problems in adjusting rents and wages that are linked to the size of the adjustments and the distribution of benefits and costs. Reformers have chosen to set rents at levels that are insufficient to recover the cost of constructing units. The driving factor behind this may not be so much a reluctance to raise rents as it is a reluctance to raise incomes. That is, rent increases appear to be determined by the size of the wage increases the government is willing to allow instead of by construction costs or market forces. The various Chinese rent setting and wage adjustment schemes which have been advanced are almost mind-numbing in their complexity; Annex B presents some notes on these schemes.

There are two points about the complexities of the Chinese situation that deserve further comment. First, many of the problems encountered in raising rents would be eliminated if the housing stock were transferred from the work units to some other body and ultimately put under private control (with the enterprises compensated). In Eastern Europe, the state usually owns the units and this particular type of "mismatch" is not present. Second, the idea that housing be provided on an in-kind basis is much stronger in China than in Eastern Europe. Moreover, there is comparatively little income from the "second economy" in China.

In Eastern Europe where conditions are less rigid, the income distribution is less equal; it is possible for a substantial share of households to pay much higher rents from their full incomes (not just the income from their "first economy" or state job). Under these conditions, more targeted state assistance is appropriate.

Problems Associated with Co-Existing Housing Markets

Three separate housing markets can emerge from attempts to sell state-owned apartments. The first is the market for state-owned rental units, in which units continue to be rationed because low preferential rents are charged. The second is the market consisting of those households who already rent state-owned units, and want to purchase them. The final type of market is the market for newly constructed units.

These different housing markets can exert influence on each other. For example, the size of the market for existing units is largely limited to households already occupying apartments since there are few households moving in and out of existing units.[8] On the other hand, the size of the market for new units is much larger and includes everyone presently in a housing queue, overcrowded households, and newly-forming households. The queues and overcrowding are due, in part, to the rationing occurring in the rental market. The size and composition of the market for new units suggests that prices will be bid up to levels exceeding the prices of existing units, even after controlling for quantity and quality.

C. LESSONS FROM THE CHINESE EXPERIENCE

The preceding analysis offers a way to think systematically about efforts to sell state-owned housing. The section on tenure choice identifies four areas in which public policy intervention could have an impact on slow housing sales. The mechanisms available to policymakers to bolster sales are:

(1) Raise rents. Low rents discourage people from buying existing homes. Wage adjustments may have to accompany rent increases if rents are too low. Because rents are tied to units and wages are paid by employers, rent and wage adjustments have redistributional consequences.

(2) Rationalize borrowing terms. Downpayment requirements, repayment

[8] An implicit assumption here is that the state would not evict a household currently living in a unit in order to sell the unit to another household.

periods, and interest rates should not be arbitrary. Lending should be at market rates. Competition for customers should cause lenders to offer loan terms that are as attractive as possible.

(3) Clarify and strengthen property rights. Both strengthening owner rights and weakening tenant rights will increase the incentive to own. Changes in property rights, like rent increases, are difficult to implement.

(4) Stimulate the demand to hold wealth. It is hard to devise policies that directly influence the demand to hold housing as an asset. Possible measures include: increasing household incomes; improving the attractiveness of housing as an asset by clarifying property rights; and improving the liquidity of housing by allowing units to be freely bought and sold.

While, conceptually, most of the interventions appear simple, real world attempts at privatization--including those in China--demonstrate that these reforms are difficult to implement. In some instances, the ability to introduce new ideas is constrained by politics or the unwillingness of people to change. In other instances, poor economic conditions limit reform possibilities. In the next two chapters, we examine the privatization efforts of Hungary and the United Kingdom to highlight additional issues and problems that can arise.

3

PRIVATIZATION OF HOUSING IN HUNGARY[9]

Hungary is attempting to sell state-owned rental units as a part of its broad housing privatization effort, which includes attempts to reform the system of producing and allocating housing as well as the system for managing and maintaining state-owned rental units. However, it is unclear to what extent that selling units is viewed as the preferred way of dealing with the problems of the social housing sector in Hungary.

So far, it is difficult to judge the progress being made, but it appears that sales are confined to units in the best locations and in the best condition, which could be an early warning sign of problems in marketing the units. In 1989, about 10 percent of the units were "claimed" by tenants.[10] Sales have been modest despite very deep price discounts from "market value". Price guidelines have been set according to when units were last renovated. Units which have not been renovated within fifteen years receive an 85 percent discount; units renovated between five and fifteen years ago receive a 70 percent discount; and those renovated within five years receive a 60 percent discount.[11]

The financing terms offered by local authorities have also been quite generous. Ninety percent financing is available (i.e., a 10 percent downpayment is required) from the local authority on an installment contract basis with a 20 to 30 year term and a 3 percent annual interest rate. (Inflation is about 20 percent per year.) Outright cash purchasers receive an additional 25 percent price discount. The sales and financing terms just stated are only guidelines for local authorities; it

[9] The information on Hungary's housing system contained in this section is drawn primarily from Hegedus and Tosics (1990a & 1990b) and Tosics (1987).

[10] A "claim" appears to refer to an intention to buy. Only 1.3 percent of the stock was actually sold.

[11] We do not know the method used to establish market prices in Hungary, although there are numerous private sales that could be used for reference. A general discussion of ways to set prices is contained in Annex C.

is not clear to what extent local authorities have deviated from them, although by mid-1990, at least some local authorities had used their discretionary powers to halt sales.

Thus far, there has been limited information about the success of Hungary's effort to sell state-owned housing. Although the sale of units to tenants has been legal since 1969, purchase activity has essentially been nonexistent until the last two years--a period during which regulations were relaxed and buying terms were made very attractive (as noted above).

