

Housing Subsidies: Who Gets What and Why it Matters



Marja C. Hoek-Smit
The Wharton School
University of Pennsylvania

Urban Forum Presentation
The World Bank,
Washington D.C.

March 12, 2009

Presentation Outline



- I Finance, Subsidies and Crises
- II Subsidies for Different Segments of the Housing Market
 - Segmenting Markets
 - What Subsidies for Which Problems?
 - Demand - Supply / Rental – Ownership
- III Some Fundamentals of Subsidy Design
 - Some Guidelines for Subsidy Choice
 - Criteria for the Design and Evaluation of Subsidies



Section I

Real Estate Finance, Subsidies And Crises



Dare we speak of Housing Subsidies in times like these -- --- or ever?

- **We have no choice!!**
- Subsidies are again looked at to “save” the housing sector, i.e., economy in many countries
- But subsidized systems are known to have worsened or caused crises
- Crises also have been cathartic
- And created innovative government initiatives to improve markets and increase affordability
- **These are critical times to reflect on subsidies!**

Financial Crises often Related to Real Estate



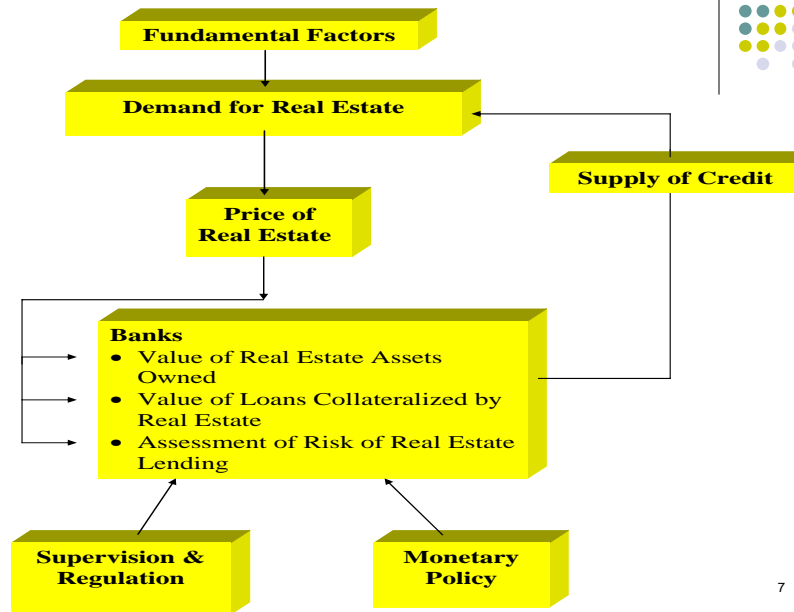
- Increasingly households borrow to buy a home
- Developers borrow for RE developments
- Size of loan that can be afforded depends on interest rate (linked to monetary policy)
- Decline in interest more than offsets increase in debt; prices increase with declining interest
- Bank lending, **particularly if subsidized**, contributes to inflation/deflation of bubbles
- When real bubbles burst, financial sector busts follow (Asian crisis, US, Japan, etc) and so do economic downturns

How does bank lending contributes to inflation/deflation of bubbles?



- Banks seek to maximize expected profits
- Desired loan concentration in RE
 - Increases as expected value of assets increases
 - Increases as capital requirement decreases (regulations/ Basel/ mortgage insurance)
 - Increases as promised returns increase (often underestimation of risks relative to higher profits)
 - Increases as the expected probability of default decreases (expectation of price increases)
 - Increases as perceived correlation with rest of portfolio decreases
- **Subsidized finance or special regulations often contribute & deepens busts**

Real Estate Booms and Banking Crises



Because real estate prices are uncertain and busts occur at long intervals

Banks and borrowers often:

- Underestimate,
- Ignore or
- Simply fail to comprehend the risks in RE investment

Often heard comment in emerging markets: "in our urbanizing country prices will always go up and RE lending is therefore safe...." But prices do come down!!

