
Housing Subsidies: The Political Economy of Reform in an Nth Best Situation

Every country uses housing subsidies, which take a wide variety of forms to address either the supply or the demand side of the market. In fact, due to the range of ways subsidies are provided, it is often a serious challenge to measure their scale and incidence.¹ This limitation has significant implications for the implementation of reforms to improve the effectiveness of subsidy expenditures. And as a result of some of the practical difficulties involved in designing housing subsidies in developing countries, there are often basic constraints on the sorts of policy options available. These difficulties can make what we know to be the most effective options for delivering assistance in a developed country context not viable. As a result, subsidy improvement is often practiced in a second- or even the third-best world, which is often characterized by thorny questions about the political economy of reform.

Before we discuss why housing subsidies are complex to administer and evaluate, we offer the caveat that there is considerable debate on whether housing subsidies should be offered by any country. There is considerable discussion within the World Bank on how targeted income support and family benefits achieve welfare enhancements, including housing. Huge subsidy programs exist in many large developing countries, and completely doing away with them is often not politically feasible. In these circumstances, housing subsidies are the second (or nth best, as in the chapter title) best option, and there is much room for improvement of the design of these subsidies.

Housing Subsidies Are Complex Even in Well-Functioning Housing Markets

The Level of Subsidies

Expenditure on housing subsidies varies a great deal across countries as well as across time within countries, as discussed in table 5.1.

This variability in expenditure suggests that the allocation of substantial public resources to the housing sector is either a political choice or a choice deeply affected by country-specific circumstances. Patterns of expenditure are idiosyncratic and therefore recommendations about whether subsidies are too low or too high are very difficult to make based on comparative evidence.

Table 5.1 shows official figures regarding housing subsidies as a portion of GDP for a sample of developed and developing countries. Three points stand out from the table. First, housing subsidies often represent a non-negligible portion of GDP, particularly in developing countries. In Algeria and the Islamic Republic of Iran, for example, housing subsidies amount to the equivalent of 4–6 percent of the GDP, making the magnitude of expenditure comparable to expenditure on education or health. Second, high levels of housing subsidies are rarely achieved in developed countries. Third, expenditures on housing subsidies vary a great deal across countries, by a factor of almost 15. Of course, a variety of country circumstances can affect the amount allocated to housing assistance, including differences in demographic circumstances, level of income, and even the country's climate (World Bank 1980). Additionally, the level of subsidies within a particular country can vary significantly, as illustrated by the case of the Nordic countries, particularly Sweden, in the past decade (Lujanen 2004).

Table 5.1 Housing Subsidies as a Portion of GDP in Selected Countries

<i>Country</i>	<i>Year</i>	<i>Housing subsidies as a portion of GDP (%)</i>
Algeria	2002	5.00–6.00
Chile	1998	1.25
Colombia	1998	0.46
Denmark	2003	2.11
Finland	2003	1.05
France	2001	1.74
Iran, Islamic Rep. of	2002	4.00–6.00
Mexico	2001	0.50
Morocco	2002	2.90
Norway	2002	1.45
South Africa	1998	0.38
Sweden	2002	1.14
United States	2001	1.54

Source: For United States, HUD; for France, Ministère du Logement; for Denmark, Finland, Norway, and Sweden, Lujanen (2004); for Chile, Colombia, and South Africa, Gilbert (2004); for Algeria, Islamic Republic of Iran, and Morocco, Le Blanc (2005); for Mexico, World Bank (2002).

Subsidy Delivery Mechanisms

Subsidy delivery mechanisms are perhaps more variable than the amount of resources allocated to housing subsidies. Table 5.2 gives a sense of just how complicated subsidy delivery can be: the columns give ten discrete qualities of subsidy programs, and the rows a list of programs currently operating in 12 Latin American countries. Combining the rows and columns indicates that there are over 1,000 program combinations possible in these 12 countries, making subsidy delivery approaches difficult to compare across countries.

Despite these analytical difficulties, specialized literature on the performance of housing subsidy programs has developed rapidly since the mid-1990s. In parallel, studies centered on the evaluation of subsidy programs have flourished in mainstream economic literature (see the references in Le Blanc 2005). As a consequence, understanding of the economic performance of housing subsidy programs, and subsidy programs in general, has increased tremendously. The core of the analysis of subsidy programs has revolved around the notions of efficiency and targeting, whereas more applied papers have emphasized issues such as transparency, administrative simplicity, incentives, and sustainability for the government (e.g. Struyk 2000, the references in Buckley and Kalarickal 2005; and Gilbert 2004).