We can, however, use Tolley's framework for assessing efforts to sell state-owned housing to gain insight into Hungary's prospects for success or failure. By analyzing Hungary this way, we can see that there exists a number of roadblocks to success. In the following section we describe the development of the social housing sector in Hungary. In doing this we will focus on areas that represent problems for attempts to sell social housing in Hungary. Using this information, we will then attempt to assess Hungary's prospects for privatizing its social housing stock.

The Development of the State Rental Sector

According to Hegedus and Tosics (1990a), following the end of World War II, the share of the housing stock made up of state-owned rental units increased dramatically.[12] Strong tenant rights were also established early on in the post-war period. Rent controls were maintained and rents were set at very low levels. The 1948 housing code gave tenants protection from evictions without in-kind compensation in the form of another flat. Tenants gained the right to transfer their right to occupancy to their heirs. In addition, with the permission of the housing authority, tenants could sublet and exchange flats.[13]

[12] At first, this resulted from new laws which gave the state housing authority broad discretion over the allocation of vacant units, second homes, and living space exceeding the needs of tenants. At about the same time (1948) a new organization known as the Public Real Estate Center was created to manage state-owned apartments. The Public Real Estate Center was given the power to take over the right of owners to manage and rent their properties. In any event, owning a home during this time was a political liability, and consequently a kind of "voluntary" nationalization took place. Formal nationalization in which the state acquired all dwellings consisting of six or more rooms took place in 1952.

[13] Rental rates for sublets are determined by mutual agreement of the parties involved. That is, the rates are market rates.

So-called "tenancy rights" were further strengthened by the Housing Act of 1971, which introduced a type of user fee for acquiring the use of a unit,[14] and by regulations passed in 1981 which authorized payments to tenants who gave their units back to the authorities or traded their units for smaller ones. Both of these measures indicate that the government has recognized the value of tenancy rights. The value of tenancy rights paid by local councils was initially set at a multiple of the user fee. By 1987, the value often was 7 to 10 times the size of user fees. Interestingly, one of the goals of buying out a households tenancy rights was to encourage them to purchase or build a private unit.[15] A problem with this approach was that many of the units the authorities got back were in poor condition.

Because of the development of tenancy rights, there are presently two main ways to acquire a state-owned unit in Hungary. The traditional and most common way of acquiring a unit is through the state allocation process. Between 1970 and 1982, about 62 percent of the households acquiring state-owned housing units received them from the state. Some studies indicate that favoritism has played a role in the allocation of units with a disproportionate number of units going to white collar and managerial type workers.[16]

The other principal method of acquiring a state-owned unit is through private transactions in the market of tenancy rights.[17] About 31 percent of state-owned homes were obtained through this method between 1970 and 1982.[18] The value of tenancy rights are freely determined by the market. Basically, the development of a tenancy rights market has resulted in a capitalization of the subsidy--the price of

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[14] This fee was set at 10 percent of the cost of the unit.

[15] Later, we will show that a more effective approach is to reduce the value of tenancy rights.

[16] See, for example, Hegedus and Tosics (1990a).

[17] Over time, local authorities lost their ability to control the exchange of flats. Two factors contributed to this. First, the administrative burden of managing all exchanges was too high; in addition, strict enforcement would sharply reduce tenant mobility. Second, the shaky political and economic climate in Hungarian cities contributed to a relaxed attitude towards these exchanges.

[18] An additional 7 percent of units during this period were acquired through inheritance or in the form of a gift from close relatives.

tenancy rights reflecting the right to receive a stream of low rents. Both the size of the rent subsidy and prices in the homeownership market affect the price of tenancy rights.[19]

Rent levels. The basic rules for calculating rents for state-owned apartments were established in 1946. Rents were purposely set very low. The next major modifications in rents occurred in 1971, 1982, and 1990. Base rents as of February 1990 range from 22.00 forints per square meter for fully-equipped units to 4.50 forints per square meter for low quality units. Depending on features such as location, rents can vary up to 25 percent for a given quality category. Despite large percentage increases in rents, the share of income that a family devotes to rent is only about 5 to 7 percent.

A side effect of the low rents is that they have been insufficient to cover renovation and maintenance costs. Since 1949, responsibility for maintaining units has rested with the Communal Management Companies (CMC). Initially, CMCs received a share of rental collections to pay for their services. However, since the end of the 1950s, rental revenues have been insufficient to cover outlays for renovation and maintenance, and CMCs have required supplementary state budget allocations. Many people blame the CMCs for the problems of the state-owned rental sector.

Recent Developments in the State Rental Sector

In December of 1989, a 50 percent rent increase was rejected in favor of a 35 percent rent increase. Fees, however, were instituted for sewage and water service, and maintenance and renovation within a flat became the responsibility of the tenant. Rent increases were not equal across-the-board; greater increases were applied to larger, higher quality units. Low-income households were exempted from the increases.

Hungarians are hotly debating the sales of state rental units. Advocates of privatization argue that selling units will reduce budget expenditures going to subsidies and increase the incentive of the occupants to maintain their units. They complain that state-owned housing makes up so much of the housing stock that

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19 The value of tenancy rights has been estimated to be at about one half the market price of privately-owned flats. This relatively low value reflects uncertainty about the future status of tenancy rights.

units cannot be efficiently maintained (at least by the current system). Some have even argued that obtaining ownership at concessionary prices is a way of repaying the people for losses incurred during the nationalization process.

Arguments against privatization in Hungary largely center on equity issues. Some say that it is simply a giveaway of state wealth, with the benefits largely going to those who occupy their units as a result of power and influence. In addition, privatization does little to help those remaining in queues unless more housing gets built. The allocation system has created large classes of winners and losers in the privatization game, and there is little hope that the losers can become winners. Another fear is that, under the guise of privatization, the government will shed its responsibility to protect the poor.

Probable Problems in Selling Units

Notwithstanding the political problems of privatization (which are considerable given that party favorites occupy the best units), Hungary is likely to encounter difficulties in selling units primarily because of low rents and strong tenant property rights. In the previous chapter, raising rents and strengthening the property rights of owners relative to renters were proposed as a way to encourage sales. These same ideas are appropriate for Hungary's situation.