Housing Subsidy Policy Requires Comprehensive Approach - Now more than ever



- **Reform old subsidies** left over from past crises – steady progress in the past few years but pressure to resuscitate old systems with current down-turn
- Dealing with **current financial sector constraints**:
 - Liquidity crisis (drying up of capital markets)/
 - High cost of credit
 - Increased credit risk through economic down-turn
- Dealing with deteriorating **affordability issues** (high interest rates, high unemployment)
 - The poor (less finance dependent, more general support)
 - The broad middle class, more market dependent, vulnerable

This Agenda cannot be Addressed through Simple Income Transfers



Income transfers subsidize consumer directly

- Considered **most efficient** (e.g., consumer choice)
- but work only in market segments that respond competitively to increases in demand
- In many countries housing finance and land markets work for small proportion of households only
- **Direct transfers do not translate in better housing**
- **+Market systems still need government inputs** (regulation and subsidies) to overcome inefficiencies
- Downside: system subsidies can distort markets

Q : Can we avoid the negatives? In the spirit of the times, dare I say “YES WE CAN?”



Section II Framing the Issues

What Subsidies for Which Problems and Market Segments?

From Band Aid Projects To Subsidy Policy



- What are the **housing problems to be addressed for different market segments**?
- What housing objectives are pursued for each?
- Should/can objectives be attained through **regulatory change**?
- What are the appropriate **types of subsidies** to reach policy objectives? Ownership or rental? Supply or demand?
- Which groups or locations should be **prioritized**? How should subsidies be **rationed**?
- Which **institution** should design, allocate, adjust the subsidy policy and programs?
- Will **Local Gvt** need incentives to make necessary changes?

Typical Underserved Market Segments and Frontiers



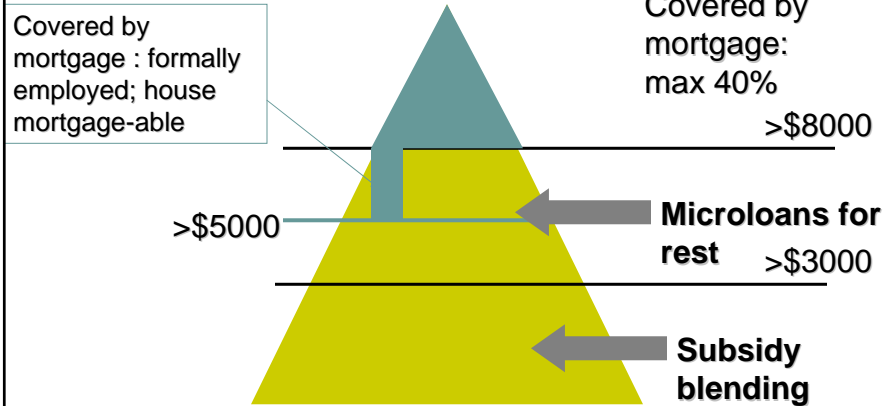
1. Households with incomes between the 40th and 70th percentile living in unauthorized, formal substandard or overcrowded housing, without access to finance
 - **Frontier:** provide formal housing options (new or resale or rental) to “households at the margin” by improving access to finance (including for rental housing)
2. Households with incomes below the 40th percentile living in substandard housing and substandard neighborhoods (public health and social equity concern).
 - **Frontier:** (i) improve living conditions and (ii) increase new suitable housing options such as incremental housing, low-cost rental options

Why not just help the Poor? Or only serve Middle Income Households so housing can filter down?



