FINAL REPORT

ROMANIA: HOUSING POLICY AND SUBSIDY REVIEW

WITH RECOMMENDED SPECIFIC POLICY REFORMS

Prepared for

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SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

This section summarizes our policy conclusions and recommendations. In brief, they are:

1. Economic and legal policies are very supportive of the development of the private housing and housing finance market, and the market is responding well. Development of an efficient and effective private market should be at the center of Romanian housing policy.
    a. Key support is a more rapid and complete expansion of construction and renovation to reduce pressure on prices and rents.
    b. One barrier is availability of serviced land.

2. In addition, some subsidy policies are useful and probably required for public acceptance.
    a. Assisting first-time owners
        i. A program for a 10-20% subsidy of the cost of a home can be affordable and useful, if designed and allocated carefully.
        ii. The subsidy could be structured in several different ways, depending on the desires as to who will benefit and what uses will be favored. These include:
            1. As a cash grant of a fixed amount or as a percent of housing costs, up to a limit.
            2. As a temporary reduction in the interest rate on market-based loans.
            3. As a payment towards the cost of market-priced mortgage insurance that permits the borrowing of amounts greater than the normal ratio of loan-to-value or payment burden.
    b. Creating more rental housing opportunities.
        i. Current programs for rental to young people could help this, but only if redesigned with higher rents and motivations for beneficiaries to move on to market housing as soon as they can.
            1. Consider supplementing with purchases of older apartments
        ii. Private market is responding and will respond more if investor base is improved, tax burden reduced, and the public sector does not undercut the market.
        iii. It is too early for non-profit social rental housing, due to difficulty of fostering such organizations and complexities of implementation.
    c. The subsidy to thermal renovation will be slow to get going, but should evolve over time to deal with reluctant owners and other barriers

3. Most other schemes are not so good.
    a. The Bauspar system is profitable for the middle-class, but a very inefficient way of helping housing.

b. Tax subsidies should be avoided in general.
c. Interest rate subsidies can be effective and useful, but only if carefully designed.
d. A lowered VAT for housing construction is an option, but it is not targeted in any way. A similar subsidy amount can be delivered through the new construction subsidy noted above.

4. One of the best investments a country can make in the housing area is in developing a group of experts who do independent analysis and evaluation of housing policies.

I. PURPOSE OF REPORT

In the framework of the Programmatic Adjustment Loan (PAL) and as part of the preparation for a proposed Capital Market Development Project, the Government of Romania is undertaking several studies in the area of housing mortgage markets. The work is funded with the Dutch Government Supplemental Technical Assistance Grant and is structured around three elements: (i) review of housing policy and subsidies, with specific policy reforms; (ii) design and implementation of housing mortgage insurance scheme (MI); and (iii) design and implementation of an enhancement facility for mortgage-backed securities (MBS).

This Report pertains to the first element – review of housing policy and subsidies - and recommends specific policy reforms to the Government. The Government has asked for an assessment of its overall housing policy design and directions, so that a comprehensive and cohesive housing strategy can be adopted for the country and be compatible with the development of other sectors, with specific emphasis on the financial side of the capital market.

The Report specifically focuses on the assessment of existing and contemplated subsidy programs in their value in meeting housing policy objectives, as well as on the financial implications on local and central budgets, including explicit, implicit and indirect subsidies in medium-term perspective. The Report also includes recommendations to the Government regarding (i) development of housing strategy in terms of ascertaining clear articulation of cohesive strategic goals, policy objectives, priorities and preferences for implementation programs and projects; and (ii) realigning subsidy programs to fit with strategic goals, objectives, priorities and preferences.

The Report is structured in a way to more efficiently inform the client, the Ministry of Transport, Construction, and Tourism (MTCT). Because the client already knows most of the details of the current economic and social conditions as well as the design and operational details of current subsidy schemes, these details are placed into four Annexes. The main report only summarizes these findings and focuses instead on the housing policy experiences in Central Europe and on our recommendations for developing a housing strategy for Romania.[1]

II. SUMMARY OF FINDINGS

II. 1. Housing Market Conditions (see Annexes A and B)

It is an important time in the long-term development of housing markets and housing policy in Romania. It appears that economic policies are generally very supportive of the

[1] This approach stands in contrast with a typical such report intended for a donor organization, where all of the background information is developed in the main report itself.

development of the private housing market (i.e., declining inflation, rising incomes, and declining unemployment). In a market economy, most housing needs must be met by private suppliers of housing, both rental and owner-occupied, and of the finance to build and own such housing. Because housing is such a long-term investment, the most important ingredient in the success of the sector is economic prosperity and political stability. These conditions have been in place since 2000 and, combined with a legal structure that has protected property rights, have encouraged banks and investors to feel comfortable financing the production and acquisition of housing.

As a result, a strongly competitive market in housing finance for homeowners has developed since 2001, and stands ready to finance the acquisition and improvement of housing over long terms (15-30 years) and at reasonable rates (9% in euros, with initial rates as low as 7%; 12% in RON). New construction is rising in general (completions up 23% since 2000 and with rising numbers of permits) and the market for new housing produced by large scale developers is in the process of appearing (4-5,000 units expected soon around Bucharest), prompted by the increase in the solvent purchasing power of many in the population, and the related increase in the prices of existing housing (the main alternative to new housing).

As part of the process of building more housing and also due to the desire of individuals to invest their savings, a growing portion of the stock, estimated to be at least 10-15% of the urban stock, is now in rental. In Bucharest, rents vary from EUR 250-500 a month (not including the market for expatriates). Although construction of large-scale rental buildings will not appear until better long-term financing arrangements can be made, this individual entrepreneurship of private rentals is meeting demand (observers report ready availability of rentals), although at a market price that may exceed the willingness or ability of many households to pay.

Our conclusion is that, at this point, private markets seem to be relatively efficiently meeting the market-based needs of average urban-dwelling Romanians as expressed on a market-basis. In other words, those who have the sufficient funds, either from their work, the work of relatives, or from wealth within the family (including ownership of privatized housing) are able to enjoy housing opportunities commensurate with their economic status, just as they do with respect to food, clothing, auto ownership, and other aspects of consumption. There do not appear to be significant failures in the market for housing or housing finance.

Whether due to the positive environment or for budgetary or ideological reasons, state interventions into the housing market operations are at a relatively low level. A past ownership program of the National Housing Agency (NHA) that competed with private developers has been reduced (although not fully ended). The early program of the NHA in offering housing finance was ended in 2003 (although there have been suggestions to start it up again). However, there remains a large program of state development of rental housing, primarily for young people, and there is a program of subsidized finance for housing through the Bausparkassen. All of these interventions into the market can be supported by valid policy arguments, but all should be scrutinized for their usefulness and efficiency (cost-benefit ratio).[2] However, it is notable that, in many ways, the current set of housing policies and programs in Romania are more defensible than those in most Central European countries.

II. 2. Current Ownership Programs (See Annex C)

There are three main ownership programs at this time. One is the process of finishing uncompleted flats that has been going on since 1994. This is in the hands of the local governments, although it uses funding from the central budget. It appears that the subsidy of about 30% of the value of these flats is not excessive (although the provision of low-rate financing is no longer appropriate), given the existence of other drawbacks in many cases. We did not examine closely the allocation process for this program, other than to note that it seems to be deeply involved in local politics.

The second main program is that of the NHA for the construction and financing of new housing. This program has never been operated at a large volume (average of about 450 units per year), which has meant that it has not cost very much and has not disrupted the private market too much, while still serving as a highly visible state policy. We agree with the government's decision to end the program as operated through the NHA, but are concerned that the NHA may still attempt to compete with the private sector in this area (through building on private land).[3]

The third program mostly targeted to subsidizing homeowners is that of the building savings banks or Bausparkassen. As noted below, in our opinion and experience, the Bauspar system has not been an efficient or effective method of delivering housing subsidies in Central Europe. It appears that the government of Romania recognized this to some extent in 2005, when it reduced the premium being offered. It should also be recognized that the Bauspar system can be attractive electorally, and, once well established, is very difficult to modify.[4] Thus, the small size of the program as of 2005 is desirable from our perspective.[5]

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[2] In fact, an area that public bodies have a primary responsibility for addressing, the provision of large scale public infrastructure such as roads and water services, does not seem to be well served. In addition, there may also be some failures in the regulation or incentive of the privatized utilities companies that is letting them not provide for the expansion of their networks commensurate with the demand for additional land for residential use.

[3] In our opinion, the NHA should be an administrator of state programs that work though the local councils or the private sector, but not be a developer of for-sale housing itself.

[4] Political battles to resist their establishment or to reduce subsidy costs have been intense everywhere in Central Europe. Poland and Lithuania rejected them only after severe battles with the Bauspar interests. Croatia and the Czech republic have had great difficulty reducing subsidies. Only Slovakia, where the premium was set by the budget law, had some uncontested control over the degree of subsidy.

[5] Our recommendation is that the government either phase out the system or change the law to state that (1) the premium can not be received without a longer period of accumulation of the savings and (2) the premium can be set each year in the budget law. If this is not possible under current circumstances, the premium for 2007 should be reduced to 10%, so that the rate of return to those who shift funds into a Bauspar account from a bank declines from the current 17-22% down to 10-15% over the two year minimum savings period.

The weaknesses of the Bauspar system include the following:[6]

1. The costs are high relative to subsidy received, because extra costs are associated with the operation of the specialized institutions and competition can not easily force the maximum amount of the subsidy through to the beneficiaries.
2. There is no direct budget limit on how much it costs, i.e., the program is open-ended. Moreover, much of the cost each year depends on past contracts and the premium amount is set in a separate law that is politically difficult to change as budget and interest rate circumstances change.
3. The effective "subsidy" (the Bauspar rate relative to market rates) delivered depends on the course of interest rates over the next 5 years. If rates go down further, the actual subsidy to renovations or other housing uses will be small, while the subsidy to those putting funds in as an investment will be high.
4. In general, most subsidy goes to it as an investment product, not a loan product, and families with EUR 5,000-10,000 to invest can get very large benefits (current rate of return can be 17-22%).
5. There is little evidence that the system increases housing production or renovations, nor is it actually used by many people to establish their credit worthiness.[7] "Housing uses" that permit receipt of the premium after a short savings period include repayment of mortgages and routine maintenance, and the use can be anywhere in an extended family. It is even difficult to assure that the use is really for housing purposes, since there is no inspection.
6. If they receive a large subsidy, Bausparkassen can distort the financial system, with an unfair advantage to attracting savings deposits and giving small loans.
7. Any valid social goal of the system can be met more efficiently through other, more direct schemes, such as direct subsidies of interest rates on loans (see below).

II. 3. Other Possible Assistance to Homeowners (See Annex C)

Western and Central European, as well as North American, governments have tried many other housing policies over the last 50 years or so. Many of them gave an attractive electoral image, but only a few were effective and efficient.

Tax Deduction of Interest. In the US and several European countries, an expensive policy has been to permit people who have mortgages to deduct the amount of interest that they pay from their taxable income. This sounds like a good idea but has many detractions.

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[6] The leading Bausparkasse in Romania, Raiffeisen Banca pentru Locuințe, has responded to this perspective with a letter making various arguments. The letter is attached to Annex C.
[7] These statements are based on the actual operations of these schemes elsewhere in Central Europe.

1. The biggest subsidy goes to people who have the biggest loans, who are basically the richer people.[8]
2. The beneficiaries usually only have a vague idea about how big their subsidy is.
3. It encourages people to take larger loans to buy houses even when they have other money that they could use instead. It also encourages people to buy larger houses, which is a nice idea, but it means that other sorts of investments receive less funding. Directly or indirectly, subsidized mortgage finance can be used to finance non-housing consumer purchases.
4. It is an open-ended program, so that it cannot be cut back easily when the budget is tight.
5. To compensate for the reduction in tax receipts, the tax rate on the remaining taxable income has to be raised higher, which further increases the reasons to hide income.
6. The actual cost of the program is hidden, so it does not receive the sort of occasional re-analysis that other programs do.