There are signs of weakness in Hungary's sales program. Given that most purchases thus far have been largely confined to the most attractive units--which may have been underpriced--it seems plausible that under present conditions further price reductions will be necessary to sell the remaining stock. However, by raising rents, the government would increase the incentive to own and reduce the need for price cuts. At the end of 1989, when big rent increases were under debate in Parliament, sales of units are said to have accelerated markedly. The World Bank has recommended that Hungary immediately stop selling units at below market prices because valuable resources are being wasted (Buckley, et al., 1990).

An odd feature of the Hungarian case that produces a strong disincentive to buy a home is the owner-like rights of tenants. The fact that a tenant has the right to buy and sell the right to occupancy at a market-determined price, and the right to occupy a unit indefinitely without fear of eviction means that the property rights gains from becoming a homeowner are small. With so little to distinguish it from conventional homeownership, renting a state-owned unit does not really amount to renting--it is more like owning (Buckley, et al., 1990). Recall that nearly a third of the occupants in state-owned rental units acquired their units through the market for tenancy rights.

Households that obtain their units through the market for tenancy rights essentially are paying market rents; however, the rent they pay is the subsidized rent they pay to the government plus the lump sum payment they make to the previous tenant. This lump sum payment--which is known as "key money"--represents the capitalized value of the subsidy and is equal to the discounted present value of the future stream of subsidy payments implied by the low rents. Note that if the authorities charge high enough fees to acquire the use of a unit, they too can obtain a market-like rent from tenants.

Because the size of the lump sum payments are positively correlated with the size of the subsidy offered, a rent increase will affect the value of tenancy rights. A rent increase results in a kind of capital loss for tenants because it lowers the willingness to pay for the right of occupancy (i.e., the right to pay a subsidized rent). This helps explain both the reason why there is extreme political resistance to raising rents and the reason why raising rents is an effective means of stimulating sales. For existing tenants, a combination of higher rent and lower value of tenancy rights should increase the incentive to buy their unit. For a household not currently occupying a state-owned unit, a rent increase creates less of an incentive to buy since the rent increase immediately gets capitalized in the form of a reduction in key money. Thus, the effective rent the household compares to its user cost of owning remains unchanged.

Clearly,if market rents were charged, one of the most perverse aspects of tenancy rights--the right to buy and sell the right to occupy a unit--would no longer exist. There would be nothing to sell because the subsidy would be gone, and a more normal rental market would develop.

With respect to financing the purchase of units, local housing authorities need to raise the interest rate they charge borrowers; with the market rate approaching 25 percent, a 3 percent rate implies a very deep subsidy. Higher interest rates work against sales, but reduce budget outlays and inflationary pressures. By increasing willingness to pay, higher rents help make higher interest rates palatable. Higher interest rates, in turn, provide an argument in favor of raising rents on equity grounds--the idea being that if the cost of homeownership goes up, so should the cost of renting.

In sum, Hungary needs to experiment with charging market rents to determine how households will respond. Increasing rents would simultaneously increase the incentive to own, weaken the relative value tenancy rights, and allow for price increases. The higher rents would help relieve the maintenance cost burden on the central budget, and higher prices would generate a bigger windfall for the government. Increased willingness to pay can be used to reduce any remaining financing subsidies, but at the expense of lower prices.

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PRIVATIZATION OF HOUSING IN THE UNITED KINGDOM[20]

Having sold over one million public housing units since 1979, an amount equivalent to about a fifth of its present social housing stock, the United Kingdom (U.K.) is often cited as an example of a country that has a successful public housing sales program. While this sales volume has been impressive, the sales campaign is an ongoing effort, which makes it difficult to judge whether the effort has been a success. Present conditions appear to favor more sales; however, it seems likely that sales will be harder to generate in the not-too-distant future because of low rents, the socio-economic characteristics of the remaining tenants, and the undesirable features of the remaining public housing stock. The United Kingdom's experience with selling public housing reinforces the point that rent levels, property rights, and financing arrangements are important determinants of privatization success, regardless of a country's economic status.

The main features of the U.K. privatization effort have been: the granting to tenants of the statutory right to buy their dwellings, provided they have lived in their units at least two years; and price discounts based on length of tenure (1 percent per year) and type of unit (a 30 percent basic discount, and an additional 20 percent discount for flats and other unattractive units).[21] The average discount on units sold since 1979 is about 45 percent (Maclennan, 1989). There is a provision for recapturing discounts if units are sold within three years.[22]

[20] This section draws heavily from Maclennan (1989).

[21] The valuation procedure has probably resulted in pre-discount home values that are below market values. Prices could previously not drop below a "cost floor" which reflected a desire to cover construction and renovation costs; however, this provision was dropped in 1988. Discounts are also subject to certain limits.

[22] Under the right to buy program, a household can also "lock in" a price and defer the actual purchase for up to three years, or it can purchase a unit gradually through a "shared ownership" arrangement (at least 50 percent must be purchased initially, after which additional ownership shares may be periodically purchased). (Maffin, 1989.)

Sales have been facilitated by the availability of finance through building societies, which have financed 95 percent of right-to-buy (RTB) purchases, and by central government measures--primarily housing subsidy cuts to local government--which have induced local governments to raise rents. The drive to sell public housing units is a part of a broader privatization effort which is also directed at improving the management and finance of housing.

The U.K. has many of the same rental housing problems of other countries which want to privatize their social housing stock. It has a small private rental sector and a large heavily-subsidized public housing stock. The public housing allocation system, in which rents do not adequately reflect differences in quality and amenity levels, results in a misallocation of resources whereby some households live in excessively large homes while other households are overcrowded. Low rents contribute to poor maintenance and increase the need for construction and income maintenance subsidies from central and local government.