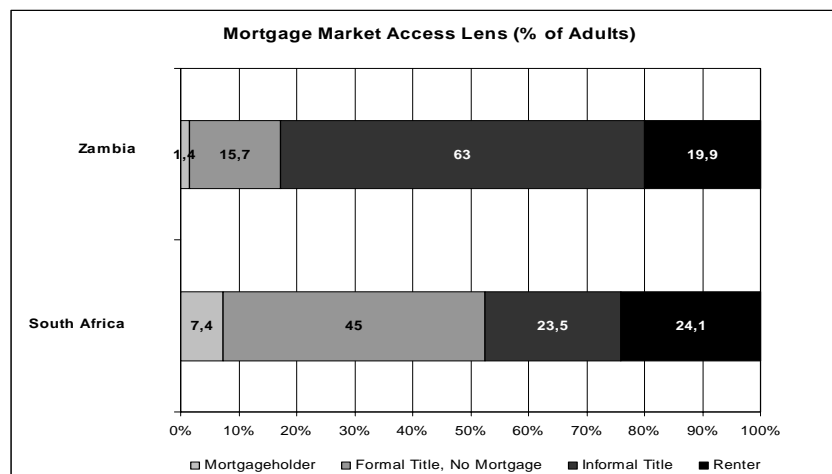
- If the middle income group is not served by formal market it captures housing made available for the poor
 - Filtering of housing from middle to low income households cannot fulfill need for low-income housing in most markets: - household increase at the low-income level is too high b/c of urban in-migration; - upward filtering requires access to finance , etc.
- Both poor and lower/middle income require support to fill gap in housing market

Mortgage and Micro Coverage



Source: adjusted from David Porteous, Housing Microfinance Presentation, International Housing Finance Course 2007, The Wharton School

Land Tenure and Mortgage Finance




Source and definitions: SA: FinScope, 2004. Q refers to relevant question number in SA database; Current mortgage holder: Q49; Ownership status: Q48a,b,c
Zambia: FinScope Zambia 2006, data extracted by Christian Keulder of FinScope

Gaps in the Egyptian Housing Market



	Income Quintile				
	1 st	2 nd	3 rd	4 th	5 th
Mkt Ownership					
Subsidized Units					
Market Rental					
Rent Control					
Informal					

 Recipients are a small portion of the households in these categories

1. The Middle-Income Segment



Typical Problems: “affordability” of developer built house; mortgage markets do not work for this group, interest rates are too high, fear of borrowing, rental market undeveloped

Three Complementary Types of Subsidy may be needed

A. Housing finance system subsidies?

- Improve information and research on credit markets
- Address specific risks that private sector cannot yet handle; e.g., funding and liquidity risks, credit risks/multifamily fin risk
- Subsidize borrower education programs
- Subsidize part of transaction costs

B. Support to Rental Investors?

C. Household subsidies?

- Increase access to finance
- Increase affordability: ownership or rental housing

A. Analysis for Possible Housing Finance System Support



Lending costs and risks preventing expansion of markets

Liquidity risk	<ul style="list-style-type: none"> • Access to (part) government-sponsored liquidity facility for all or a certain class of mortgage/ micro-finance lenders 	<ul style="list-style-type: none"> • Structure as a joint public/private venture to limit government risk exposure
Credit risk /Collateral risk	<ul style="list-style-type: none"> • Subsidize information collection and research on property and credit markets • Shift credit risk to a public/private MI entity (including for social rental) • Pay for premium of private mortgage insurance (overlap with household subsidies) • Provide for borrower education on home-maintenance and mortgage credit procedures, rights and duties (overlap with household subsidies). 	<ul style="list-style-type: none"> • Additional government action needed to limit moral hazard/agency risk: <ul style="list-style-type: none"> • Credit bureau • Property information systems • Improved foreclosure methods • Educate the courts/judiciary • Community negotiations in case of default • Neighborhood investment plan to mitigate neighborhood risk (see below)
High transaction costs for loan origination and servicing	<ul style="list-style-type: none"> • Subsidize research and information collection • Subsidize transaction cost of lender for selected loans through cash payment or compensation for higher interest rate. 	<ul style="list-style-type: none"> • Required industry action: <ul style="list-style-type: none"> • Improved underwriting and servicing methods (see also under credit risk)

Analysis for Housing Finance System Support cont.