Box 5.1 Targeting and Coverage: A Basic Framework

Suppose that a country's population can be divided into two categories of households, "poor" and "nonpoor." Suppose also that the "poor" category is the official target of subsidies. For any given subsidy program, a two-by-two table can be constructed that gives the repartition of the population depending on the poverty category and the benefit of the subsidy program.

Targeting and coverage of subsidy programs

	<i>Poor</i>	<i>Nonpoor</i>
Reached		Leakage issues
Not reached	Coverage issue	

If the program were perfect, cells out of the diagonal of the table would be void. On the contrary, the presence of households in the upper right cell of the matrix indicates problems of leakages, i.e. households not included in the target benefit from the subsidy. The presence of households in the lower left cell of the matrix indicates problems of coverage, i.e., populations included in the target are not reached by the subsidy.

Source: Coady, Grosh, and Hoddinot (2004).

The Bank has recently reviewed the developing countries' experience targeting subsidies in a paper by Coady, Grosh, and Hoddinot (2004), which presents a format that is quite flexible and easy to adapt in broad terms to our discussion of housing subsidies. Their basic framework is presented in box 5.1.

Using the Framework to Analyze and Improve Subsidy Targeting

Consider, first, how the two most important housing-related subsidies used in developed countries score in terms of the framework given above: assistance to poor households, usually renters, and assistance to homeowners, usually through a form of tax favoritism.

Homeownership Subsidies

Research by Coady, Grosh, and Hoddinot has found that homeownership subsidies in relatively well-functioning housing markets tend to be regressive. That is, most of the assistance is provided to those in the upper right cell of the matrix in box 5.1. The research suggested that substantial gains could be made by better targeting housing subsidy programs. Correspondingly, as detailed by Turner and Whitehead (2002) many countries did just that, although this form of mistargeting of housing subsidies was significantly reduced in the 1990s.

During the 1990s, France, Sweden, and the United Kingdom, phased out, or drastically reduced, tax advantages for homeowners, the most pervasive of which was the deductibility of mortgage interest from taxable income. The United States also reduced the regressive tax favoritism for homeownership, by reducing the gains free from capital gains and placing limits on the amount of deductible mortgage interest. As the research made clear, not only was this type of subsidy regressive, it also had a built-in bias against poor households, since the latter usually fall below the threshold of the income tax and loan eligibility and therefore cannot take advantage of the deduction.

Rental Housing Subsidies

Analyses of how to most effectively deliver housing subsidies to the poor have also led to prescriptions for the use of voucher schemes (Boelhouwer 1997). Under a voucher scheme, policy makers simply define the rules and then respond to demand. The central idea is that well-functioning housing markets should be best able to respond to the enhanced demand of poor households. Armed with housing vouchers to augment their purchasing power, the poor can search for the best deal. They can select new or existing units of a minimum standard in locations they choose (subject to the

Table 5.2 Characteristics of Housing Subsidy Programs in Selected Latin American Countries

<i>Country</i>	<i>Program</i>	<i>Demand subsidy?</i>	<i>One-time subsidy?</i>	<i>Is it portable?</i>	<i>Does it finance only dwellings built under the program?</i>	<i>Does it finance progressive/self-built housing?</i>	<i>Is it constrained to the savings capacity?</i>	<i>Is the credit provided by a public agency?</i>	<i>Does it include credit programs with private financial intermediaries?</i>	<i>Is the interest rate lower than the one in the market?</i>	<i>Does it subsidize fixed costs or risks by financial intermediaries?</i>
Argentina	Fonavi	No	n.a.	No	Yes	No	No	Yes	No	Yes	n.a.
Chile	Serviu and others	Yes	Yes	Yes/No ^a	Yes/No	Yes/No ^a	Yes	No ^b	Yes ^b	No	Yes ^b
Colombia	Subsidios a la vivienda de interés social	Yes	Yes	Yes	No	Yes	Yes	No	Yes ^c	Yes ^c	No
Costa Rica	Bono familiar de vivienda	Yes	Yes	No	No	Yes ^d	No	No	No	n.a.	n.a.
Ecuador	Sistema de incentivos para vivienda	Yes	Yes	Yes	No	Yes	Yes	No	Yes	No	n.a.
El Salvador	Programa de contribuciones para la vivienda	Yes	Yes	No	No	Yes	No	No	Yes	No	No
Guatemala	Foguavi	Yes	Yes	No	No	Yes	Yes	No	No	n.a.	n.a.