Especially under current circumstances, where housing supply is only starting to revive, it is not a good idea to subsidize the cost of housing loans in a general way, because a broad boost in solvent demand may push prices for housing up further.

Other tax subsidies. As Romania has found, it is better to not exempt many types of income or grant other subsidies through the tax system, and instead to have the lowest possible tax rate. This encourages the reporting of economic transactions and also gives the government more control of the budget situation. It is better in general to give subsidies in a transparent and on-budget way. Thus, deduction of payments for renovations or tax-exemption of Bauspar premiums and other hidden subsidies should be avoided (but see below about VAT treatment).

Interest rate subsidies. A very popular approach to housing policy is to have the state either provide low-rate funds or to pay part of the interest that people pay to financial institutions for housing-related loans. This is done in almost all countries in at least some cases and was done in Romania from 1997 to 2001.

There are several shortcomings to such an approach, but there are also advantages and it may be appropriate in some cases. The shortcomings include:

1. Most of the cost of such schemes, usually 90% or more, is in the future and not accounted for in the current budget. This becomes a burden on future budgets that can no longer be changed.
2. If the subsidy is large enough to really save people money and permit a much larger loan, it makes the rate so low that the borrower has no incentive to repay early, and maybe an incentive to delay repayment as long as possible (e.g., if the

[8] In practice, this disproportion is often much worse. Lower income people receive a certain amount of minimum deduction from taxable income anyway, so only the portion of their interest payments over this minimum saves them money. In addition, they are in lower tax rates, and so benefit less from the deduction.

rate is only 5% for 20 years, then it may be better to keep money in a bank rather than repay the loan early).

3. Such a subsidy usually ignores that the household income will rise over time, and thus the subsidy is much larger than it needs to be to permit the household to repay a bigger loan. Any subsidy that reduces the rate for 20 years into the future is inherently very inefficient.

But such subsidies may still be attractive because the public finds such a program easy to understand and to see how much it benefits them. Also, because most of the cost is hidden in the future, such a policy is convenient when the budget is tight, since the effect can be obtained now while the cost is paid over a long future time (this sort of effect is a major source of Hungary's budget deficit).

They also have an advantage over tax subsidies because the eligibility for it can be more refined through regulation and that the number of such subsidies to be awarded in a year can be limited (it is not open-ended like a tax subsidy is).

A viable solution in some cases is to offer such a subsidy in a manner where the subsidy declines over the first 5-10 years and to try to calculate in the budget the present value of these future costs and set them aside this year.

Cash Grants. An alternative approach is to provide buyers or builders of housing some sort of grant or discount. These are generally called lump-sum or cash grants, and one large advantage of them is that the cost is fully reflected in the budget in the year that the subsidy is received, so that there are no long-term burdens on the budget. Another advantage is that the beneficiary usually knows just how much of a subsidy is being received.

One way of offering a cash discount on the cost of housing is to apply a lower VAT rate to the construction of housing. This could be done in general, or just applied to a certain amount of expenditure. Several European countries have chosen to do this. But one drawback of this sort of cash grant is that it can not be targeted just to first-time buyers or lower-income households, and will be much more expensive than some proposals because it includes self-builders as well. In addition, there can be further revenue losses if other "worthy" sectors seek the same special treatment.

At this time, our opinion is not opposed to this as an incentive to the housing production sector, as long as it has a limit associated with middle-class housing, say on the first 50,000 euros of construction costs. However, it will be a costly provision and it is important that the actual cost be reported as a housing subsidy each year.

However, overall, an actual cash grant such as 10-20% of costs avoids many of the disadvantages while having the same advantages. The simplest approach would be to offer this to all first time buyers for housing up to some maximum quality and/or size. This would be a fair way of giving every young person the sort of substantial assistance given to their parents in the privatization process. However, this would be very expensive and probably mostly just push up prices in most cities.

Another advantage to cash grants is that they can be used to substitute for cash downpayment of young homebuyers. Another and potentially even more efficient form of cash grant to facilitate homeownership is to subsidize the purchase of mortgage default insurance (not currently available). In that case, the cash grant permits all those eligible to borrow part of the normal downpayment, but pays only for the expected losses from those borrowers who default.

We discuss below various formulations of targeted cash grants as part of the overall policy strategy.

Thermal Renovation. There is a major program being organized currently to provide cash grants for thermal renovations of multi-unit buildings. In this case, the cash grant is for two-thirds of the cost of the renovations, with one half the grant coming from the central government and one-half from the local government. This is a very deep subsidy. However, in other countries, such programs have been slow to be heavily utilized because local governments do not allocate their portion of the funding and many apartment owners refuse to pay their one-third share of the costs.

In principle, though, such programs can work, and it is likely that this one will also be successful as the burden of fully de-regulated energy prices rises and alternative financing arrangements for the owner contribution are worked out.

II. 4 Current Rental Programs (See Annex D)

Young People's Rentals. The single largest housing subsidy currently (almost 15,000 units over the last 5 years) is the program of building rental buildings for young people. The idea of facilitating access to rental housing for young people responds to a public perception that many such households find it hard to find rentals or financially difficult to afford decent rental accommodations.[9] Thus this program is good for electoral popularity and could be good for the housing situation at a reasonable cost.

But, in our judgment, the actual operation of the program is poor. The rents are set at levels well below what these households can reasonably afford to pay, and by doing so, local governments are not collecting the funds they will need for the long-term maintenance and renovation of these buildings. Equally disappointing, the very low rents

[9] It appears that, in Bucharest, rents for flats are in the range of EUR 200-500 per month. This is very high relative to average reported net wages, and even many two earner households would have difficulty affording these. But such rents are appropriate given the cost of flats, a cost which seems commensurate with market values for land and construction. It is possible to argue that the state should help at least some people deal with such costs. The point here is that these programs should be designed to do so in a optimal manner.

will discourage the households from leaving these flats. This sharply reduces the potential for such flats to ease the situation for many more young families starting off and even discourages the beneficiaries from seeking their best job opportunities if in another city.

Social and Necessity Housing. All advanced countries have used subsidies to rental housing at various times to address low incomes. This is in spite of the observation of many economists and social policy observers that it would be better generally to provide programs of training, health care and resolution of various social problems help households support themselves, and meanwhile offer general cash assistance. Instead, the general view is that the housing portion of the overall household situation should be augmented to a certain minimum because it is a highly visible measure of poverty and because better housing environments can improve the chances of children in rising above their parents economic situation.

Thus, at a smaller scale (3,500 units over five years) than the young people’s rentals, local governments and the MTCT have been adding units intended for lower-income people and those temporarily dislocated for some reason. The rules are similar as for the young people's rentals, but in this case it is more appropriate for rents to be low and stay low. However, the program is currently being run at such low rents that the beneficiaries are being unnecessarily subsidized and the local governments are not being funded to properly take care of the buildings.

II. 5 Other Possible Assistance to Renters (See Annex D)

Large Scale Social Housing. The need for rental housing production based on Western European social housing production models has not been established. Such programs do not have any magic formula for lowering the real cost of delivering rental housing and have struggled even in Western Europe to achieve their goals in recent years. They require an institutional framework that includes highly skilled real estate development and management professionals. The government presently does not have the capacity to effectively manage the limited social housing stock, and cannot be expected to oversee the development and implementation of a complex non-profit social housing scheme.

Buying Existing Apartments. The method used by the current program to deliver a rental subsidy is relatively inefficient. New housing is built on valuable land that could instead be sold by the local government and the proceeds be used for the purchase of existing flats in panel flat buildings at a much lower cost than the true cost of using the land for new housing plus construction costs. Building up a stock of social housing for young people in this manner would be much more efficient and avoid creating colonies of poorly maintained buildings in the future.[10]

[10] On the other hand, we recognize that using older flats is not so much good electoral image, because renting out such flats is not highly visible, and there may also be much controversy over the sale of the local council land instead to the private market.

Housing Allowance. Conceptually, the most efficient approach to subsidizing rental housing for young people or poor people is to pay some form of assistance towards the rent that they pay for a private rental unit that they choose. There are many advantages to such a program. The beneficiaries have the ability to find the combination of location and unit features that best suit their needs. Private landlords operate in an efficient way and are not subject to politicized considerations in managing the properties.

However, this approach heavily relies on accurate information about incomes, as well as on the presence of private landlords willing to work with the sorts of people who tend to live in low-income rentals. This system can work well in more developed housing markets, but is unlikely to do so in Romania.

III. HOUSING POLICY IN CENTRAL AND EASTERN EUROPE

Under state ownership and central planning, most countries of Central Europe followed housing sector development policies very similar to those of Romania. As of 1990, this had left them also with a legacy of state-owned multi-level buildings of inferior quality, usually heated as part of centralized heating companies organized on a district basis. There were variations around this model. As of the 1980s, Hungary had embarked on a program of the building flats of a better quality for sale to the public, with below-market financing available through the state savings bank. Poland had created a middle ground between private ownership and state rental with an extensive program of cooperatives that was also partly resident financed. These patterns applied only to urban areas. The rural population largely continued traditions of self-building of houses on their own land.

All of these countries were under pressure to privatize much of the state-owned stock soon after the shift to a private economy. The first step was usually for the central government to give the state-owned stock to municipalities. All countries followed this up by issuing directives as to the rights to privatization to sitting tenants, but sometimes these were limited (especially in the Czech Republic) with a significant amount of local autonomy in setting prices and retaining properties for rental.

Although Hungary, like Romania, experienced a super-homeownership rate due to almost total privatization, Poland and the Czech Republic have chosen to retain a large portion of the stock in a subsidized rental state (about 30% in the case of CZ, thus leading to a large political issue with respect to raising rents on these units). Slovakia pursued a middle course, leaving it with 8% of the stock still in rental in 2001. Both Poland and the Czech Republic have experienced complications in the management of the rental stock due to restrictions on the rentals to sitting tenants in the case of restituted units.

The political situation with respect to housing has evolved in very different manners across these states. In Poland, an early pressing issue was supporting the large construction enterprises. This led to programs of construction of further multi-level buildings (mostly as cooperatives) and also to tax subsidy of new construction by private individuals. In the Czech Republic, debate focused on privatization policy and raising rent levels on public rentals. Programs were adopted early on to support home purchase by first-time buyers, and the Bauspar system was quickly (1993) installed (against the wishes of the government) with promises of boosting construction. Slovakia also adopted a Bauspar system early on (1992), with the crucial difference that the state premium was under the control of the state budget. Particular concern was stated for young households as well as large construction companies, and a result was a program of construction of flats and other subsidies for young households.

In Hungary and Poland, there was a very large fiscal overhang from the issuance of fixed-rate mortgage loans by the state savings bank under earlier “for-sale” programs. This burden caused both countries to be restrained in offering large new subsidy schemes. However, as the burden declined in the 1990s, the attraction of expanding other forms of housing sector schemes grew.

By 1994, Hungary had substantially reduced most of its deep interest subsidy schemes (which were generally only partially compensating for high inflation). This seemed to have created a political vacuum, as it appeared that the government no longer was concerned about the sector. To compensate, within 6 months, the government announced a large expansion of an existing scheme of grants for construction of new housing. This expansion was poorly designed and subject to abuse. Within another 6 months, limits were placed on it, but in such a way that a very large number of units remained entitled to the more liberal rules for several years afterwards.

It is not easy to generalize about specifics of housing policy across these countries as the transition progressed. However, there have been some interesting tendencies. One is the difficulty of democratically elected governments to establish rents for publicly owned units that will cover even regular maintenance, not to mention long-term renovations. Another is a pattern of truly deep subsidies to encourage housing finance even when (or especially when) economic conditions dictated against such long-term financing. A third pattern has been the creation of supposedly self-supporting schemes that are clearly (from an objective analysis view) not going to be self-supporting, because the subsidies are too deep or costs are not recovered. This leads to bursts of production of new housing or offering of a new subsidy, only to be followed after several years by a retrenchment.

These tendencies are not surprising given the past history of housing expenses being a small part of household expenses. Perhaps because of this, more moderate subsidies of the sort that other more electorally mature countries might adopt (e.g., a 1-2% reduction in interest rates) are not common. Instead, subsidy schemes have been deep and not very restricted, which tend to mean that they are expensive and may have little social value other than enriching the beneficiaries, with most benefits going to the middle- and upper-middle segments of society.