Funding constraints and risks/ accessing capital markets

Constraints	Subsidy Options	Main Issues
Limited access to or high costs of funds for lending	<ul style="list-style-type: none"> • Cash subsidies to the cost of funding for housing finance • Tax subsidies for funds channeled to housing finance (e.g., bonds, savings) • Subsidized cash-flow guarantees for debt funds channeled to housing lenders 	<ul style="list-style-type: none"> • This class of subsidies is often provided through special government-sponsored institutions, adding to the cost of the subsidies and possible distortions in the housing finance market.
Interest rate risk/ prepayment risk	<ul style="list-style-type: none"> • Shift (part of) funding risks to government-sponsored agency, secondary mortgage market agency 	<ul style="list-style-type: none"> • Obvious moral hazard/ and potentially large government risk exposure

Lessons from Subsidizing Housing Finance Systems



- **Design of such types of subsidy should:**
 - Limit the period in which change has to occur/ phase out
 - Calculate short and long-term costs and risk to government/ run scenarios
 - Have an on-budget subsidy allocation, where possible
 - Avoid possibility of “skeletons”, hidden future cost to government
- **Increase competition to access subsidies where feasible**
 - Expand pool of lenders by leveling playing field across govt. and private lenders
 - Use auctions for govt. subsidy programs linked to finance
- **Be complementary to policies to increase sector efficiency:** e.g., registration systems, mortgage law; consumer protection law, regulations about sharing of credit information, foreclosure process

B. Importance of Rental Housing



- **Affordability**
 - Rental housing does not require significant down-payment; typically lower cash flow burden than owner-occ housing
 - Serves young households; older hh to lesser degree
 - But ownership rates are not related to country income level
- **Labor and Social Mobility**
 - Lower cost to move to take advantage of job opportunities
 - better neighborhoods
- **Diversity of Investment and Tenure**
 - Ownership ties up savings that could be used for alternative investment (e.g., small business)
 - Rental housing can be an important investment alternative

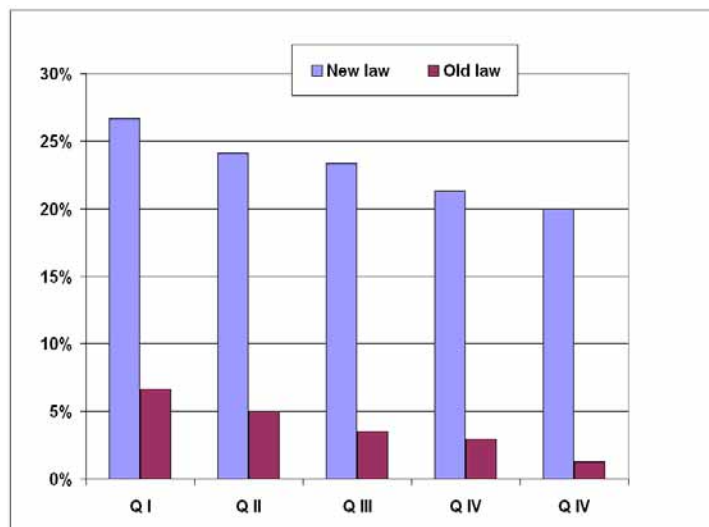
Public Rental Housing and Rent Control Predominant in the Past



- Below-market rents, tied to the unit, highly inequitable
 - Prevents people from moving, loss of subsidy
 - Renters are like “owners”
 - But have no control over maintenance, which is nearly always poor
- ⇒ No longer preferred models of subsidizing rental housing/ privatization in many countries
- ⇒ Focus on stimulating private (or social) investors in formal middle income rental housing
- ⇒ But why is that so difficult?