The sale of public housing in the United Kingdom was intended to reduce central government housing expenditures and improve the maintenance of units. In addition, it has been argued that the creation of a "property owning democracy" is desirable, and that homeownership develops a sense of pride and identity. The sale of public housing to tenants is also seen as a means of spreading wealth and as a step to help revive the private rental sector. Simply transferring the ownership of units cannot, however, remedy all of the problems of the housing sector--additional reforms are needed.

While some of the problems of the U.K. may be similar to those of China or Hungary, privatization in the U.K. has taken place in a totally different context. First, the U.K. has a well-developed housing finance system that has proven itself capable of providing funds to tenants exercising their right to buy. Second, tenant rights are weaker than they are in China and Hungary, and tenants generally devote larger shares of their income to rent. Third, the U.K. has a personal income tax system through which homeowners can receive potentially large tax benefits. Fourth, the quality of the social housing stock is better and is composed of fewer large multifamily apartments. Finally, under the British political system, the provision of housing is chiefly a local responsibility; as a result, the central government sometimes has difficulties influencing local housing policies.

Following the approach taken for Hungary, this section begins with a description of how the social rental sector has developed in the United Kingdom, concentrating on those factors which have affected the sale of council housing. It then examines recent outcomes in the RTB program and presents some conclusions.

Development of the U.K. Public Housing Sector

By the time Thatcher took office in 1979, a number of problems with public housing had begun to emerge. Many local authorities had poorly managed their public housing and failed to provide the types of units that households were demanding. During the 1970s, the number of economically active households living in public housing shrank as the number of retirees grew, and as unemployment among tenants rose. Meanwhile, many local authorities adopted low rent, low maintenance policies for political reasons.

As living conditions in public housing deteriorated, many middle-class households, which would have resided in public housing in the past, sought other housing solutions. By the 1980s, public housing vacancy rates reached as high as 5 percent in large cities (Maclennan, 1989). The steady deterioration of public housing conditions provided the motivation for the government to shift its emphasis to a market-oriented system of providing housing.

Local authorities have had the power to sell public housing without Ministerial consent ever since the enactment of the Housing Act of 1952, but few have exercised this right.[23] The "right-to-buy" (RTB) concept that was introduced as a part of the 1980 Housing Act was a means to circumvent the discretion that local governments held over a tenant's ability to purchase a unit. The provision of housing has long been the responsibility of local governments and many local governments were reluctant to give up their control over an important resource. Housing is one of the largest expenditure categories for local governments and consequently is often a sensitive local political issue.

[23] Sales are permitted as long as they conform to certain terms. The Housing Act of 1952 allowed price discounts for the first time and contained provisions for recapturing discounts if units were resold within a specified period. Only 2 to 5 thousand units were sold annually by local authorities in England and Wales between 1952 and 1967.

Tenure. Large shifts in tenure have occurred since World War I. Before World War I, over 90 percent of households in England and Wales rented from private landlords. Both individual homeownership and the social housing stock grew dramatically in the period following World War II. Growth of the social housing sector was spurred, first, by political pressure in the early post-war years, and, later, by the desire to replace private slum dwellings. By 1976, 30 percent of households in England and Wales were in public housing; 55 percent were in owner-occupied units; and 15 percent were in private rental units (Murie, n.d.). By 1987, less than 10 ten percent of the British housing inventory was privately rented. Today, about two-thirds of the stock is owner occupied and over 70 percent of the rental stock is publicly owned (Maffin, 1989).

Large cities tend to have a disproportionately large share of the public housing stock. By the early 1980s, half the population in cities with populations exceeding half a million lived in public housing.

The RTB program contributed greatly to recent increases in homeownership but was by no means the only force at work. Between 1975 and 1987 owner occupancy increased by 11 percent (3.2 million units). Slightly less than a third of this increase (over a million units) was due to sales of public housing. The vast majority of the public housing sales were through the RTB program (Maffin, 1989). Since 1984, new construction and transfers from the public housing stock have made roughly equal contributions to homeownership (Maclennan, 1989).

Public housing sales peaked in 1982 at 240,000 units; annual sales dropped to 115,000 units by 1986, but rose again in 1987 and 1988. This recent increase came at a time when the housing market was rising (making housing more attractive as an investment), and the momentum of sales became greater. Tenant interest in purchasing their units remains high according to a number of studies (Maclennen, 1989).

Since 1961, homeowners in the U.K., like those in the United States, have been entitled to mortage interest tax relief and a capital gains tax exemption. The average mortgage interest tax relief was about 490 pounds in 1988-89. Up until 1989, no equivalent tax relief was granted to investors in private rental housing.

Rent Levels. Rent increases--or the fear of rent increases--may have facilitated the high rate of public housing sales. The central government essentially forced local governments to raise rents by reducing subsidies to them, and by restricting the ability of local governments to redirect other revenues to housing funds.

Even though rents have grown faster than the overall inflation rate, the increase relative to income growth has been quite modest. For example, in England and Wales, public housing rent (before rebate) as a share of income rose from 7.3 percent in 1979 to 10.7 percent in 1982, and then fell to 9.7 percent in 1986 (Maclennan, 1990).

Given these small changes in rent burden, it is hard to argue that higher rents have played a major role in sales thus far. A more plausible explanation for the high sales volume is that the heavy discounts combined with tax benefits have been more than adequate to compensate households for their loss of rental subsidies.

Tenant Rights. Tenant rights vary quite a bit among municipalities. Public housing tenants are allowed to sublet parts of their units and to have relatives living with them in an extended family arrangement (Maffin, 1989). Rents of private rental units have been controlled since World War I. However, newly-constructed and vacated units and are now exempt from rent controls.