Overall, the housing subsidy budgets of these governments have been fairly large. In Hungary, in 2003, the total housing subsidies have been estimated to be about EUR 1 billion.[11] Part of this was the implicit subsidy calculated for the small amount of remaining local government rentals and miscellaneous aspects. But over 80% was for direct subsidization, including tax subsidies.

In the Czech Republic, total expenditures were about EUR 800 million, with more than half of this going for premiums to the Bausparkasse system. Other than a small amount in the form of tax subsidies, all of this was on-budget and totaled about 3% of the state budget. However, the largest single subsidy in the country, the low rents on the government-owned rental housing, is not included (this is appropriate for comparative purposes because the other countries essentially provided a similar subsidy by giving the stock away earlier).

In Poland, the total has been estimated at EUR 2 billion for 2003, mostly in the form of tax subsidies (these do not show up explicitly on the budget).[12] The tax subsidies were both for the cost of construction directly and for interest on mortgage loans. In addition, significant funds were provided at low interest rates for construction of "social housing," similar to the young-peoples rental housing in Romania (however, with much higher and more sensible rents).

Policies in Slovakia followed the Czech Republic initially, with the premiums on the Bausparkasse system ballooning to 1.4% of the state budget by 1998. But contributions to the State Housing Development Fund (an entity similar to the NHA) began rising to become almost as large as the Bauspar premiums. Total subsidy expenditures were about EUR 300 million in 2003, or 3.1 % of the state budget.

It is a difficult question as to whether these expenditures have accomplished much more than giving some (quite a few in some cases) lucky citizens access to a home for much below cost (and generally much less that what they could actually pay). They often seemed designed primarily to make middle-class citizens feel cared for by their politicians (using their tax money). This was perhaps a response to the previous situation of the state essentially providing for housing. The result was large financial transfers to the main buyers of housing, i.e., the relatively well-off, but with relatively little improvement in housing stock or any usual social goals. In other words, the goals seem to have been to gain electoral popularity.

For example, the main subsidies in Hungary were to mortgage borrowing. The largest subsidies were initially reserved for first time buyers who were building new homes, but that was soon expanded to all loans for new homes. In addition, two large subsidies went to all loans in general.[13] This simply pushed many citizens to take out loans in order to tap into the subsidies (one could put the funds into a bank to earn for more than their cost), with the state picking up the huge cost of intermediating these funds. This

[11] All estimates of total budgets are from Christian Donner, *Housing Policies in Central Eastern Europe* (2006).
[12] Donner, p. 162
[13] This additional subsidy was supposedly associated with the use of mortgage bonds for funding, but it flowed over to the rates requested by lenders on the loans so financed.

transformed Hungary from a country where at most 10-20% used credit for housing purposes into society massively drawing down credits that were almost free or better than free. This was very profitable for OTP, but has burdened the budget far into the future. Surprisingly, it did not significantly raise housing prices, probably because prices had already risen enough in the late 1990s to induce new construction (see above).[14] After a delay of 2 years, housing production rose significantly, only to lead to an over-supply after the new government cut back the subsidies.

The role of appealing to middle-class voters was played by the Bausparkassen in the Czech Republic. This program quickly grew into such a source of extraordinary profit for those with significant money that it proved politically impossible to turn down the flow of subsidies even as all experts recognized that it made no sense other than welfare payments to the middle-class.

This critique of housing policies in Central Europe is based on the experience of the authors in these countries. However, we are not alone in these views. Two recent studies by European observers, one Austrian and one German, have reached similar conclusions.[15]

There are some useful lessons to be observed about housing policies in Central Europe . In addition, there are lessons to be noted from the longer history of housing policy formulation in Western Europe and the US.

Housing policies in the latter countries were shaped partly by the period of economic prosperity in the 1960s and 70s and the needs for greater fiscal constraints since the 1980s. In the earlier period, subsidies were deepened, new construction of low rent housing expanded (even in the US), and financial truths such as the ultimate need to renovate social housing were ignored. Often the private rental sector was suppressed in favor of social rentals.

Since the 1980s, the reverse has held more generally, with reductions in subsidies, including subsidies to middle-class housing, and an expansion of more rational methods of supporting housing for low-income people, such as housing allowances to pay a portion of the rents in private rentals. Social rentals were reformed in the direction of varying the rent according to income and less production of new buildings. Subsidy schemes tended to become more targeted and less likely to be entitlements (i.e., not all those eligible for a subsidy could receive it when they wished). Hidden subsidies, such as tax deductions, and long-term subsidies, such as interest rate subsidies, were cut back to regain control of the budget.

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[14] The program and its effects were reviewed in "An Evaluation of the Hungarian Mortgage Program" by József Hegedüs and Eszter Somogyi, included in József Hegedüs and Raymond J. Struyk, *Housing Finance: New and Old Models in Central Europe, Russia, and Kazakhstan.*

[15] See Donner (op cit.) and Hans-Joachim Duebel, Housing Policy in Central European Countries in Transition, Center for Legal Competence, Vienna, December 2003.

It is from this perspective that policy analysts such as the authors came to Central and Eastern Europe after 1989. This sort of perspective was offered to Central European countries as part of technical assistance, but political considerations generally overrode it. This is probably appropriate for young democracies, especially in the early years of their recovery from deep economic recession. However, even in Central Europe, there is a notable pattern of subsidy reduction and rationalization since a peak in 2003 in most of these countries.

This situation of a history of low quality housing policies in Central Europe is particularly disappointing for Romania, because Romania shares so many of the basic policy issues with those countries and would have benefited from more positive experiences. However, useful negative lessons from Central Europe include:

1. Raising rents on government-owned rental housing is very difficult, so it is essential that rent-setting systems be designed initially in a way that finances full maintenance and eventual renovations and includes an automatic escalation with costs or incomes.
2. Interest rate subsidies should be avoided in general, as they create long-term commitments of budget resources. If low-rate loans are offered:
    a. the subsidy should phase out over time
    b. the subsidized rate should float at some gap below a market rate
    c. there should be a floor in case market rates come down and the subsidy is not needed anymore
    d. they should be targeted, either by explicit eligibility or by a system used to allocate a limited number of such subsidies in a given year.
3. Tax subsidies should be avoided, as being an entitlement, usually difficult to target, and the recipients do not usually fully appreciate their cost.
4. Bausparkasse systems are an inefficient and generally ineffective way of delivering subsidies.
5. The emphasis on deep subsidies for housing reinforces the feeling that the state still bears a significant part of the burden of housing the citizens. It is useful to avoid that impression by avoiding very deep subsidies and targeting what subsidies are offered to those who are recognized generally as deserving special help.

These same points have been noted above and seem to eliminate most options from considerations. But they are not absolute rules, just warnings to be kept in mind as a housing policy is worked out. They emphasize weaknesses of several approaches, but ignore the practical reality that electoral politics will require a certain degree of state intervention and support, and that the task in developing a housing policy is not one of scrutinizing whether every intervention is ideal or even worthwhile, but rather that they are relatively reasonable and relatively effective. There are better and worse approaches and better and worse ways of executing any specific program or policy.

IV. SUGGESTED HOUSING POLICIES FOR ROMANIA

IV. 1. Creating a Strategy

Keeping in mind all of this negative experience and warnings about pitfalls, how might Romania go about creating a housing policy? A five-step guide to doing this is suggested in Diamond (2006).[16]

1. Determine the Housing Issues or Goals to be Addressed.

If the criterion of success is the efficiency (benefit relative to cost) and effectiveness (total benefits relative to desired benefits) of a subsidy scheme, there is no choice but to start with asking about the purpose or goal of the scheme. "What exactly is wrong with the housing situation, and why? Is this a reason to use public monies? What might be done to solve that problem relatively efficiently?" Answering that the goal is to get people in general into better houses is not good enough for such an analysis. Why do they need better houses instead of other things that might be done with their taxes, i.e., their own money. Who exactly needs the better housing? Does everyone or just a small group?

Overall, the low level of subventions to housing is good for the undistorted development of these private markets, and reflects a prudent conservation of state resources for the many other expensive development needs of the country. However, in a democracy, there are also needs to respond to pressing social problems as perceived by the electorate. Thus, the criteria for setting these goals should include not only objective measures of social problems but also the public perception of them.

2. Regulatory or Policy Reform Instead of Subsidy?

Once the reasons for the constraints in the housing system are understood, the analysis should address the question of whether the constraints can be corrected through regulatory or policy reform (e.g., excessive costs of registering or enforcing a lien, or other market or legal imperfections causing excessive spreads on loans), or maybe only solved at the macro-economic level (e.g., high inflation causing high interest rates). To the extent that they can not (e.g., it is politically unpopular to strengthen foreclosure or reduce inflation), second-best but still relatively efficient subsidies can be designed.

This does not seem to be an urgent issue in Romania, except perhaps with respect to the option of young people being able to utilize mortgage default insurance to permit them to borrow more than 75% of the cost of a home.

[16] Douglas B. Diamond, "Thinking about Subsidies to Housing Finance," in József Hegedüs and Raymond J. Struyk, *Housing Finance: New and Old Models in Central Europe, Russia, and Kazakhstan,* Open Society Publications, 2006.

3. Which Subsidy?

After establishing the need for a subsidy for specific segments of the market and what the goals are, one can move to outlining relevant sub-sets of subsidy options and selection of the best implementation agents based on agreed-upon design principles. As noted above, although the choice is large, many of the approaches have significant drawbacks. Also, although much can be learned from the experience in other countries, there are almost always special circumstances within each country calling for customization of any solution to that specific environment.

4. Costing and Budgeting.

Once the goal is identified, and subsidy measures that actually address that goal are being contemplated, it is critical that the costing out and design of the subsidies be done properly, taking into account both the current and future costs, both direct and indirect, and comparing these to individual and social benefits, equity considerations and alternative ways to make the subsidy transparent.

Costing of the subsidy is particularly important. If the total real future costs are not calculated, the political system will prefer programs where most of the costs are in the future while the benefit is today. The result will be a subsidy scheme that is either unsustainable or, at least, much more expensive than expected. This is one reason why lump-sum up-front subsidies are widely favored by policy analysts and tax and interest rate subsidies are favored by politicians.

5. Implementation, Monitoring, Evaluation.

Even the best designed subsidy, properly budgeted for, can fail to be efficient and effective if it is not implemented properly. Finally, and unfortunately very rarely, existing subsidies should be quantitatively monitored and evaluated over time for effectiveness and efficiency and needed refinements.

There is evidence that this last step is the key to moving gradually to a rationalized subsidy policy, since even rudimentary analysis can make it (embarrassingly) clear that some schemes have little net effect relative to their cost or are badly targeted, while others are effective and should be expanded. It will be recommended below that Romania spend a small but significant part of its housing support funds of creating just such a capability to do things such as examine exactly who is living in the young peoples rental housing and exactly what is happening in the Bauspar system.

Meanwhile, we will use the evaluations of current programs and experiences in Central Europe to help guide the choice and design of schemes suggested here.

IV. 2. Identifying Goals

If a policy is to have a hope of being logical and consistent, it must start with clarification of what the goals of the policy are. Not only can such goals guide the creation of a policy, but they can also provide a basis for evaluating the ex post effectiveness of the programs designed to implement that policy.

So, what should be listed as goals of housing polices for Romania?

Housing Construction. One goal that has been common throughout Central and Eastern European countries is promotion of new construction. This view partly reflects the perception throughout Communist times that housing was in short supply. However, as all of these countries have discovered, when faced with the real cost of providing much more housing, especially of a worthwhile quality, and also influenced by low birth rates and high emigration, societies no longer perceive that same shortage. None of the transition countries have found it necessary to go back to the levels of production of new units experienced in the 1970s and 1980s. Much lower levels of new production (and much higher levels of size and quality) seem to be accommodating the desires and demographics of the citizenry.