23

Egypt: Rent-to-income ratio by standardized income quintile; old law is rent control (USAID study 2006)



24

Identifying Constraints in Provision of Private Rental Housing



Frequent reasons:

- **Poor taxation and regulations** for the rental sector that discourage investment
- **High credit risk on debt** to rental investors and hence lack of debt finance for the sector
- Mismatch between **incomes** of priority tenant groups and the **cost of production and operation** of rental properties.

Problems differ by market segment and require different government intervention.

Types of Private Rental Investors



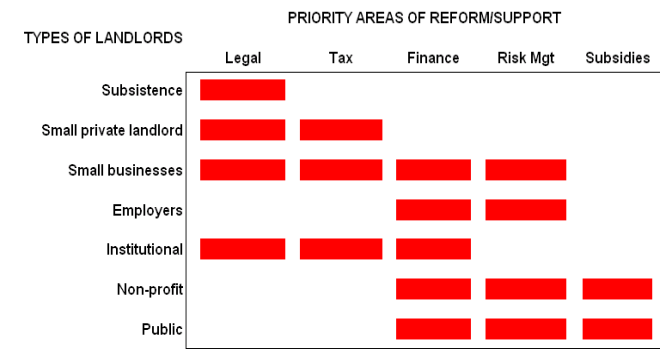
Typical situation in emerging markets:

- **Subsistence and small private landlords** -- buy-to-let
- Employers (not many)

Missing investor and collection agents:

- Small businesses (10-50 units)
 - developing in some East and West European countries (Poland and Lithuania, UK buy-to-let market, Germany)
- Institutional investors (pension funds, insurance co's)
- Non-profit housing associations, foundations, cooperatives:
 - e.g. risk-taking social investors in South Africa, Poland
- Property management companies (e.g. Poland)
- PPP models between developers and public housing companies

Rental Investors and Their Support Needs



Smaller landlords primarily mobilize existing stock or build progressively

Larger buy-and-hold investors have different needs

27

Regulatory and Tax Treatment



Critical first measures:

- Improve **regulatory and tax environment** e.g.,
 - Adjust **building code** requirements for multi family housing
 - Adjust **tenant protection regulations**
 - Remove **rent control**
 - Remove double **taxation** on production side, and unfair taxation on income side

Not easily done and main reason for **informality** of low-moderate rental sector in most emerging markets

Direct Types of Support to Private Rental Investors



- Direct subsidies to private investor in middle income sector to balance rent and operating costs, e.g.
 - **Interest payment buy-downs** (on budget and phased out/ not life long)
 - **Credit guarantees**/ using future rent cash flow as security/ do not under-price
 - **Special depreciation schedules** for tax purposes
- Tax subsidies are less transparent and in the case of private investors, they are often regressive
- Tax subsidies will not benefit small informal landlords who do not file income taxes

Alternatives to Private Rental: European Social Housing



- Social Rental Housing Provided By Local Governments/ Housing Associations (NGOs)
 - Government provides initial equity
 - Privatization of units and management
- Increased Use of Private Finance
 - Rental cash flow can support loans (less risk if back-stopped by government through rent support)
 - Associations can pool collateral or rents to spread risk
 - Gvmt may provide guarantees, subordinate finance
- **Policy Shift Away From Supply Support to Renter Support/ social housing is expensive**
 - Move to market-based rents with **housing allowances**
 - South Africa and some transition countries have this model, but³⁰ production remains small

Three Important Issues in Social Rental Housing Finance



- Who provides Social Rental Housing (public entities, private non-profit, other) ?
- How are investors funded (off-market; market through intermediary, e.g. special funds; market directly) ?
- How are their loans secured (Federal or local government guarantees; mutual guarantee fund, e.g. Netherlands, UK; normal collateral) ?