Murie (n.d.) notes that public housing tenants are in principle much less secure than tenants in privately-owned units. In practice, however, there has been little distinction. At the same time, there are cases in which local councils have been unduly intrusive. For example, cases exist where local authorities have invoked extremely strict rules on public housing tenants (e.g., tenants have been instructed to paint their doors certain colors and to redecorate the interior of their homes a certain way). This type of intrusion on personal freedom has been used to support arguments in favor of selling public housing.

The 1988 Housing Act contains a number of measures which should eventually strengthen tenant rights. The Act turns rent setting into a contractual relationship rather than a statutory one, with agreements being made between tenants and their landlords. The Act also gives tenants the right to choose their landlord and to negotiate tenant rights with the landlord they choose.[34]

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[34] By giving tenants the "right to choose" a different landlord (which could include, for example, a housing association or a private firm) the government hopes to introduce competition among housing managers. If tenants select a private landlord, the landlord purchases the unit from the local authority.

Housing Finance. The RTB program promises seller financing to those who cannot qualify for a loan from a lender (plus, alternative purchase plans are available). Building societies, however, have financed about 95 percent of public housing sales.[25] The conventional loan instrument is a variable rate, 20 to 25 year mortgage.

In this context, it is important to note that financing need not be critical to selling units. The local council can simply arrange the sale and collect payments, in effect providing seller financing by not having use of assets equivalent to the value of the units sold until the loans are repaid. As noted, in Hungary units are being sold on this type of installment basis.

Outcomes of the Right-to-Buy Program

Considerable insight can be gained into the RTB program by examining the characteristics of buyers and of tenants who have not purchased their units.[26] Marion Kerr published a study in 1988 that examined the characteristics of a nationwide sample of buyers and tenants as of late 1985; some of the results from this study are presented here.[27]

There are no real surprises with respect to who has purchased homes. The households have tended to be relatively well off financially in terms of incomes and savings. Households buying homes have often had more than one wage earner. Over half of the households were headed by a person between 35 and 59 years of age. Older couples without children tended to purchase flats while larger adult households tended to buy houses (semi-detached units and row houses).

Large, semi-detached houses and row houses in suburban and rural areas have been the most popular types of unit sold. Nearly four-fifths of the sales of

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[25] Building societies are similar to savings and loan associations in the United States.

[26] As of June 1987, there still were about 5.8 million public housing units even though over a million units had been sold.

[27] Kerr's work was summarized by Maffin (1989). The following discussion is based on information drawn from Maffin's report.

these unit types have been for three-bedroom units. Sales of apartments represented just 4 percent of total sales.[28]

The life cycle factor is also reflected in the buyer statistics. Long term tenants were less likely to buy as were widowed and divorced individuals. This is consistent with the notion that taking on a new financial burden is an unattractive option for older households. The growing number of elderly public housing tenants represents a constraint on the potential number of buyers.

The Kerr study also examined the characteristics of tenants who have not participated in the RTB program. According to Maffin (1989, p. 16):

> [T]hose tenants who did not buy were generally younger or older, poorer, less economically secure, more likely to be widowed or single, to have young children or none, to live in large cities or towns on large estates (projects), to be less skilled and less likely to be wage-earners than those who bought under the right to buy.

These findings support the claim that "creaming" has occurred: the best units have been sold to the households in the best economic position. The flip side to this is that the remaining housing inventory is of lower quality on average, and is occupied by households that are economically and socially the worst off. Nevertheless, Maffin (1989) notes that the number of tenants still living in the most desired unit types--semi-detached or row houses in suburban and rural areas--is large. This suggests that the housing stock retains considerable sales potential.

Other Housing Reforms

Housing reforms are being implemented or considered in another area closely linked to the effort to sell the public housing stock. The "right to choose" program has been in effect since early 1989 and, as mentioned earlier, allows tenants to choose their landlord (which can, for example, be a private landlord, a housing association, or a local authority). The main purpose of this program is to stimulate competition among landlords. However, the program also provides a mechanism for private investors to purchase entire projects from local authorities and for tenants to form cooperatives.

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[28] One of the unique aspects of the British public housing stock is that it that it is not primarily made up of high-rise flats. In 1987, about three-fifths of the stock was made up of semi-detached or row houses. Most of the remainder consisted of apartments and duplexes.

Conclusions

There is no doubt that the United Kingdom has sold a lot of units, and there is reason to believe that in the short run it will continue to sell more. If one were to grade the U.K.'s effort thus far, it would get high marks for its efforts to put building societies and commercial banks on even terms. Financial sector reforms have helped to ensure that housing funds are available for the participants in the right-to-buy program.

On the other hand, the U.K. should probably get a failing grade for its pricing and rent policies. Apparently, no serious attempt has been made to raise public housing rents to market levels, and to target subsidies more tightly on lower-income occupants. Meanwhile, inadequate rents continue to cause poor maintenance of public housing and to deter investors from investing in private rental housing. Eventually, the low rents will cause sales to slow after the households motivated by the hefty price discounts and tax benefits are through buying units.

It is too early to assess what impact the 1988 Housing Act will have on tenant rights. However, to the extent that tenant rights are strengthened by the right to choose a landlord and to negotiate tenant rights, public housing sales could be adversely affected.

A final point is that while a goal of the Thatcher government is to reducc expenditures on housing, the tax benefits offered to homebuyers offsets at least some of the rent subsidy savings. It is unclear what net effect the right to buy program has on the central government budget.

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CONCLUSIONS

The examples of housing reform reviewed in the previous sections reveal-remarkable consistencies (see Table 1): the need to raise rents is universal, while rationalizing borrowing terms and clarifying property rights is needed in China and Hungary. Most disturbing is that the cases provided more examples of what can go wrong with a privatization effort than they did of what can go right.

Table 1

Summary of Factors Affecting Sales Volume of State Rental Units in China, Hungary and the U.K.