Promoting housing construction may have been worthwhile goal during the 1990s recession because of the employment aspect, but today construction labor seems to be in short supply currently in Romania and the economy is growing at a pace that probably cannot be accelerated. Moreover, new construction is already accelerating because of continuing economic growth and the rise in the prices of older housing. Thus, it should be recognized that new construction is not as pressing an issue as it once was from a demographic, macro-economic, or even housing sector perspective.

But there is another possible perspective. As noted in Annex B, a key determinant of the welfare of ordinary Romanians is how costly housing is, either to own or rent. As demand for housing has been rising with rising incomes and falling interest rates, the cost of it has risen to levels where it is profitable to build or invest in more of it. At this point, the further rise in prices and rents will be reduced by incremental supplies of new housing. This supply is facilitated mostly by access to serviced land, but can also be augmented by subsidies. (But the subsidies will help only if the supply of serviced land is reasonably large enough to accommodate more construction.) It may also promote expansion of the private rental stock, because many of the units vacated due to additional construction become rentals.

Homeownership Opportunities for Young Families. A second concern enunciated throughout the region is that of the ability of young families to become owners. There are several sources for this concern. The most obvious is that there is an inter-generational gap in experience, as the parental generation received their initial housing at very little cost.[17] The younger generation has to face market-determined costs (as do most young people in Western Europe and the US). A second concern is that the high cost of housing is contributing to the sharp decline in child-bearing (although this is mostly due to other factors). A third concern, heard in Romania but not in Central Europe until recently, is that high housing costs contribute to the emigration of talented young people. (This is debatable given that housing costs relative to incomes are as high or higher in other parts of Europe than in Romania.)

Rental Opportunities for Young Families. A third goal that has been enunciated in Romania and Central Europe has been the expansion of access to rental housing for young families. The main social benefit of this is often stated to be for economic mobility, as part of the restructuring of the economies. However, in nearly all cases, actual policy has shifted away from mobility and towards welfare, i.e., reducing the cost burden on families. The problem is that these goals are incompatible to some degree.[18] The deeper is the subsidy provided through the social rents, the more costly it is for a family to move out of it.

Rental Opportunities for Poorer People. A fourth concern is that there are few supports for many households with limited earning capacity who cannot afford what is considered to be a unit of minimal quality. In Western Europe and the US, these form the target group for social housing schemes (although the level of maximum levels of income to get a subsidy and the minimum level of housing are different between Europe and the US). This concern about the housing opportunities of the relatively poor is widespread, but so is the recognition that Central and Eastern European countries are not rich enough to address it comprehensively. In addition, such programs are inherently means-tested, and much information on income is not accurate in some of these countries, including Romania.

Long-term Maintenance of Panel Apartments. A fifth concern, related to that of low incomes, is the inability of many recipients of privatized units to afford the long-term maintenance of the units. This includes the completion of thermal renovations that, in general, may save the resident more in heating costs over time than they cost. We were not able to confirm the size of these savings and it is not clear whether all such owners should benefit from a deep subsidy.

The Bauspar system is seen as a source of subsidy to renovations to housing in general. As noted above, it is a relatively weak and costly tool for such a goal.

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[17] A second interpretation of the political support for homeownership programs is that owning a home is an emblem of reaching middle-class status and a part of the national culture in general. Because of this, it is important to support this aspiration, while not supporting such things as buying a car. Thus, as a matter of democratic politics, Romania needs a program for supporting this aspiration of the middle class. As discussed below, there are a wide varieties of approaches to doing this. Most such approaches used in Central Europe and also Western Europe and the US can not be recommended.

[18] It is not a coincidence that some of the countries with the largest programs of social housing, such as Holland, have the least concern about mobility (because of its small size). The privatization of much of the social rental stock in Britain in the 1980s encouraged needed mobility among the unemployed and underemployed.

Development of the Housing and Housing Finance Markets. There is at least one more goal, one that is not always emphasized publicly but is the most important of all. This is the development of strong market-based housing and housing finance markets. Most governments and electorates understand that public resources will no longer carry much of the burden of paying for housing. This burden has now fallen to the private sector and if it is not dealt with well there, the society will suffer. This means that modern and efficient methods of organizing and financing the construction and marketing of new homes, and the pricing, trading, and financing of the existing stock of homes.[19]

IV. 3. Choice of Subsidies and Budgeting

How might Romania best proceed to seek these goals, in light of all of the experience noted above and local experience and political perspectives?

IV. 3. 1. Housing Construction

As noted above, there is little demographic and macroeconomic urgency to simply forcing the construction of additional housing units. In fact, unless done carefully, an increase in government-sponsored new construction will tend to be offset by a reduction in new construction by the private sector. This substitution effect will arise when the sponsored activity siphons off some of the demand for private units that would have existed otherwise or raises the cost of land or construction. However, as noted below, there may be reasons within a specific program to favor new construction.

IV. 3. 2. First-time Owners

Even with the overall homeownership rate being close to 90%, there are good reasons to support the aspiration of young people to become owners. Their parents have generally received a housing unit almost free from the state, but they are facing the full cost of a home, albeit with the option today of financing the purchase over 20 years or more. As a result, the ownership rate will gradually decline over time, back towards a rate reflective of more normal tradeoff between renting and owning. But most societies support ownership for social and political reasons.

But it may be useful to ask more questions about this goal. Do all young people need state assistance to become owners? Is there a way of distinguishing who does? Will the ownership rate fall drastically if they do not get that assistance? How much can the country afford to pay to help them?

[19] It also encompasses all other aspects of the real estate market, such as the development of shopping malls and industrial parks, airports and toll highways, office buildings and hotels and so on.

Who Needs Helps? It seems to these observers that a great many young people do not need such assistance. The main reason that this is true is that their families have a large amount of wealth already in the form of homes, including homes held by grandparents and parents. In principle, the younger generations can use that wealth to acquire their own home at the time of the passing away of one of the earlier generations. In fact, there already is a tradition throughout Central Europe of parents using the grandparents home or the proceeds from the sale of that home to provide a home for their children.

Unfortunately, this simple proposition fails in many cases. If the parents and grandparents live in a rural village where homes are not worth very much, there will not be much support for the purchase of a home in a major city. Similarly, some families have more children than others, and are less well positioned to support the housing of all of them.

Thus children from large families or rural communities are disadvantaged relative to children from small urban families. But even some urban families parents and grandparents do not have valuable homes, either because they are living in homes that are subject to restitution or because the units they do own are very poor quality or poorly located.

It is a separate question as to how critical it is that young people be given an encouragement to become owners. Most will seek to be owners in any case, and will be helped to do so greatly by being able to get long-term credits at low market rates. The main effect of state assistance will be to move to an earlier age the time that they make that shift. This early shift may encourage earlier marriages and a higher birth rate, both of which may have social value. But it should be recognized that the overall ownership rate will remain high even if large amounts of assistance is not forthcoming.

What Sort of Subsidy? What might be the best tools for delivering assistance for this purpose? The discussion in Section II indicated that the best tools are either cash grants or limited-time reductions in interest rates. The cash grants could take the form of discounts or rebates of VAT taxes, but the more effective approach for targeting according to need and limiting the budget impact would be through a discount offered to those selected in some kind of allocation process.

The discount could take the form of a percent (say, 15%) of the value of the housing unit, up to a maximum (say, EUR 10,000) that would be payable at the time of the purchase of the unit. Alternatively, it could be payable in the form of a reduction in interest rate that decreases over time, e.g. 4% for 2 years, then 3%, 2%, and 0% after 5 years. The beneficiaries could have the choice, or only one option could be included (see below).

What Sort of Allocation Process? How might the allocation process be organized? In particular, is it possible in the allocation process to identify those who are more likely to actually need the assistance to become an owner? In theory, it would be useful to know all about the financial and housing situation of the young people and their parents and grandparents. Although this is not feasible in general, there may some indirect ways of screening out those who are less in need of the help.

One basic step is to employ the sorts of point allocation systems already used by the NHA in their previous programs. But the system needs to be thoughtfully constructed. For example, if 10,000 subsidies were to be given each year, we know that that number is less than 10% of all young households in each age band. This is important, because it indicates that most young people will not want to depend on the subsidy to buy their first home. This automatically means that those who wait for their turn to get the subsidy are more likely to need it.

However, it not advisable to use a simple waiting list. This will distort the housing decisions of many people by giving them a very specific incentive to wait before buying a home and also rewards those who apply early, despite not necessarily being more deserving. It will also mean that the list grows endlessly, as each year, fewer subsidies are given than there are new applicants. Of course, many of the old applicants may have bought a house and thus no longer be eligible, but that cannot be easily determined.

A better approach might be the following:

Each year, all those interested make an application. If they have applied previously, they only need to update their previous information every 12 months.

New applicants would have to indicate:

1) age (10 points if 25-29 or over 34, 20 points if 30-34 **plus one point for each year over 30)**
2) Married (10 points) or single (0 points); a married couple gets assigned the points for whichever of them has the largest number of points with respect to age
3) Number of children living with them (5 points per child)

All applicants can not have owned a home previously or own a home at time of application, and can not be living in a home owned by their parents (unless cohabitating) at time of allocation of the subsidy. Proof of current residency situation is required.

At the start of each quarter, 25% of the annual allocation of these subsidies would be allocated via a public lottery selection among those with the highest number of points. These recipients would have 1 year during which they can contract for an eligible home. The home will be limited in size (e.g., 80 square meters) and value (e.g., EUR 80,000).

Such a scheme has the potential for naturally excluding most of those who do not need assistance to become owners. First, it is unlikely that one will get a subsidy before age 30. Those who have other options will tend to exercise them instead of waiting for a chance to get a subsidy. Moreover, the chance of getting a subsidy goes up with age, both because there are more points with age (although a preference for those 30-34) and because it is more likely that applicants will be married and have children. The system is designed such that married couples in their early 30s with one or more children are very likely to get a subsidy.

New Homes Only? The key question is whether the choice of home is limited to only new homes or any home (with appropriate restrictions against homes owned by relatives or other non-arms-length transactions). This is where a political decision has to be made about linking such a program with new construction.

One big advantage to doing so is that it sharply limits the number of people applying, thus increasing the chances of the applicants of winning (or decreasing the amount to be budgeted for the program). Most first time buyers are not going to be able to afford a new home, unless they (or their family) are relatively wealthy or perhaps living in a rural community where building a new home is relatively easy.

In either case, it is likely that most such households who can afford a new home, either before or after a subsidy, are already well-enough off to afford an existing home. In other words, such a subsidy will not be the difference between their becoming a homeowner or not. At best, it can be the difference between their buying a new home or an older one. Thus, restricting the subsidy to new construction implies a very weak effect on what has been stated to be the goal, getting more young families into ownership.[20]

If instead, the subsidy is applicable to existing home as well, and in addition, the subsidy is restricted by size and price of housing bought, it is likely to go to people who would not have bought a home without the subsidy. So you get a bigger effect on homeownership (recall that this is the goal) by focusing the subsidy on such first-time buyers.

On the other hand, if the political support (say, from builders) for the scheme is needed and so the housing must be new, it may be possible to get some better impact on homeownership by restricting eligibility to fairly small (under 70 square meters) and low-value units (under EUR 1000 per square meter) units. These are unattractive to most higher-income households, i.e., those who would have had no trouble becoming owners.

Other Aspects. A key aspect of this proposal is that the number of subsidies to be allocated is limited. Several Central European countries have gotten into budget trouble when such programs have been offered on an open-ended basis. Thus, in the political discussions around this program, it should be made clear that this is intended to help those who need it so much that they are willing to wait a while. Also, it is important to limit the overall number of winners to avoid boosting the prices of homes.

On the other hand, a scheme that was limited to first-time owners buying new homes would probably be so small that there would not be a need for an allocation process. It is very likely that most buyers of new homes already own a home, so that an allocation of, say, 5,000 subsidies of EUR 12,000 on average (a total of EUR 60 million) would

[20] However, it must be recognized that very many subsidies are provided that are actually more politically appealing than effective in reaching the publicly stated goals.

probably be enough to cover all those who are eligible (especially given limitations as to size, price, age of applicant and constructed by a registered contractor).[21]

Another key aspect is that the allocation scheme should be done at the central level, so that (1) it not get involved in local politics and (2) beneficiaries not be constrained as to where to move to buy their home. It would seem that the NHA could organize to receive applications (by mail or internet) and confirm conformity with the rules for those who are allocated a subsidy.