Source: Claude Taffin

Alternatives to Private Rental: Public Private Partnerships



- Many different types of partnerships
 - Often focused on public provision of land and infrastructure against obligations to produce affordable units
 - Increasingly sophisticated structures e.g., public-private SPV that issues debt to commercial lenders, pays the developer and holds the properties while local government gradually purchases the units (Poland).
- **Problem: PPP (laws) usually foresee limited government risk, yet in practice often shift risk to government (marketing risk, financial risk)**

C. Household Subsidies: Middle Income (tied to mortgage finance for ownership, or rental)



<i>Household Constraints/Risks</i>	<i>Possible Subsidy Support</i>	<i>Additional Support and Possible Issues</i>
Income constraint (relative to targeted house price and cost of finance, or rent price)	<ul style="list-style-type: none"> •Contribution towards loan amount (or investment in land/house) •Partial coverage of monthly payments or interest due (buy-down; rental vouchers) •Tax subsidies for loan repayments 	<ul style="list-style-type: none"> •Interest rate subsidies are often inefficient and regressive •Tax subsidies are regressive and mostly ineffective
Savings constraints	<ul style="list-style-type: none"> •Support with closing/titling costs •Contribution towards owner's down-payment/equity •Payment for mortgage insurance (lower Loan-to-Value ratio 	<ul style="list-style-type: none"> •Requires access to savings facilities •Savings programs linked to subsidy programs
Income/employment volatility (payment irregularity)	<ul style="list-style-type: none"> •Borrower education •Rental vouchers?? 	<ul style="list-style-type: none"> •Flex. mortgage, line of credit •User-friendly servicing •Community support organizations/funds •Rental / multifamily hsg support

Household Subsidies: Middle Income -- ownership



Focus on Increasing access to finance for middle-income home-ownership (new and existing)

- Lump-sum cash grant towards down-payment or loan amount/ requires land/finance mkt to work
- Transparent interest subsidy for initial period of the loan (buy down of payment)
- Payment for mortgage default insurance; allows higher LTV (always keep down-pmt requirement!), extends mortgage lending

Avoid interest rate and individual tax subsidies

- Often regressive
- Non-transparent cost
- Tax subsidies ineffective

Household Subsidies: Middle Income -- rental



Two main types:

- **Rental allowances/vouchers** to tenants who find their own private rental units (criteria apply):
 - to protect against rental shocks following decontrol
 - as permanent housing cost support for the poor, elderly
 - Latvia, Poland, East Germany, US, Western Europe
- **Purchase of occupancy rights** from the private rental stock (i.e. gov. subsidizes rent temporarily through landlords)

NB: lower rents enforced through subsidies to investors are technically supply-side subsidies

35

Household Subsidies: Middle Income -- rental



- Important Advantages of Housing allowances
 - Equitable, can be targeted much better than supply sub
 - Allow consumer choice
 - Transparent / on budget
- Issues in emerging markets:
 - Private low/moderate-income rental markets must work
 - Heavy budget commitment if entitlement (social risk)
 - Administrative complexity (e.g., lack of data in calculations of local median rents in subsidy calculation, enforcement of quality)

2. The Low-Income Segment



Problem: Low incomes, land-markets do not work for this segment, micro finance for housing is not available and mortgage finance not accessible, formal rental markets are not developed

Complementary Policy/Subsidy Components may apply:

A. Neighborhood Improvement:

- Provide public services and property rights to existing areas
- Complement with grants for home-improvements complementing micro-finance loans (see below)

B. Expanding Access to Micro-Finance

- System subsidies to strengthen micro-finance industry

C. Support for rental housing/ public private partnerships

D. Household Subsidies for Low-income housing:

- Household grants towards serviced lot/ incremental house
- Household vouchers in transition economies

A. Real Side Neighborhood Upgrading Subsidies



Complement real side subsidies with measures to facilitate home improvement /expansion:

- Upgrading of informal areas (improves living conditions for low-income renters and owners alike)
- Bring in Micro-credit Industry with appropriate products
- Support for community participation efforts/ local government or specialized NGOs

Much sound experience but currently mostly small scale implementation – project rather than policy based