	China	Hungary	U.K.
sales price relative to market price	low	very low	low
tenant protections/ implicit property rights	strong	very strong	moderate
rent levels	very low	low	low
financing for unit purchased:			
- available	limited	readily	readily
- cost	low	very low	market rate
sales volume	very low	low	moderate

One gets the sense that some nations have been too eager to sell their housing stock and have not thought out their objectives well. Of particular concern is that big discounts are so readily resorted to, most likely because raising rents and tampering with property rights is politically uncomfortable. The value of the resources being transferred between the state and individuals via discounts is enormous. A country should not lose sight of the fact that when it offers a discount on a home to a household, it is offering a discount on what will probably be one of the most expensive assets that the household will ever buy. Each percent of a discount represents a lot of money--money that can be used by society for other more pressing needs.

Beyond the more obvious benefits to be derived from charging market rents and market prices, such as the better allocation and maintenance of units, lie more subtle, but still important, benefits. For example, it is evident that market rents would weaken the overly strong rights held by tenants in Hungary. In addition, in any country, equity concerns--with respect to who benefits from subsidies--will diminish if market prices are charged. This is not to say that the marketplace does not have its victims. Subsidies for disadvantaged households are an important part of any progressive society, and it is the duty of public officials to devise means that effectively target these funds.

In sum, policymakers can influence rents, lending terms, and property rights--key variables influencing sales success. The directions in which they should manipulate these variables is clear. In particular, sales would increase if policymakers would raise rents, facilitate lending at market rates, and strengthen the property rights of owners relative to those of renters. Whether policymakers have the political will to make the necessary changes is the big question.

In the remainder of this paper, we present a few additional comments on privatization which were prompted by the cases we examined.

Concomitant Actions

There are at least three areas in which governments will need to act to facilitate the privatization of the state rental stock. First, in raising rents--which is absolutely necessary if units are to be sold at more than "fire sale" prices--the poorest families will have to be protected. In short, the social safety net must be extended to the housing sector, probably in the form of a well-designed housing allowance program whose benefits can be carefully focused on the poor. Such a scheme is being implemented in East Germany and is under very active consideration in Hungary. In both cases, pensioners and families with low earnings comprise the target group.

Second, the housing finance system will have to be able to provide financing at market rates to facilitate the purchase of units. Without the availability of financing, sales will either not take place or they will only occur with large subsidies. The exception to this rule is when the state is willing to act as its own banker and sell the unit on an installment basis. While this is certainly possible, it may be unattractive because the state cannot use this capital for other purposes during the installment period.

Third, the management of the properties must be changed. Currently, the state rental stock (and even most of the other stock) is typically managed by state owned enterprises, each of which manages tens of thousands of units. Because of the combination of few resources and general laxity in management, maintenance and other services have been at very low levels. Both tenants paying higher rents and owners will demand better services, and these will only be forthcoming if the property management system is transformed. Moreover, only through competition among companies will a true market in rental housing emerge. The big SOEs should be broken up and private for profit and non-profit entities should be permitted to compete for management contracts on individual buildings. Where buildings are owner-occupied, the residents can select the company; in buildings that continue to be rentals, a combination of local government and residents can make the decision. The critical point, however, is to improve the services provided so that occupants see that they are receiving additonal services in exchange for greater expenditures.

Reconsidering the Goals of Privatization

One of the more difficult tasks facing any country considering the sale of state-owned housing is defining its goals. Part of the problem is that privatization per se is not a goal to be achieved; instead, it is a means to achieve the broader goals of equity and efficiency in housing markets. Losing sight of these broader goals can lead to the development of unproductive policies.

There is a tendency to treat the benefits and byproducts of creating a more efficient housing market, or the prerequisites for creating such a market, as if they were the goals of housing reforms. For example, lower budget deficits, higher savings, greater labor mobility, and less inflation can result from efforts to improve the efficiency of housing markets. When they are stated as goals, these benefits of efficient housing markets can misguide policy decisions.[29]

To illustrate that this is more than just a question of semantics, consider the following hypothetical situation. A country guided by a desire to reduce inflation and increase savings may decide--as a part of its privatization effort--that it is desirable to have big downpayments on housing loans since this would soak up excess demand and force people to save. The country may take this action without considering the negative effects this may have on equity (i.e., poorer households are hurt) and efficiency (e.g., people may give up trying to save because the effective price of buying a home is too high).

Another plausible scenario is that a country experiencing severe budget problems will try to sell the state-owned housing stock without regard to cost recovery--that is, below cost. Driven by the goal to reduce its budget deficit, the country can lose sight of the fact that recovering construction costs is an important feature of a well-functioning housing market. If subsidies are introduced to further stimulate the sale of these units, and these subsidies are not financed through new taxes, then the subsidies can cause inflation. Perhaps most importantly, the country can squander an incredibly valuable resource.

The point we are trying to make here is not that it is wrong to refer to outcomes such as deficit and inflation reduction as goals; instead, we are emphasizing the need to use the broader goals of equity and efficiency as guides for policymaking.

Measuring the Success of a Privatization Effort

A matter closely related to program goals is the issue of how to gauge the success of an effort to sell state-owned housing. What can a policymaker use as a measure of progress? In addition to changes in the homeownership rate[30], obvious signs might include shorter queues, more frequent and rapid exchanges of housing[31], and a higher incidence of better maintained housing. To judge these benefits, the policymaker must know what they cost--in terms of foregone sales

[29] Other "goals" of privatization which are commonly cited include better maintenance of units, more efficient allocation of housing, improved citizenship, and greater political stability.

[30] Of particular interest are homeownership rates for specific demographic groups, e.g., young married couples, single person households, elderly households, etc.

[31] A sign of progress would be the appearance of a vacancy rate that is linked to the normal turnover of units instead of the number of units that are unoccupied because they are in poor condition.

revenue and forgone interest income on subsidized loans--and who the beneficiaries are. If new owners are primarily high income families that could have afforded home purchase without financial assistance, and these families received very large subsidies, then the surge in the homeownership rate is a dubious accomplishment.