Mexico	Fovi/SHF Programa financiero de vivienda	No	No	Yes	No	No	No	No	No	Yes	No	No
Mexico	Prosavi Programa especial de crédito y subsídios a la vivienda	Yes	Yes	Yes	No	No	Yes	No	Yes	Yes	Yes	Yes
Peru	Mivivienda	No	Yes	Yes	No	No	Yes	No	Yes	Yes	Yes	No
Peru	Techo Propio	Yes	Yes	Yes	No	No	Yes	No	Yes	Yes	No	No
Uruguay	Sistema integrado de acceso a la vivienda	Yes	Yes	No	No	Yes	Yes	Yes	No	Yes	Yes	n.a.

Source: IDB (2004).

Note: n.a. = not applicable.

a. According to the program.

b. Since 2002.

c. The methodology of financing is not included in the program, but banks must use 25 percent of the increase in credit to finance housing through controlled interest rates.

d. Only for groups already organized.

resource costs of providing the minimum standard unit). If eligible families want a better location or higher level of housing-related amenities, they can rent it in the market. However, rather than using public assistance to augment their demand, they have to use their own resources. In terms of the Coady, Grosh, and Hoddinot (2004) framework, use of people's own resources helps target the neediest, i.e., the lower left cell of the matrix.²

Today, even in countries where public housing is widespread, such as the Netherlands, most low-income housing assistance takes the form of vouchers to lower-income families. These programs have different terms and conditions across countries, but the general approach is to use demand-based, portable vouchers, generally referred to as housing allowance schemes. This approach has been found to be the most effective instrument for assisting the poor because it provides beneficiaries with the ability to rely on competitive markets to afford the greatest range of affordable choices at the lowest cost to the government. That is, again in terms of the Coady, Grosh, and Hoddinot (2004) perspective, simple steps can be, and were, taken to improve subsidy targeting. In short, the framework offers a number of simple ways to reduce the mistargeting of public subsidy expenditures, and they were realized in many developed countries.

The Story Gets Complicated

The housing subsidy situation varies considerably in developing countries in a number of important ways. First, the conditions under which the subsidy instrument works best—a competitive supply of housing services, particularly in cities with dysfunctional urban land markets—either does not exist or exists on a very limited scale. Accordingly, the increased purchasing power generated by vouchers generates little or no supply response. As a consequence, while the vouchers provide safety net protection for beneficiaries, they do not elicit an increase in the supply of the targeted level of services.

Second, and more importantly, in most developing countries, reaching the poorest groups of the population is complicated by the size of the informal job and housing sectors. That is, most poor households are de facto excluded from the reach of instruments designed to function within the bounds of formality (vouchers, mortgages income tax deductions, and tax breaks to developers). In addition, information problems related to measurement of income or wealth, and also merely identifying beneficiary households, often complicates the processes of defining eligibility and selecting households for subsidy programs.

Another consequence of the absence of reliable information is the lack of appropriate support to renters in most developing countries. While we have seen that support to renters in the form of vouchers is one of the two pillars of developed systems of housing subsidies, rental subsidies generally do not

exist in the majority of developing countries. The bulk of subsidies to households in developing countries have been shifted to homeowners, and private sector renters receive little help of any kind. As a consequence, entire segments of poor populations have been mostly left out of the subsidy system.³

Fourth, despite the frequently large share of resources involved, there is still lack of information on the housing subsidy system in most countries. While some subsidies are accounted for in the national budget, others, such as tax expenditures, are less visible; at the other end of the spectrum, land subsidies to public developers or various forms of rent control are often not accounted for at all. As a result, in many cases, governments tend to focus primarily on housing subsidies measured in the budget at the expense of other subsidies. But this subset of housing subsidies is often only the tip of the iceberg, representing no more than 10 to 20 percent of total expenditure on the sector, as shown by Le Blanc for Morocco (2005). Without a broad picture of the system, the coverage of the poor population cannot be properly assessed or managed.