B. Subsidies to Strengthen Micro-finance for Housing (HMF) Systems



- HMF is critical for home-improvement and progressive construction
- HMF needs to **move to scale and become more competitive for rates to come down.**
- Some support measures that have proven fruitful:
 - Liquidity finance (longer terms and higher loan amounts)
 - Assist transformation from NGO to bank; access to savings/ Increase competition
 - Mibanco, Peru;
 - Bancosol, Bolivia (both supported by Accion and others)
 - Support through credit guarantees or insurance
 - Support to improve technical systems (IT platform)
 - Support borrower education

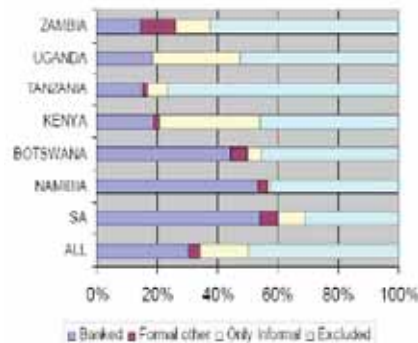
Access to Financial Services is Limited



Access to Finance by Households



Financial service access and usage in South & East Africa



Sources: Honohan, *Access to Finance in Africa, 2007*; Bankable Frontier Associates, *Financial service access and usage in South & East Africa, 2007*; Kecia Rust, *Housing Finance in Africa, FinMark Trust, 2008*

C. Support to Low-Income Rental Sector



- In Urban Africa and Asia Rental is Large Segment of Housing Market
- But most is private **informal**— both informally constructed and operated
- **One room dwelling units** with shared facilities predominate, either in high rise but mostly in low-rise buildings
- Tax and other regulations make it unfeasible to formalize the sector

41

Support to Private Low-income Rental Sector



- Provide services and infrastructure in high density areas where informal rental is prevalent
 - Increases value of housing asset/ stimulates investment
 - Improves quality of living for tenants and resident landlords
 - But: Increases danger of evictions in case of non-resident landlords
 - Gradually step up enforcement of sanitation standards
- Move to new formal rental investment:**
- Allow high density mixed commercial and rental developments (see also middle income)
 - Support employers to provide well located rental housing
 - Other PPP arrangements? Success depends on enforcement systems for payments and rent increases

42

D. Household Subsidies Low Income -- ownership



- Serviced lot with core house as upfront subsidy- link to micro-credit for incremental construction
- Home-improvement grant possibly linked to upgrading and/or private micro-credit (piso firma success in MX)
- Upfront capital grants or vouchers in transition economies where formal private low-income ownership markets work

Avoid: government credit-linked subsidies to households!

- Poor repayment record, high admin. cost

Household subsidies Low-Income -- Rental



- Rental vouchers are not effective when low-income rental market cannot operate efficiently
 - Low-income rental market is informal (landlords do not participate in voucher program)
 - administratively complex
 - major budget commitment when target group is large
 - poverty trap
- Subsidized rents mostly linked to government housing (poor record) or employer housing

Fourth Leg of a Subsidy Policy Incentivize Local Government Reforms



- Provide subsidies for land market reforms and/or
- Make access to federal subsidies conditional upon local government reforms to:
 - adjust development regulations
 - ease permitting process (source of corruption)
 - improve property right and registration systemsExample: US Block Grant
- Repeal federal regulatory subsidies that hinder formal low income development, inclusive rent control, stringent tenant protection legislation



Section III Fundamentals of Subsidy Design

Subsidizing Housing Flow or Stock?



Flow or New Housing:

- When urban growth rates are high and incomes low
- When objective is stimulating housing construction

Stock or Resale/Upgrading of Existing Housing:

- When urban growth rates are modest, and/or population is aging == Western Europe, Japan
- When filtering of housing units is a possibility == i.e., where markets are working
- When urban growth is high, but incomes are low/ income distribution is skewed, and informal settlements are an important mode of new production

=>In most countries both are needed

Location-based or Scatter-site Subsidies?