There is some danger of policymakers focusing too much on the homeownership rate as an indicator of success. The problem is the difficulty in determining what the "correct" amount of homeownership is for a given country. Furthermore, housing policies are rarely, if ever, neutral with respect to tenure. The establishment of a policy environment that favors neither owning nor renting is difficult to imagine, and it is not clear that this is even desirable if it is true that homeownership generates intangible, but real, external benefits for society. In any event, everyone would agree that some sort of rental market is desirable to meet the needs of people requiring short-term housing solutions or having uncertain plans about where they want to live.

Even if a homeownership rate were to fall over time, this would not necessarily indicate a problem. For example, in some Eastern European countries, such as Hungary and Czechoslovakia, homeownership rates are very high. This is usually due to a large rural population in which most families own their homes. Homeownership rates in cities are often much lower. As these countries continue to urbanize, it is possible for the overall rate to decline even while the urban rate goes up.

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ANNEX A

SIMPLE ANALYTICS OF HOMEOWNER USER COST VERSUS RENT

This annex presents a few simple equations which help to highlight the relationship between rent levels and the prices that households are willing to pay to purchase homes.[1] We begin by defining the relationship that must hold for a household to be indifferent between renting and purchasing a unit:

$$(1) \quad R = iV + dV + E$$

where R is the annual rent, V is the value of the unit, i is the annual interest rate, d is the annual depreciation rate, and E is the annual cost of operating and maintaining the unit.

The right-hand side of the equation is the user cost of ownership and consists of: the annual interest charge, iV; annual depreciation, dV; and annual operating and maintenance costs, E. The interest rate, i, is a composite rate which reflects both the interest charged on the outstanding loan balance and the foregone interest on equity in the home.

Equation (1) states that a household will be indifferent between owning and renting when rent is equal to the user cost of ownership. If rent were greater than the user cost of ownership, the household would prefer to buy the unit; conversely, if the user cost of ownership were greater than the rent charged, the household would prefer to rent.

To demonstrate how the price a household is willing to pay to buy a unit varies with rent levels, we can solve equation (1) for V, which yields:

$$(2) \quad V = (R - E) / (i + d)$$

Equation (2) shows how R is positively related to V. We can substitute some numbers into this equation to illustrate how a proportional change in rent, R, requires a more than proportional change in unit value, V, for equation (2) to still hold. For example, if R equals $1,000, E equals $100, i equals .10, and d equals .02 (reflecting a 50 year depreciation period), then V must equal $7,500 for

[1] For a more extensive treatment, see Tolley (1990).

equation (2) to hold. However, if we now raise R by 50 percent to $1,500 and hold the remaining variables on the right-hand side of equation (2) constant, then V must equal $11,667 for equation (2) to hold. Thus, if rent, R, increases by 50 percent, unit value, V, must increase by 55.6 percent--a disproportionate amount. This demonstrates that willingness to pay to purchase a unit can be particularly sensitive to rent changes.

We can expand equation (1) to include other factors which influence tenure choice:

$$(3) \qquad R - T = iV + dV + E - Q(Y,Z)$$

Equation (3) contains two new terms: T is the annual value of the property rights held by a tenant; Q is the annual value of a variety of benefits received by homeowners. Q is a function of a set of family characteristic variables, Y (which includes things like income, wealth, and life cycle stage) and a set of non-shelter variables, Z (which includes items such as property rights, appreciation, and tax consequences). The right-hand side of the equation is still the user cost of ownership; the left-hand side is the cost of renting.

We can again solve for unit value, V, which gives us:

$$(4) \qquad V = (R - T - E + Q(Y,Z)) \;/\; (i + d)$$

Equation (4) summarizes how a household's willingness to pay to buy a unit varies with the rent level, R, the value of tenant rights, T, the benefits of homeownership, Q, and the interest rate, i. As before, R is positively correlated with V. Higher rents make it possible to charge higher prices for units. If T increases, i.e., if tenant rights become stronger, V must decrease for equation (4) to hold (all other factors held constant). In other words, strong tenant rights will suppress the amount that a household is willing to pay to buy a unit. On the other hand, if Q goes up, so must V (all other factors held constant). Thus, for example, if the capital gains or tax benefits that a household with characteristics Y expects to receive increases, then the household's willingness to pay to purchase the unit will also increase. Note that while we have assumed Q to be positive, it could be negative. In both equations (2) and (4), the interest rate, i, appears in the denominator of the user cost of ownership formula; therefore, if the interest rate increases, V must decrease for either of the equations to still hold (all other factors held constant). This is simply another way of showing how raising interest rates can lower the effective demand to buy a home.

ANNEX B

RENT AND WAGE ADJUSTMENTS IN CHINA

Four types of rent could form the basis for a rental policy. "Market rent" refers to a rent level that would result from a rental market in which renters and landlords are free to negotiate prices. Market rents can confer short run gains and losses because of the inability of suppliers to respond quickly to changes in demand. In contrast, "cost-based rent including site value," which is equivalent to "equilibrium rent," refers to a rent level that is reached when supply has fully responded to demand. In this situation the cost of producing an additional unit just equals the amount someone is willing to pay for that unit. Both market rents and equilibrium rents are hard to estimate in the absence of freely functioning housing and land markets. A third type of rent is "cost-based rent excluding site value." The absence of a land value component makes this rent easier to estimate, and this rent concept, commonly referred to as "commercial rent," has figured prominently in discussions of Chinese housing reforms.[1] Finally, there is the idea of "preferential rents," which is a name given to a variety of cost-based rents which are lower than the so-called commercial rents.[2] It appears that low preferential rents rather than commercial rents are being charged in the Chinese housing experiments. These low rents reduce the incentive to buy an apartment.