Fifth, in developing countries, particularly rapidly urbanizing countries, this information problem about beneficiaries is by no means specific to the housing sector; it applies with equal force to other kinds of subsidies. In delivering housing subsidies to developing countries, it has become popular to combine various direct and indirect methods of targeting, the latter consisting of designing subsidy programs to ensure that the targeted households self-select into the programs. Inventive ways of circumventing these problems have been devised throughout the world (for a review of alternative methods, see Coady, Grosh, and Hoddinot 2004), but there is a long way to go before conceptually simple but administratively complex approaches can be pursued. Indeed, an opposite approach, that is, conceptually complex mechanisms that are administratively simpler to implement, are being pursued.

Finally, in many developing countries, housing subsidies are likely to have multiple objectives.⁴ For instance, the occupants of low-income housing in the slum of a megacity more often face difficult social problems that are likely to be targeted by public assistance than do low-income families in developed economies. In the former, attention must be given to many other considerations besides the housing cost problem that vouchers are so well-designed to address. However, as is well known, the tradeoff for pursuit of multiple objectives is usually a reduced ability to achieve any specific objective.

Box 5.2 illustrates many of the points highlighted above. It shows how Moroccan housing subsidy programs perform against different public finance criteria. Subsidies to the housing sector constitute a big drain on Morocco's resources, with an estimated yearly expenditure of around 9 billion Moroccan dirhams per year (2.6 percent of GDP). However, most of these subsidies are implicit and not accounted for.⁵ While it is immediately apparent from the figures that gains in efficiency and targeting of the

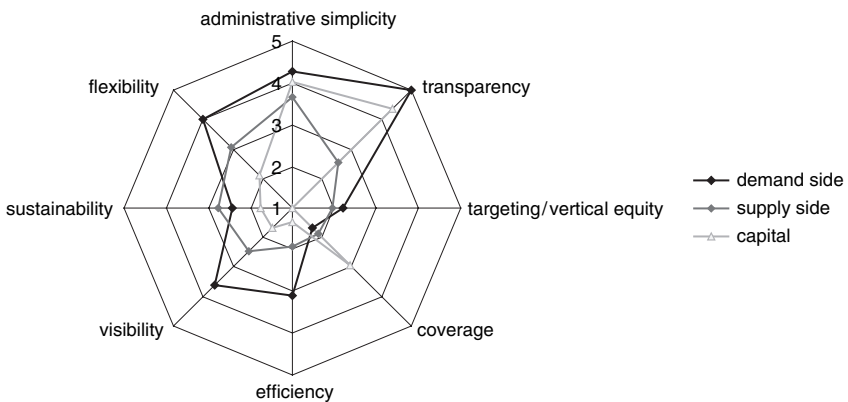
Moroccan subsidy programs could be achieved, it is also apparent from the way the figure arrays the achievements across different possible objectives that in most cases an improvement according to one measure usually comes at some cost in terms of other goals.

**Box 5.2 Housing Subsidies in Morocco:
An Illustration of the Complexities**

In Morocco, interest rate subsidies on mortgages, represent only 4 percent of overall expenditures on subsidies. Income tax deductions of mortgage interest, tax breaks to developers, and land subsidies to public developers represent much higher costs. Interestingly, the single most important subsidy item is a reduction in local taxes for homeowners (not applicable to renters), which is deemed to have little direct impact on welfare or housing construction but constitutes a serious drain to already insufficient local government resources.

The first figure below summarizes the performance of Moroccan housing subsidy programs, grouped into three broad categories, against different public finance criteria (see Le Blanc 2005 for a description of the methodology and data). Overall, all subsidies appear to be insufficiently targeted, do not achieve a good coverage of the poor population, and are not sustainable in the long run. The shape of the figure also implies that

Performance of Housing Subsidies in Terms of Eight Public Finance Criteria, Morocco, 2002 (aggregated by broad type)