Location specific subsidies:

- **can positively impact collateral value** and encourage investment/lending in a particular neighborhood/area (critical in urban renewal/upgrading programs)
- **tend to be capitalized into real estate values and taxes** and will in the longer term be less effective from an equity/distributional perspective
- **can leverage community inputs** which scatter-site subsidies can not do

National or Local Level Subsidies?



- In a decentralized government system, **local governments**, are responsible for the housing function in their jurisdiction.
- **State/Federal** level subsidies are needed:
 - To improve the effectiveness of a nation's housing finance system or construction industry.
 - When local governments are not able or interested to improve the housing conditions of underserved households (e.g., NIMBY= not in my backyard); e.g. slum upgrading, low cost rental or progressive hsg

Who Should Be Subsidized? (1) Entitlements or Rationed Subsidies?



- Should every household falling below a defined income/wealth threshold receive housing assistance?
- What should be that threshold?
- Should assistance ever be given to households above the threshold?

Who Should Be Subsidized? (2)



- If not every qualified household is to receive a housing subsidy, who is to be preferred?
 - the neediest?
 - those who will be helped the most by the assistance?
 - those for whom assistance will do the most for the housing system as a whole?
 - the most deserving (e.g. the working poor)?
 - groups with special problems (e.g. the handicapped, the elderly)?
 - households living in an urban renewal area?
 - no one? Distribute housing assistance through a lottery

Who Should Be Subsidized? (3)



- How should this question be approached?
 - better housing, somehow defined, is an intermediate goal
 - who is to be favored with a subsidy depends on the higher level objective; that is.....

Why, precisely is a housing subsidy being considered?

Criteria for Designing and Evaluating Housing Subsidies (1)



- **Efficiency** (with respect to a specific purpose)
 - Lowest cost per subsidy/cost of provision by government versus private sector
 - Does expenditures reflect true opportunity costs?
 - Is market value of assistance in line with recipient's valuation?
 - "Buying out the base"/fungability of funds/ recipient's reduction of own spending on housing because of assistance
 - % of recipients on the "margin"?

Criteria for Designing and Evaluating Housing Subsidies (2)



- **Equity**
 - horizontal
 - vertical / "cliff-effect"
- **Transparency** (fiscal costs and allocation)
- **Effects on Public Investment Portfolio** (present and future)

Criteria for Designing and Evaluating Housing Subsidies (3)



- **Effect on housing market** as a whole
 - production (housing allowance vs. production subsidies)
 - prices
 - quality
- **Effects on Labor Mobility** (an oft problem with subsidized rental housing)
- **Administrative simplicity**
- Political Feasibility or Imperative

Given these Criteria, Is It Possible to Design an Optimal Subsidy?



- **Multiple conflicting goals and values** make achievement of optimality impossible
- **Subsidies that seem appropriate in one country may not be appropriate in another**
 - differing values, institutions, conditions and
 - already existing subsidy arrangements throughout the economy

Nevertheless, some subsidy arrangements are better than others in any particular situation



Contact:
Marja C. Hoek-Smit

International Housing Finance Program
Wharton School
University of Pennsylvania

<http://housingfinance.wharton.upenn.edu>
mhoek@wharton.upenn.edu




Appendix 1

Subsidy Defined



“A subsidy is an *incentive* provided by government to enable and persuade a certain class of *producers or consumers* to do something they would not otherwise do, by lowering their *opportunity cost* or otherwise increase the potential benefit of doing so” (adapted from US Congress, 1969).

 *A Subsidy is about changing behavior of households or housing producers.....*

Subsidies and Opportunity Cost



- *Opportunity Cost for Consumers or Producers of Housing:*
Current costs, net present value of future costs, uncertainty of future profits or costs related to lack of information
- *Opportunity Cost for Government to Provide a Housing Subsidy:*
The costs of the subsidy compared to the allocation of funds to alternative uses or sectors.