Despite being a break even policy in which total wage increases equal total rent increases, rent and wage adjustments can generate windfall gains and losses among the suppliers and recipients of housing. Several factors contribute to this problem. First, wages are increased by a fixed percentage, while rent increases are calculated using price per square meter. This makes it possible for two similar households to have the same wage increase but different rent increases depending upon the size of the units they happened to occupy.

Second, if the work unit paying the wage increase is different from the work unit collecting the rent increase, a transfer occurs between the work units. This

[1] There could be considerable variation in cost-based rent excluding site value depending on the type of housing. Components of this type of rent include interest, depreciation, maintenance, management, taxes, insurance, and profit.

[2] Lower "cost-based" rents are obtained by omitting certain cost components such as taxes, insurance, and profit.

could occur, for example, if two or more family members work for different work units, and one of the work units has to pay higher wages but does not receive any additional rent.

Third, a transfer from work units to housing bureaus can occur if a housing bureau provides an apartment for a worker in a work unit, and the housing bureau collects the rent increase while the work unit pays the wage increase.

Fourth, if workers living in privately-owned housing are allowed to receive higher wages, they will receive a windfall gain at the expense of their work unit.

The problem of redistribution between individuals has received some attention from Chinese reformers; however, it is unclear to what extent the redistribution between work units and housing bureaus has been a problem and whether measures have been devised to cope with this problem. Low rents can minimize distributional problems and reduce the need for large wage increases, but at the expense of lowering the incentive to purchase homes. This is the fundamental tradeoff that must be considered in setting rents.

Wages and rents will need to be adjusted over time to counter the effects of inflation. The relationship between wages and rents can be kept the same by indexing wages and rents to a general price index.

ANNEX C
DETERMINING THE MARKET VALUE OF HOUSING

We have discussed the rationale for selling state-owned housing at market prices, but have yet to describe how to determine these prices. The fundamental problem is how do you determine market prices when a freely functioning housing market does not yet exist? A related question is how do you initially set prices when the market is largely limited to existing tenants receiving large subsidies? In this section, we briefly describe some common ways of appraising dwelling values and then highlight some of the problems of implementing these methods in the Eastern European context.

There are three traditional means of appraising the value of properties: the market data, cost, and income approaches.[3] Under the market data approach, appraisers determine the value of a particular unit by examining the prices of similar properties which have recently been sold. Under the cost approach, an appraiser determines the value of a property by estimating the cost of reproducing a unit and then subtracting accrued depreciation from this reproduction cost. The cost approach is based on the idea that no one would pay more for an existing unit than what it would cost to reproduce a similar unit on a comparable site. Under the income approach, an appraiser estimates the value of a property by capitalizing the future stream of benefits the property is expected to yield.

When sufficient information on comparable properties is available, the market data approach is the preferred method of appraising values. This method is intuitive and less prone to serious error than the other methods. However, none of these methods is inherently superior to the others in a logical sense, and it is common to use more than one approach with more weight given to the method thought to be the most accurate under the prevailing circumstances. The market data approach is most effective in situations where similar units change hands frequently (i.e., many comparable units can be found). The income approach is well suited for evaluating income producing properties. The cost approach is useful in instances where few comparables exist and properties do not generate measurable income. This approach can be particularly useful for setting the upper limit of

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[3] This material on property valuation was drawn from Chapters 6 through 8 of Arnold, Wurtzebach, and Miles (1980).

what a unit is worth and is best suited for newer properties where little depreciation (which is hard to estimate) has occurred.

In Eastern Europe, a number of factors inhibit the application of the market data and cost approaches. Low mobility and few private transactions involving units resembling state-owned dwellings will result in a shortage of comparable units for the market data approach. The shortage of comparable units is likely to be felt most during the early phases of a privatization effort. Another serious problem in establishing a market value using the market data approach is that the market for existing units is largely limited to current occupants. Without open competitive bidding for units, it is hard to determine what others would be willing to pay for them. The cost approach to property valuation may also be difficult to execute since accurate cost information may not be readily available and valuing the land component of housing in the absence of a freely operating land market is problematic.

Of the three traditional methods, the income approach may prove to be the most effective means of appraising the value of state-owned dwellings in Eastern Europe since information on market rent levels and operating costs is often more available than information on sales transactions or construction costs. The rents obtained through the renting of comparable privately-owned units or the subletting of state-owned dwellings (when the rents of sublets are unregulated) can offer guidance as to what market rents should be for state-owned housing.

One way to begin establishing market price guidelines would be to auction a portion of the vacant state-owned housing stock. These dwellings could be newly-constructed units or existing units that have turned over and are now unoccupied. The units sold during the auction would represent the beginning of a database of comparable units. Furthermore, in situations where the resale of units is not restricted, there are opportunities to observe resale prices. The state could also place occupied rental units up for sale, and allow existing tenants to bid for their unit along with outsiders. This could be unpopular from a tenant's point of view, but the state could grant tenants the right of first refusal and provide relocation assistance to those unable or unwilling to buy. In addition, this method of selling units has the political advantage of giving more people the opportunity to purchase a unit--not just those who currently occupy their units because of political connections.

Up to this point we have discussed various ways to estimate the market value of a unit; however, determining the market value of a unit is not the same as determining the price at which a unit can or should be sold to an existing tenant. The setting of the initial sales price is a political decision in which the government must decide how much of a price discount it is willing to give to a current occupant given what others would be willing to pay for the unit (i.e., the market value). Current occupants of state-owned housing will never be willing to pay market prices to buy their units as long as they are certain they will continue to receive rent subsidies in the future and not be evicted. Thus, the state will incur losses when selling units to existing tenants if it fails to raise rents or reduce the security of tenure enjoyed by these tenants.

One way to set initial asking prices that will maximize the state's return is to simply experiment. Units could be offered for sale at prices reflecting an appraiser's best estimates of market value. Prices can then be lowered or raised based on the sales response. It may be better to start with high price estimates since it is politically easier to lower prices than to raise them at a later date.