It was noted above that the subsidy could take the form of a cash rebate or as a limited time reduction in the interest rate on a mortgage loan. One aspect of choosing between these approaches is that loans will be of interest only to those who actually do not already have enough cash to buy a home. The reduction in the interest rate would be large enough to enhance their ability to borrow, but must not so large as to make borrowing cheaper than bank deposits.

Designing the subsidy to be a reduction in the interest rate can be viewed as another way in which the subsidy is focused on those who actually need it to become owners. But there is a big drawback. This approach would exclude from the scheme those who, for no fault of their own, can not access a mortgage loan. This would include those with irregular or totally unreported income, and also many in the rural areas where there is no reporting of incomes and perhaps lenders are not interested in making loans (e.g., it is not usually possible to sell a home in a small village in a foreclosure sale).

Another negative to a subsidy of the interest rate is that it will be very tempting for a government to ignore the commitments being made against the budget over the next 5 years or so. This is probably not too serious if the subsidy becomes smaller after only 1 or two years, but large commitments for 3-4 years out should be reflected in the budget in some manner, or possibly paid out to the lender in advance so that it is shown in the current budget accounts.

IV. 3. 3. Rental Opportunities for Young People

In discussing this goal above, a distinction was made between providing rental housing at a low cost because young people cannot afford the market rents and using rental housing as a mode of living that entails low levels of costs of entry and exit, i.e., that facilitates mobility. It was noted that these goals were incompatible to a large degree. If the subsidized rents are too low, and cannot be easily obtained at another location, then mobility becomes as costly, or more costly, than homeownership.

[21] A major caveat here is that many wealthy families could abuse the program by paying for the construction of an eligible house for a child in order to get the subsidy, even though the child could not afford this. In some cases, the parents could even turn the units into a rental or sell it soon afterwards.

Why Not The Private Market? At a practical level, there is no more efficient way of providing mobility than private landlords offering older, smaller units for rent in an unfettered market based on contracts that permit either landlord or tenant to end the contract in no more than 1 year, or even with only a few months notice. Such a market is the great bulk of the rental market in the US, and is essential in a country where moves of 50-5000 kilometers are frequent.

Such a free market is rare in Europe, where a history of landlord-tenant tensions (most urban dwellers were tenants before the first world war and many enjoyed frozen rents between wars) and sharp swings in rents under crisis circumstances have often left landlords with severely restricted options and often left tenants in a position of quasi-ownership of their unit. This situation obviously reduced mobility, but mobility is not considered to be crucial in most of Europe. It also reduced the interest of the private sector to provide rental housing, a void that many countries have filled with various types of "social rental housing."

In Romania and in some Central European countries, there is much discussion about how there is not enough "rental" housing to permit ease of mobility around the country. This is debatable as a statement, because some of these countries, including Romania, have relatively healthy private rental markets. More could be done for those markets (see below), but the evidence that we have heard is that rental units are available in Bucharest for rent at costs (EUR 200-500) that seem commensurate with the underlying economic factors (i.e., the value of selling the unit, the cost of long-term renovation and maintenance, etc.).[22]

Thus it is not clear that the real problem is mobility or that the general concern over the real costs of housing relative to incomes. We suspect that part of the concern over mobility is the issue of adult children living with parents beyond the time that either party (parents or children) wish to. This is mostly a cost issue and not availability of a rental unit.

If the issue were simply cost, then there would seem to be no difference between rental opportunities for young people and those for poorer people. But there may still be an important distinction to be made in formulating programs. That distinction is that there seems to be a desire for a program for young people who are at an early stage in their career and that is mostly why they are relatively poor, in contrast to those who have such low skills or other barriers to ever having higher incomes.

If we are correct that the social policy concern here is both mobility and "starter" housing for middle-class families, the correct policy choice seems to be the same, namely that the

[22] The World Bank has recently published a broad study of rental housing in Central and Eastern Europe. One of its conclusions is that "Countries should consider basing their rental housing policies on the principle of relying mainly on the efficient private formalized rental sector, supplemented by well-targeted social rental housing programs." See "Rental Choice and Housing Policy Realignment in Transition: Post-privatization Challenges in the ECA Region," by Hans-Joachim Dübel, W. Jan Brzeski, and Ellen Hamilton, December 2005.

subsidy must decrease over time. Moreover, as we argue below with respect to social housing for poorer people, it is critical that rents be set as high as possible to ensure that the units can be maintained. In other words, the subsidy should not be very deep to begin with and then must be subject either to an automatic or some other kind of phasing out.

Setting the Rents. The current program of building new rental housing is, in principle, an expensive way of solving any such problems, relative to buying units on the private market or subsidizing rents in such units without buying them (see below about Housing Allowances). But if the political situation is such that local governments prefer to use their valuable land for such projects (instead of selling it at open auction), then the current NHA scheme may be a reasonable approach.

However, we recommend that the government should change the Housing Law for the young-persons program to require that at least the cost of construction (or, almost equivalently, the annual depreciation) and maintenance be recovered through the rents, and that these base rents be changed each year with inflation in construction and operational costs. This would mean that the flats will not become burdens on the local council, both now and when renovations are due, or that additional units could be built. It will still leave the rent about 30-50% lower than for similar private flats (because there is nothing included for land, infrastructure, interest and profit), but not so low that young people will not want to move for other job opportunities or for a better housing.

In addition, to ensure fairness in the use of these flats, the rent should be set at 25% of net income when this is higher than the base amount and rents should rise to full market level after occupancy by the beneficiary for five years. This will make it more likely that the apartments become available for someone else as the family income rises over time.

If these steps are not taken, it should be recognized that the scheme as currently operated is probably unsustainable, and certainly not responding to any defensible public policy goals. It is operating on the basis of giving away new flats for more than free (because charges are less than maintenance) to the lucky few who obtain them, but also trapping these households in a situation where they can not sell this windfall. (Alternatively, some may illegally sub-lease their units and move on, but this then still wastes the social usefulness of the units.)

On the other hand, with such features as rising rents, the current program of large scale construction of rental for young people can make good sense. It will operate as transition housing and maintain a reasonably high level of turnover, enough to add a subsidized portion to the mobility market otherwise restricted to market-rate units. Moreover, the higher rents will support the better maintenance of the units today and their renovation in the future.

Admittedly, this is a new idea, one that no Central European country has had the courage to try, but the long-term rewards from such a sensible housing policy will be significant.[23] The difficult part is to show that there are real benefits from pushing the first tenants out over time. These benefits are for all of the future parents and children (and employers), and reflect the unavoidable conclusion that, as currently designed, the program of construction is not only very unfair but it can not be maintained endlessly and one day, relatively soon, it will end and future cohorts will not have a subsidized path out on their own.

Policy Reforms. In addition to such a program of subsidized rentals, Romania should look at ensuring that it is doing what it can to encourage private landlords to offer housing for rent. One place that it appears to be failing at that is with respect to taxation. Expenses are assumed to be 25% of gross income, whereas it is more likely that the true share is over 50%. It is not clear that this distinction matters, if in fact most rental income is not reported to the tax authorities. We are not knowledgeable about whether this is the situation.

In the longer-run, new construction of private rental buildings may become feasible over time, if rents are high enough and long-term financing is available from pension funds and other institutional investors. Some countries have looked to non-profit entities to provide some such rentals at below-market rents, but these systems are difficult to create and, in our initial opinion, Romania does not have the basis for doing so currently. Meanwhile, some more realistic tax treatment might help attract additional investment in rental housing.

IV. 3. 4. Rental Opportunities for Lower-income People

Nature of the Goal and Experience Elsewhere. As noted above, the use of subsidized rental housing to enhance mobility is completely different from its use to compensate for low incomes. All advanced countries have used subsidies to rental housing at various times to assist those with low incomes. This is in spite of the observation of many economists and social policy observers that it would be better generally to provide programs of training, health care and resolution of various social problems help households support themselves, and meanwhile offer general cash assistance. Instead, the general view is that the housing portion of the overall household situation should be augmented to a certain minimum because it is a highly visible measure of poverty and because better housing environments can improve the chances of children in rising above their parents economic situation.

There has been just about every conceivable approach taken at some time to how to improve the housing of poorer people, ranging from low-rent public housing to public-private partnerships, to simply supplementing the rent-paying capacity of poorer people. The general consensus in Western Europe, the US and much of Central Europe is to employ some form of the last format, usually called a "housing allowance," whereby the

[23] Some countries, including Poland and the Czech republic, have instituted concepts of "cost rent" that at least try to ensure that social rents cover likely out-of-pocket costs, including in Poland an amount for loan repayments.

rent burden is limited as a share of income and the rest is paid by the state. Such a formulation is ideally used to include living in private rentals (with some restrictions on rents and quality) as well as social rentals. Such a liberal approach permits the beneficiaries to move to better economic opportunities without losing their subsidy.

There have been several drawbacks to such an approach as used in Central Europe. First, it is expensive if it is made available generally. In other words, it is cheaper to build a 1000 units of subsidized housing each year (very expensive per unit, but a very limited number of units) while letting 50-80% of the needy people make do without any subsidy than it is to offer all the lower-income households a direct and mobile grant to find their own housing.

Second, if the actual net rent in social housing goes up as a tenant's income goes up, the social make-up of the residents will become more “lower-income” over time. This is one of the most potent arguments for not using the scheme just in purpose-built social housing. The concentration effect is much lower if the beneficiaries can use their subsidy to find housing anywhere in the private housing stock as well.

Third, if the size of the subsidy depends on reported income, there is a reward to those who are more successful in hiding their true income. In the richer countries, with more comprehensive tracking of income, this is less of a problem. But it appears that it would be a significant problem in Romania. It is for this reason that we do not recommend such an approach on a large scale in Romania at this point. (However, we do recommend that rents be linked to incomes in rental for young people, but with a minimum rent (to cover real costs) and a phased rise in rents over time independent of income.)

New Construction or Existing Units. As noted above, the private sector is the most efficient way of providing rental housing. Even if it is not possible currently to broadly subsidize the rents of poor people in the private sector units, it may still be cheaper for local governments to acquire units in private buildings and use those for social housing. The total costs of acquisition and maintenance will be less than the true cost of new construction, and thus it seems that subsidies from the central government ought to be useable for this sort of acquisition.

However, there may be some further considerations. In particular, if other social services are delivered to people in low-income social housing, then it may be more efficient to put such people together in a purpose built complex. There may be design aspects of such buildings that are also better suited for such people.

But it does suggest that expansion of this stock through new construction not be a priority until better options become available, such as purchase and use of units in existing buildings and better measures of household ability to pay.

Setting the Rent. Until such time as incomes are more verifiable and the private rental market is better developed, it may be necessary for the housing policy to remain one of local governments owning a stock of true social housing, rented at low rents. However, this scheme should not be viewed as a source of major income support to low-income people, especially since such a small proportion of those possibly eligible are served. Thus, the beneficiaries should be expected to pay a share of their income similar to that paid by better-off people, on the order of 25-35%, instead of the 10% provided for in the Housing Law.

IV. 3. 5. Maintenance and Renovation in Multi-Level Housing.

There is a pervasive problem throughout the former Communist countries with the ability of some former tenants to afford to maintain and renovate their buildings that they now own a flat in. It appears that no country has yet resolved this problem on a large scale, despite it being over 15 years of transition. To some extent, it is resolving itself for the individuals involved, with pensioners dying or selling out to those who can afford to buy and renovate. But there is a process going on that does not bode well for the future. Flats in the worst buildings flats are going for the lowest prices and thus to the poorest folks. There may be a presumption (not entirely surprising) that the state will bail them out eventually.