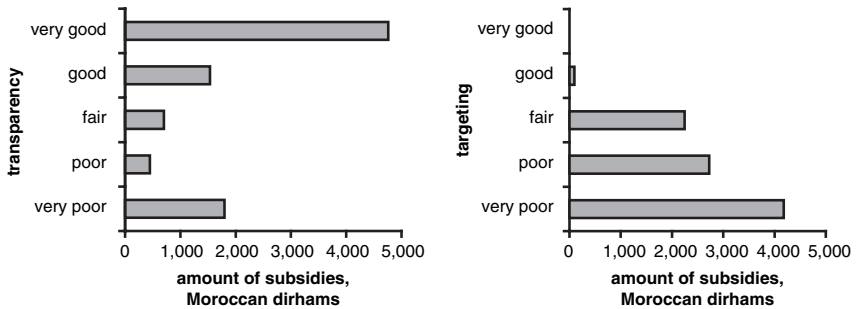


Source: Le Blanc (2005).

achievement of the subsidy goals usually entails reduced effectiveness with respect to other goals.

The second figure below breaks down total subsidy expenditures by degree for two criteria, transparency and targeting. Transparency in this case refers to the clarity of the program's eligibility and participation criteria and effective implementation by the responsible entities. Overall, housing subsidies are fairly transparent (mainly due to the importance of tax breaks, which follow explicit rules accessible to all) but insufficiently targeted.

Aggregated Performance of the Housing Subsidy System: Transparency and Targeting, 2004



Source: Le Blanc (2005).

Lessons Learned

What Works...

Pragmatism. Political economy constraints are particularly prevalent in the area of housing subsidies. As a consequence, there is often a gap between what benevolent governments are willing to do and what can politically be done at any moment in a given country. A pragmatic recognition of these constraints is key to achieving concrete steps in reforming public spending on housing. One concrete translation of this general recommendation is to carefully distinguish policy dialogue on the relative merits (e.g., efficiency and targeting) of alternative housing subsidy systems from operational work (e.g., administrative setting, parameters, and transparency) aimed at designing and refining individual subsidy programs to help them reach their intended beneficiaries. Those two types of activities should be undertaken in parallel.

Sequencing matters. Political economy considerations arise because of the multitude of institutions involved in the management and reform of housing subsidies. Following the specific kind of subsidy at stake, natural champions for reforms vary widely across countries. As a consequence, in any country, the packaging and sequencing of housing subsidy reforms must take into account the local mix of subsidy programs and the interests of their managing institutions.

Reforming subsidy programs takes time. Most of the time, subsidy reforms are better envisioned within a global, long-term (programmatic) framework, as opposed to one-shot reforms. The institution of new systems of subsidies tends to induce long-term financial and administrative commitments that may be difficult to shift or reverse. Indeed, political difficulties associated with changing the welfare system are so high that often, in order to discontinue one subsidy, governments have to introduce another one.⁶

...And What Does Not Work

Lack of clarity as to what is expected from broader housing sector reforms. As argued in the 1993 World Bank housing policy paper, housing subsidies form an integral part of the housing sector, and as such, failures to reform the broader sector often condemn subsidy reforms. For instance, a number of countries have postponed or abandoned structural reforms to the legal and regulatory environment of the land and housing markets while maintaining subsidies known to perform poorly. Examples include continued investment in public rental housing when the local conditions do not allow sufficient collection of rents to even maintain the constructed dwellings, as in Algeria; keeping special funds, or financial circuits, for housing whose structural characteristics prohibit efficient functioning, as in Mexico; subsidizing public rental units so much that the private rental market cannot develop, as in Russia; and subsidizing public land developers and builders who have crowded out private investment in the housing sector, as in Bangladesh.⁷

In summary, the international experience shows that in the majority of developing countries, housing subsidies represent an important item in the flow of public expenditures. However, the extent and incidence of subsidies is often not well known by governments, notably due to the natural fragmentation of housing subsidies between different levels of government and the use of different types of subsidy mechanisms. Nevertheless, the evidence is compelling that in nearly all cases, the efficiency of public spending in housing subsidy programs could be improved, essentially by better targeting low-income households. Such improvements would allow government assistance to serve more households or serve households more

efficiently. Altogether, these considerations make the case for further Bank involvement in housing subsidy programs. Fortunately, many of the Bank's largest borrowers share this view. The recent involvement of the Bank in operations supporting big client countries willing to evaluate and reform their systems of housing subsidies (such as Brazil, the Islamic Republic of Iran, Mexico, Morocco, and Russia) reflects a belief by both the Bank and its borrowers in a more pragmatic vision of housing subsidy reform in which political economy considerations are fully taken into account.