This is not a problem that can be solved by a relatively simple scheme. The government has proposed a scheme to deal with thermal-related renovation that relies on cash grants from central and local governments to cover two-thirds of the cost. The emphasis on cash grants rather than low-rate loans or guarantees is a good step. But there are many details to work out with respect to how buildings should go about gathering their contributions and if there is a potential scheme for buildings to take up loans at commercial rates to finance the contributions of those who refuse to or cannot pay.

Nor does this amount of renovation resolve longer term issues of rehabilitation in other respects. Basically, no one knows how the care of such the buildings will be financed in the long run. But in the short run, if a program of subsidies for thermal renovation involving financing for building-wide renovations can be implemented, it should provide a good guide to longer-run solutions.

IV. 3. 6. Development of the Housing and Housing Finance Markets

As noted above, housing and housing finance markets seem to be working relatively well in Romania. This is a major achievement in the transition to well functioning economy and society. There are two proposals being considered that might improve upon the status quo in this regard, both related to housing finance and both being studied as part of this Technical Assistance Grant.

One is that there be created some sort of entity offering a mortgage default indemnity or insurance scheme. From our perspective, and without judging how or if such a entity should be created, the appearance of such an insurance would provide the state with an additional potential tool for its housing strategy. Having an entity willing to, for a price, bear some of the risk associated with making larger loans than normal, specifically improves the access of young people to first-time ownership.

Moreover, the government could choose to grant, on a targeted or limited basis, cash grants usable towards payment of the insurance premium. Such grants would be taken up primarily by those who really do need extra assistance to achieve ownership, and not by those who can do without. This can become a very efficient and low cost means of supporting that for those who do not want to wait for the larger subsidy available through the lottery.

The second proposal is to possibly support a partial guarantee on certain mortgage securities. The benefits of this do not flow directly to any of the target groups discussed above, but specifically towards the last goal, the long-run development of the mortgage market to its fullest extent. Development of a mortgage security market can permit lenders to offer loans with fixed rates and other features that can benefit all housing borrowers. Such a proposal has to be considered carefully with respect to exposure of the state and the pricing of that risk, but the possible benefits merit that investigation.

A related policy initiative is that for the fuller development of institutional investors such as pension funds and insurance companies, all part of the PAL III agenda. These investors are the natural complement to the introduction of more sophisticated mortgage securities. The full evolution of these aspects of the housing finance market will take at least 5 years or more, but will further support the ability of the private market to maximize the housing options of Romanians without heavy burdens on the state budget.

IV. 4. Creating a Policy Development and Evaluation Capability

If any of the policy initiatives discussed above were to be pursued, an equally important step is that a plan be created to investigate the actual impacts of the policies over the next 3-5 years. This impact would not be the normal measures of program outputs or expenditures, but the real impact in the form of who were the beneficiaries, how did they act differently than they would have, how did their actions affect the larger housing market, and so on. Ultimately the study should show how, if at all, the policy affected the stated goal of the policy.

As is probably evident, creating good housing policy requires such good data (and knowledge as to what the data really mean), sharp analytical skills, and sympathy for political goals as well as social and economic ones. It also helps to have formed contacts in other countries facing similar circumstances, if only to learn from some of the mistakes made elsewhere. This blend is difficult if not impossible to find among senior government policymakers or officials involved in implementation of policies and programs.

Several countries, including the US, Britain, France, and Scandinavia countries have found it fruitful to develop a grouping of policy analysts to do such a job. In some cases, these analysts are located outside of the government, such as in research institutes or in university faculty. In other cases, the government has fostered a group within its own staff, often within the Ministry of Finance or the line Ministry in charge of housing. In all cases, the analysts are encouraged to take objective looks at proposed programs and to track and evaluate the effects of current programs. They are primarily economists and financial analysts, not architects, engineers, or lawyers, whose skills are more relevant to implementation.

The net result of such a capacity is that housing policy becomes more effective and efficient over time. It is not necessarily the case that the current government immediately accepts the evidence that some policies are more efficient and effective than others. In fact, there is place for electoral image in all public policies and that is not within the capacity of the analysts to assess. But such a capacity can identify which aspects of any given policy are likely to be most troublesome and perhaps costly. They can look back and identify when policies had real effects and when they did not. They can look forward to guessing how new policies might be best developed in their details, as it is so often the case that the "devil is in the details." They can also look for ways that housing markets themselves can be improved without subsidies.

In several advanced economies, the growth of the housing analysis community, both within and outside of government, can lead to a consensus that supports moving policies in more constructive directions. For example, in the US, such a consensus formed in the 1980s as to the inefficiency of building new buildings for social housing relative to supporting rent paid to private landlords in the existing stock. More recently, a consensus that the tax deduction for mortgage interest has almost no social benefits has permitted elected officials to speak about possibly cutting it back, or, at a minimum, to retain the limit on such mortgages at USD 1 million (which is starting to impact more than a few households).

Such an investment in the ultimate rationalization of housing policy usually has a very high benefit relative to its cost, simply because housing is a major sector in the economy and most countries have housing programs that encompass 1% or more of the state budget (and sometimes up to even 3% or more). As Dübel, et al. conclude: "Transition countries should develop a minimum public, agency, and private infrastructure for policy formulation, implementation, and evaluation. As long as housing is a priority for public policy, capacity in government should be adequate and independent. …. Program and sector data monitoring is key and should be organized under housing policy. An independent evaluation capacity, ideally within the private sector, should be established to regularly evaluate program efficiency."[24]

This may be the single most useful step that this government could take to improve the long run housing situation of Romanians and push itself and future governments in the direction of more efficient and effective housing policies.

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[24] Hans-Joachim Dübel, W. Jan Brzeski, and Ellen Hamilton, "Rental Choice and Housing Policy Realignment in Transition: Post-privatization Challenges in the ECA Region," December 2005, p. 89.

ANNEX A: ECONOMIC AND HOUSING SECTOR CONDITIONS

A. 1 Economic Conditions[25]

The Romanian economy has been performing well since 1999. After a decade of decline and difficult restructuring, the economy was transformed into one of relative macroeconomic stability, high growth, low unemployment and increasing foreign investment. Economic growth since 2000 has averaged over 5%, rising to 8.3% in 2004, despite declining population. Growth is expected to continue in the range of 5-6%. Romania was granted the status of a 'functional market economy' in October 2004 by EU officials, and is expected to join the EU in 2007 or 2008.

Inflation remained high until after 2000, when it dropped from 30.3% in 2001 to 9.3% in 2004, 8.5% in 2005 and it is now expected to fall to 6% in 2006. Unemployment also sharply declined and is now (January 2006) at only 5.2%, partly accelerated by a major migration of at least 10% of the prime-age work force to other European countries. With real wages rising rapidly and remittances from emigrating workers also growing, a boom in consumer spending, accelerated by the arrival of large-scale consumer credit, has further spurred the economy. This has also caused an expansion in the current account deficit, a possible imbalance which has attracted the attention of the National Bank of Romania.

In January 2005, Romania's new government imposed major fiscal reforms, replacing Romania's progressive tax system with a 16% flat tax on both personal income and company profit. However, as in some other transition economies, the overall tax burden on reported wage income remains very high (over 60%), due to the need to fund social expenditures for all portions of the population (about 60% of the population are dependent). This situation has meant that a large part of actual wages remain "gray," a circumstance that causes difficulties in underwriting housing credits and in granting need-based subsidies.

Romania's level of international debt was estimated at $24.59 billion in 2004, or 24% of GDP, which is relatively low. However, as Romania is currently undertaking several major infrastructure projects, and has a great need for additional such investments, as well as social investments, often funded through concessional credits. The sovereign credit rating of the country has been improving, currently at BB- with Standard & Poors.

The Romanian Leu declined by over 60% from 2001 to 2004, relative to the euro, but since 2004 has appreciated by about 15% (and much more relative to inflation). On 1 July 2005, the Romanian leu was subjected to revaluation so that 10,000 old lei (ROL) was exchanged for 1 new leu (RON). The official exchange rate for April 2006 was

[25] A more comprehensive analysis of the Romanian economy and financial sector can be found in the World Bank Working Paper # 45, "Capital Markets and Non-bank Financial Institutions in Romania," 2005.

about 1€=3.5 lei (National Bank of Romania). Romania is planning for the adoption of the euro within 5 years after EU accession.

The official average gross wage per month in Romania is RON 1121 as of December 2005. This equates to €311.38, based on international exchange rates. The average net salary per month in December 2005 was RON 848. However, in both cases, these figures are underestimates due to unreported incomes.

Table 1 reports on some of the key indicators of the economy.

Table A-1: Main Indicators of the Economy of Romania

#		2003	2004	2005	2006 (est.)
1.	GDP (€)	70 Bn	77 Bn	86 Bn	90 Bn
2.	GDP (% real change)	+5.3%	+8.3%	+5%	+6%
3.	Inflation	14%	9.2%	8.5%	6%
4.	Minimum wage	285 RON	310 RON	330 RON	360 RON
5.	Median gross wage	765 RON (220€)	870 RON (250€)	995 RON (285€)	1145 RON (335€)
6.	Unemployment	6.4%	6.3%	5.6%	5%
7.	National Budget	?	?	25 Bn€	30 Bn€
8.	FDI	3.9 bn€	5.1 bn€	6 bn€	8 bn€
9.	Foreign-exchange reserves (bn€)	14 bn€	16 bn€	20 bn€	30 bn€
10.	Mobile phone users	9,000,000	10,000,000	13,370,000	16,000,000
11.	Cars production (units)	160,000	240,000	320,000	500,000
12.	Internet users	5,180,000	7,800,000	10,400,000	13,600,000

Sources: N.I.S., N.B.R.

A. 2 Housing Sector Overview

The housing sector was transformed much earlier than the rest of the economy. Even before 1989, 67% of the stock was held privately, most of this in the form of single-family residences in rural areas. Most households in urban areas, and even some in relatively small towns, lived in state-owned rental properties, paying a nominal level of rent. (There was no form of cooperative or condominium ownership in Romania.) Over 55% of these urban housing units were built from 1970-1990, mostly as large apartment blocks out of prefabricated panels.

With the end of the centralized economy in 1990, most such construction stopped, leaving a large number of units in an unfinished state. Reported completions of new housing units declined sharply from 48,600 in 1990, averaging around 30,000 since then (see Table A-2). Notably, up to 20% of new housing completions remain in the public sector, due to the operations of the National Housing Agency discussed below. Most private construction is categorized as self-built (meaning organized by the owner, but usually with most of the work being contracted out), and has been performed, in most of the cases, without using a long term mortgage loan.

Table A-2. New housing construction (selected years)

	1990	1994	1997	2000	2002	2003	2004	2005
TOTAL	48.599	36.705	29.643	26.290	27.722	29.125	30.127	32.368
Private	5.779	25.896	26.149	24.703	24.169	22.670	25.047	28.575
Public	42.820	10.809	3.494	1.587	2.956	6.086	4.903	3.793

Source: N.I.S.

As of even 1990, the process of privatizing the social rental units had started. The terms of the sale to the sitting tenants were a minimum partial payment of 10-30% of the official price, plus the signing on an installment plan with the CEC (savings bank) for the remaining amount, at a 2-4% rate of interest, over 25-30 years. However, many chose to pay all cash or pay back the loan as quickly as possible. Otherwise, the high levels of inflation during this period have fully dissipated the real value of these debts.

Thus, by 2000, over 97% of the housing stock was privately held (see Table A-3). About 4.2% of the total private occupied stock was reported in the 2002 Census as being used for private rental, yielding an overall rental share of 6.7% of the occupied stock. However, over 80% of this was in the urban areas, so that the overall rate of rental housing in urban areas was about 11-15% (see discussion in the Rental section below). This was recorded before the boom in investment in apartments in 2003-4, which probably raised the share in urban areas in rental even higher.

Table A-3. Occupied housing by tenure category

Owner – occupied	6.680.523	93.2%
Public rental	179.116	2.5%
Private rental and other	138.703	4.2%
Total occupied units	7.165.792	100%
Total housing units	8.107.114	
Vacancies	941.322	11.6%

Source: N.I.S.

On the other hand, the difficult economic conditions in the 1990s prompted migration out of some rural areas and also out of mono-industry towns where the industries were no longer viable. Some of this migration was into larger cities, but it appears that much of it was out of Romania. As a result, the total population of Romania, currently estimated to be about 22 million, has declined by over 1 million since 1992, and there is a large share (almost 12%) of the total housing stock which is reportedly unutilized.

Overall, the average size of household has declined from 3.1 to 2.9 and the average amount of "useable space" per capita has increased from 11.6 s.m. to 14.3 s.m.

With the privatization of the state rental stock, the official role of the state in the housing sector declined dramatically. Today, the governance and maintenance of the huge private multi-level stock in urban areas is entirely in the hands of the private sector, with the homeowners associations contracting with private management companies and organizing for the long-term repair and maintenance of buildings.

Whatever public role there is in the housing sector has largely shifted to local governments. The remaining portions of the old state rental stock, generally that in the worst condition or subject to restitution claims, is now owned and managed by the local councils for use as either "social housing" for those whom are judged to be incapable of affording housing otherwise or as "necessity housing" for those who are temporarily displaced by natural disaster or evacuation for purposes of restitution, eviction for non-payment of utility charges, foreclosure, or other reasons. All additions to the socially-oriented rental stock are the responsibility of the local councils.

The local councils have also been given a key responsibility in the production of new housing, that of provider of off-site road infrastructure. Most other trunk infrastructure, including electricity, gas, water, and telephone, is in the hands of foreign-related private companies. As discussed below, many councils and such companies seems to be failing in providing extensions of infrastructure and this may be a source of constrained supply of new housing being sought by households experiencing rising incomes.

The housing sector is largely governed by the Housing Law of 1996. Key provisions of the Housing Law include (some of which have been removed since 1996):

- provision of social and necessity housing by local councils, with rents limited to 10% of net income;
- assisted owners are also exempt from local property tax for 10 years;
- basic provisions for leasing;
- minimum housing standards;
- tax exemptions on profits for companies that invest profits in building dwellings;
- the requirements for housing (condominium) associations for managing owned apartment buildings.

The various earlier subsidy programs (see below) had been put in this law or into the Law establishing the National Housing Agency (NHA). There is no law specifically governing rental housing and landlord-tenant relations, beyond some sections of the Housing Law.

The housing finance sector is governed by several laws and by regulations set by the National Bank of Romania (NBR). The most important of these includes the Law on Mortgage (1999), the Emergency Ordinance 200/2002 which authorized non-bank Mortgage Companies and the recent set of laws governing mortgage securities and mortgage banks, namely the Law on Mortgage Bonds, the Law on the Securitization of Receivables, and certain related amendments to the Law on Mortgage.

In addition, the National Bank of Romania has taken a active role in regulating the housing finance sector, both from the point of view of prudential norms and for management of macroeconomic tendencies.

The specifics of these laws and policies will be discussed below in more detail, as part of the examination of trends, policies, existing and proposed programs, and possible alternatives, separately for the owner and rental sectors.

ANNEX B: THE OPERATIONS OF THE HOUSING MARKET

B. 1 Housing Prices

The market for housing is being impacted by a variety of economic and financial forces currently. Economic stability and rising real incomes usually triggers rising interest in expansion of the quality and size of housing consumption. One immediate result in most transition countries has seen a sharp increase in the price of existing housing at some point in the recovery process.

The course of prices of housing units in such circumstances usually reflects some basic economics of housing markets. When housing demand is low, the price of housing primarily reflects the purchasing power of the public and not the underlying cost of building housing. When the purchasing power is very depressed, the prices can be very depressed. When the purchasing power recovers, prices can rise rapidly, especially if, at the same time, housing finance becomes more available and affordable. Eventually, as the price rises on existing housing, it approaches the cost of new construction and may even surpass it if the supply of new construction is slow to expand.

Thus, for example, if, especially in the absence of mortgage finance, all that most people can afford is to pay EUR 10,000-15,000 in cash for a 2-room flat in a multi-level building, then that will be the price, despite the fact that it might cost EUR 50,000 to build a similar flat. If incomes rise, and more families want to buy 2-room flats, because existing supply is relatively fixed in the short term, prices rise commensurate to the increase in demand. Finally, the price becomes such that it becomes more attractive for the most solvent part of the population to seek instead newly built, higher quality housing, both apartments and villas. At this point, the prices of older flats tend to stop rising, and the production of new homes expands to meet further increases in demand.[26]

To some extent, that seems to be what has happened in the cities of Romania. Prices for existing flats were very depressed even as of 2001, with prices of EUR 10-20,000 being common even in Bucharest, far below the cost of reproducing such housing. But as soon as the economy began to recover, these prices started to rise, eventually jumping rapidly towards reproduction costs in 2003-4. (There is no specific data on this, but this is the view of several market participants.) Prices for those same 2-room flats may be as high as EUR 40-60,000 today, which appears to be as high or higher than one might expect for new construction (about EUR 1000-1200 per square meter).

Market observers put the price of existing 1-room apartments at EUR 35-50,000 and 3-room apartments in multi-level buildings at about EUR 60-80,000. There are now a large number of new apartments and row houses appearing in the range of EUR 80-150,000.

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[26] A good example of this process is in Hungary, where completion of new housing was flat at about 20-25,000 per year, but then rose to 35,000 in 2003 and then 44,000 in 2004 soon after prices rose in 2000-1.

The future course of prices depends on further increases in solvent demand (both increases in wages, in remittances, and in affordability of housing finance) and the course of effective supply. We look at the supply side next.

B. 2 Housing Production

In a well-functioning housing market, all of the key ingredients for new production of housing come together fluidly in response to the appearance of solvent demand. These include raw land; trunk and on-site infrastructure; construction finance, materials, labor, and management; and official permits. Unfortunately, a constriction on any one of these elements can lead to slow supply and overpriced housing.

As well as we can determine, construction materials and management skills are not in limited supply. Apparently, there are some shortages in labor appearing because of the large out-migration, but these can probably be resolved. Even construction-period finance appears to be available at reasonable prices, both for individuals and for larger developers.

In much of Western Europe, housing prices are higher than otherwise because of restrictions in either land or permits. Sometimes there are natural limitations on the amount of buildable land around a city. But much more commonly, there are strong restrictions on permission to build. Because of relatively high population densities in Western Europe and strong preferences for green semi-rural areas right next to major urban areas, the supply of land with permission to build on is extremely limited. There may also be very tight limits on the ability to redevelop areas of low-density housing into higher density. The result is a very low supply of new housing, very high prices per square meter of space and relatively small typical housing space despite very high per capita incomes.[27]

Such self-imposed constraints may yet apply in Romania, despite the low population density and the large amount of space around most major cities. But it appears that the more significant constraint affecting supply currently is that on trunk infrastructure. It appears that both privatized utilities and local councils have not found a way to rationalize the financing and pricing for these critical inputs into the overall supply of housing. (This comment was made by several observers, but has not been independently confirmed.)

Partly as a result of that situation, it appears that the surge in housing demand and prices is being translated into an increase in the supply of housing mostly in areas with existing infrastructure, such as sites of former state-owned enterprises. According to real estate market observers, there is a large number of such projects in the process of coming onto the market, both in Bucharest and some other cities, and there will more as the last

[27] Almost all Western European countries report an average size of dwellings as less than 100 square meters. In the UK, it is 85 square meters, and new dwellings are averaging 76 square meters. Note that these are not referring to "usable space" but actual enclosed space. Source: UK Policy Exchange, *Unaffordable Housing*, 2005.

restitution situations are resolved. These observers feel that the market prices have now reached the level (above EUR 1000 per square meter in Bucharest) where new flats are an attractive option and that this will slow or stop the increase in housing prices, at least until the general wage levels rise enough to support further increases.

B. 3 Restitution

Formerly Communist countries have taken different approaches to the question of compensation to those who were dispossessed of their property at the time of the Communist takeover of power. Except in the case of Hungary, which compensated in the form of vouchers for state property funds, these countries have tried to restitute the actual property. This approach has caused many problems for those currently using the property and for the claimants. Even when this is not the case, as for vacant land, the uncertainty of title can create real barriers to development.

In Romania, it appears that there have been additional complexities created by appeals to the European Court of Human Rights and other court cases that have delayed closure in this area. These delays appear to be coming to an end, and hopefully titles will become clear for both land and pre-War central city housing areas that can be redeveloped into much higher densities. Until that is the case, however, restitution issues may yet slow down the supply response of the private construction sector.

B. 4 Solvent Demand and Affordability

In contrast to much of public discussion, economic logic does not admit of the idea that housing can be so expensive that it is unaffordable in general. This is because, as long as it is observed that houses are being bought and sold on a significant scale, that implies that the prices are affordable to some significant part of the population. However, housing can become less affordable over time. The implication of this is that people who do not currently own housing may have to settle for less of it when they come to buy or rent it, just as they would reduce consumption of meat or petrol if the price rises.

For example, the current price of a 2-room flat in Bucharest seems to be about EUR 40,000 or more. This is often contrasted with the average monthly net wage in Romania of about EUR 240. This implies that the price of such a flat is almost 14 times the average annual wage, which would be considered to be very high in most countries. However, the economics of the housing market is such that the prices of such a commonly available flat can not rise above the level that is actually being paid (and is thus "affordable") by many households every day. Thus, the basis for understanding that high price must lie in a misunderstanding of the purchasing power of the typical household.

Could the EUR 240 per month be an erroneous measure of that purchasing power? There are several reasons to think so. First, Bucharest has many more people than other areas who are in skilled professions which are paid substantially higher than the average wage, perhaps making the average closer to EUR 400. (Notably, we have been told that house prices are much lower in many smaller cities, commensurate with the lower wages in those areas.) Second, many, if not most, households seeking to buy a 2 room flat include 2 persons, either partners or roommates, so that the underlying income of most homebuyers in Bucharest is probably closer to EUR 700-800 per month. Third, this measure of income appears to be only that reported for tax purposes. The actual full income of the household could be 1000 euros or more, reducing the price ratio to only 3.3. (This ratio is typically 4 or more in Europe.)

In addition, many young people looking to buy a flat receive assistance from parents or even grandparents in doing so. It is a profound fact that this society has a stable or declining population and over 90% ownership of housing. Thus, on average, there is a death of almost the same number of households each year as there are births of new households (other than for the tendency to smaller households), and that the household that dies leaves the full value of their housing unit for the use of the next generation of households. Thus, in many cases, a parent or grandparent in effect leave a bequest sufficient to fully or partially support the acquisition by a new household of a housing unit.

Of course, these averages and economics are of no comfort to a young person trying to acquire a flat with only one income (including those where a young mother is not working) and without any timely bequest from a senior generation. And that may be a valid basis for a social policy designed to assist such households. In fact, the situation can be viewed as a social issue, perhaps because lower housing consumption might affect marriage plans and birth rates.

However, the existence of some such households is not an indication that housing is simply unaffordable to most young households. It may imply that they cannot afford the same size and quality of their parents housing until they have become more senior in their work. But many, in fact, are working in new sectors of the economy with relatively high wages and can afford even better housing already. Moreover, with the appearance of mortgage finance on attractive terms, the solvent demand of many households has been increasing as interest rates have declined and loan maturities have grown longer. This expansion of mortgage finance can cause the prices of flats to jump further, but it also levels the playing field for those who have income but not the bequest or other assistance from relatives.

We look next at the evolution and status of the housing finance sector.

B. 5 Housing Finance

The Romanian mortgage market had an explosive evolution over the last three years. At the end of 2002, the volume of residential mortgage loans amounted to approximately 200 million euros, which was less than 0.5% of GDP. In 2003, this level doubled and has risen further to approximately 1.5 billion euros by the end of 2005, representing almost 2% of GDP. Although as a stock of loans, this is very small relative to the EU average (45%), it represents a major shift towards using credit to facilitate the initial purchase of a home or a step towards expanding housing consumption. This shift occurred several years earlier in the Central European countries and is mostly associated with the arrival of macroeconomic stability and the strengthening of the banking sector.

Table B-1. Growth in mortgages outstanding

Year	Residential Loans Outstanding (million Euros)
2003	500
2004	823
2005	1500

Source: N.B.R.

Over 90% of the mortgage loan activity in Romania is supplied by universal/commercial banks. As a result of privatization, hyperinflation, and various economic and banking crises, almost all of the commercial banks in Romania are foreign-owned. With the privatization of Romania's largest bank – Banca Comerciala Romana (BCR) – completed in 2005, 27 of Romania's 31 commercial banks, with 80 percent of total bank assets, are majority foreign-owned. At present , the Romanian Government is in the process of privatizing the former State Savings Bank, C.E.C. Foreign bank branches have also a significant presence with about 8 percent of the bank assets.

Commercial banking is fairly concentrated, the 5 largest commercial banks holding 62 percent of assets in June 2004, with BCR alone accounting for 29 percent of total system assets.

Most lenders offer mortgage loans as well housing (or real estate) loans (see below) in local and foreign currency with tenure up to 15-25 years. (OTP Bank has just introduced a 30-year term.) Because rates on all currencies have been declining, fixing the rates on loans is not popular in general (but see below).

Most of the mortgage loans are provided in foreign currency, with only 13% from the current loan portfolio being in the RON. This preference reflects the fact that, until recently, the differential between RON and euro rates had been as high as 15% even into 2005, and thus euro contracts offered much higher loan amounts than RON ones. Moreover, the RON has been rising against the euro. However, it is notable that, because of the long history of high inflation until relatively recently, many employment contracts are stated in euros and thus the forex risk of taking a loan in euros is minimal.

Correctly understanding the rates on offer and the difference between euro and RON rates is difficult currently. This is because of various NBR regulations that are artificially pushing up the cost of Euro funding and also encouraging banks to offer extra low rates for the first 1-2 years. These aspects of the market will be explored below. In general, the current rate structure is for loans in Euros to average around 9% on a floating basis and 11-13% in RON. However, for underwriting purposes, rates as low as 7% in Euros and 9% in RON are being marketed. The spreads between the cost of funds and lending rates had been very high but have been gradually declining due to intensifying competition (see Table B-2).

Table B-2. Interest Rates by Credit Institutions in ROL/RON (%) (all outstanding credits)

	2001	2002	2003	2004	2005	Jan. 2006
Average lending rates	45.7	36.6	26.2	25.8	19.2	15.2
Average deposit rates	26.2	18.4	10.8	11.3	6.2	4.2
Average spreads	19.5	18.2	15.6	14.5	12.1	11.0

Source: NBR

To make the situation even more complicated, there are two types of housing loans, both of which would be called a mortgage loan in most countries. In Romania, by the Law on Mortgage Credits, a mortgage loan must be a credit used for a housing purpose. It can not be a consumer or business loan secured by a residential mortgage. In addition, and even more importantly, a mortgage loan with a variable rate must be indexed to one of the main public market rates for low-risk short-term debts, namely EURIBOR, LIBOR, or BUBOR (Bucharest Interbank Offer Rate). It is these credits that are tracked in table B-1.

In response to these restrictions, banks and other lenders offer what are called “housing loans” which essentially are credits (which may or may not be secured by a mortgage) that need not be for a housing purpose and can have a rate that varies on any basis the lender wishes. This step is essential to most banks, simply because their cost of funding does not really vary with any of these rates. This is clear in the case of forex, where there will be many factors affecting a bank’s cost of funds relative to EURIBOR or LIBOR. It is not obvious that the bank’s deposit rate would not vary closely with BUBOR, but in a rapidly evolving banking market such as Romania has had for several years, it is plausible. Thus, banks prefer to index their loans on their own cost of funds.

There is little specific data on the size and uses of mortgage loans (including both “mortgage loans” and “housing loans”), but market participants indicate that the average size is about EUR 20-25,000 and the number of loans made in 2005 was about 25-30,000. Typically, the loan-to-value ratio (LTV) is between 50% - 75%. Apparently, the largest part of the market is for the acquisition of an existing residence. However, a significant part of the market may consist of parents mortgaging their own residence to help finance the construction of a new one or the purchase of another one for a child.

No one knows the number of transactions in the existing stock of urban dwellings (the relevant market size), but based on a stock of about 4 million urban units, and a minimal turnover of 3%, that would imply at least 120,000 transaction in a year. It appears that most such transactions are still fully in cash, presumably because the buyers have full equity from their previous home or from the sale of a deceased relative's home. However, such financing is large enough and common enough to play a significant role in supporting the growth in prices in large, relatively sophisticated cities such as Bucharest.

The main sources of funds for mortgages from commercial banks are time deposits and, to a much lesser extent, loans from international lending institutions like the EBRD and the IFC. Three banks have issued domestic corporate bonds up to now, but it is not a major source of funding. A growing source of funds has been internal transfers from the mother banks for the foreign-controlled banks. As of January 2006, the portfolio of mortgage assets of about 1.5 billion euros is about 30% of the portfolio of forex time deposits (about 5 billion euros, growing only 10% in 2005). There is almost as large a pool of RON-denominated time deposits as well, however, and this is growing at a much higher rate (72% in 2005) than the forex deposits (because of the policies of the NBR below). Funding could become a problem as the loan portfolio grows, depending on the preferences of savers and borrowers for currencies, but it appears that both savers and borrowers are shifting towards RON, encouraged by the evolution in the interest rate differentials offered by banks.

This shift to RON-denominated loans is the result of a conscious and strong policy of the NBR to discourage lending in forex. The most visible aspect of this policy is a statutory reserve ratio for forex liabilities of 40% (recently raised from 30% then 35%) in contrast to a 16% reserve ratio for RON liabilities.

It should also be noted that the NBR does offer mortgage loans a 50% risk weight with respect to capital adequacy requirements. However, the basic capital adequacy ratio is currently 12%, instead of the 8% basic ratite applied in most European countries under Basle I. As part of the effort to encourage lending in RON, the NBR has also raised the basic capital required for forex denominated assets to 30%, instead of the 12% norm. Thus, forex mortgage loans bear a 15% required capital rate relative to RON-denominated rate of 6%.

Up to date, three non-bank mortgage finance companies – Domenia Credit, Imo Credit, Finans Credit Imobiliar -- are required to register and report data to NBR, and will come under NBR supervision and examination under the a Law on Mortgage Banks that was recently passed.

These institutions, and perhaps the banks, are looking towards the recent legislation on mortgage securities to expand their funding base. This package of legislation included a Law on Mortgage Bonds, a Law on the Securitization of Receivables, and certain related amendments to the Law on Mortgage. However, the likely investors for large scale issuance of such mortgage securities-- pension funds, insurance companies, and mutual funds -- are not yet well established in Romania.

Foreclosure for residential mortgages is, on paper, relatively swift and certain, but the process is so far largely un-tested. As importantly, a Credit Bureau has been created, owned and established by banks with 27 members, to upgrade the underwriting on mortgage loans. It only provides negative information currently, but is expected to encompass positive information soon. However, a large portion of the consumer lending sector is not included in its records at this point.

One of the major policy controversies in this sector was the decision in 2004 by the NBR to restrict by regulation certain key terms on all consumer lending. Specifically, the NBR has set specific norms with respect to the guarantees or security provided for all such loans and on the maximum repayment burden of the loan and of all credit. These restrictions are as follows:

Minimum ratio of security or guarantees: 133% of the value of the credit[28]
Maximum ratio of loan repayment to monthly income: 35%
Maximum ratio of repayments on all loans to income: 40%

These restrictions were adopted based on the view that the rise in the current account deficit was partly due to the sharp rise in consumer credit after the year 2002. However, it is not clear that housing should be included, because most of its value added is domestically produced. More importantly from the point of view of the housing sector, the first limit, on LTV ratio, does not so much limit the increase in the amount of credit for housing or even the construction for housing (apparently, relatively little of housing credit is for new construction), but instead selectively limits the ability of just those households with relatively little in cash assets from accessing enough credit to acquire the existing house that they wish.

On the other hand, the impact of the limits, especially the second and third limits, reveals an underlying weakness in the Romanian economy, the large role of black payments designed to avoid the heavy social taxes. On the face of it, a 35% ratio of payment to income is in line with practices common in many other countries. However, the desire to go to ratios of 50% or more is not due to a view that such ratios are safe, but rather to recognize that total actual income of many households is much higher than what is officially observable.[29] It is the resolution of this situation which would create a better long-term basis for regulating underwriting standards.

Another rationale for these limits was concern that the rapid rise in prices from 2002 onward might feed into a speculative price bubble. Such a bubble would not be good for buyers, or for lenders who are too exposed to high LTV loans. However, if that is the rationale, the higher risk could have been compensated for by raising the risk-weight for high LTV loans to 100% from the current generous 50%. In any case, if there is evidence

[28] It seems that this restriction had been in place prior to 2004, but not always enforced. It implies that the maximum loan-to-value (LTV) ratio is 75%.
[29] Apparently, some borrowers are compensating for this restriction by having parents and others also offer to pay the loan, and thus permitting their income to be counted.

that prices are stabilizing in response to rising supply of new housing, the NBR may want to reconsider these limits.

These restrictions have resulted in some distortions in the market. The most pronounced is the offer of what are called "teaser" rates in the US, namely, below-market interest rates that apply only for one or two years but that permit the borrower to qualify for a larger loan. For example, one bank is offering a stated rate of 6.9% in euros for two years, then reversion to their usual floating rate. That floating rate is currently about 8.9%, and may go higher given the global uptrend in interest rates. (On the other hand, these teaser rates may also be a bet by the banks that the NBR will reduce the onerous terms it applies to forex liabilities and assets, and the rates on euro loans actually comes down in Romania, despite rising rates in general.)

There are two other sources of housing finance that need to be considered. The National Housing Agency was functioning as a housing lender from 2000-2003, but has now dropped that role in deference to the private sector. A new set of institutions modeled on the German Bausparkassen has started up in 2004-5 to offer subsidized savings and credit contracts. Both of these aspects of housing finance in Romania are discussed under the next section, on subsidized schemes.

B. 6 The Market for Rental Housing

A dynamic rental sector is an important feature of any well-functioning housing market. It can provide affordable housing opportunities for households that cannot afford the large upfront costs of acquiring a unit or do not wish to. Market rate rental housing is especially important for labor mobility, as it allows people to quickly relocate with relatively low transaction costs compared to those associated with buying a home. Subsidized rental housing can also play a key role in a country's social safety net.

Many observers of Romania's rental stock have noted that it is small compared to some European countries (especially those with large social housing stocks), but it is probably larger than what most people believe it to be. According to the 2002 census, the share of occupied units made up of rented units was about 4.4 percent, and an additional 2.3 percent of the occupied stock consisted of households who occupy housing without formally paying rent (these are sometimes called "rent-free renters"). This combined 6.7 percent, however, is not the entire occupied rental stock. Due to the way the National Institute of Statistics (INS) compiles tenure figures, we know that an additional 1.3 percent of dwelling units occupied by more than one household contained combinations of owner households with renter households and households not paying rent. Table 5.1 shows that about 92 percent of occupied units were entirely owner-occupied. To put it another way, about 8 percent of all occupied units contained renters or rent-free renters.[30]

[30] There often is confusion between the size of the owner-occupied stock and the size of the privately-owned stock. The privately-owned stock contains both owner-occupied and renter-occupied units. Therefore, the owner-occupied stock is smaller than the privately-owned stock. The publicly-owned stock only contains renter-occupied units. The term "tenure" normally refers to the characteristics of the

The renter-occupied stock is a subset of the total rental stock, which by definition includes dwellings that are vacant but intended as rentals. At the time of the 2002 census, the vacancy rate was about 11.6 percent (about 941 thousand units). The INS does not collect information as to the intended purpose of vacant units (which can be rented or sold), but it is likely that at least some share of the 11.6 percent was available for rent. Some of the vacant stock was probably going to be sold and some of it was likely to be converted to non-residential uses or demolished, but if just 2 to 3 percentage points comprised vacant rental units, then the total rental stock could probably have been around 10 percent of the total number of dwelling units. This is a conservative estimate.

occupants of a unit (i.e., owner-occupancy and renter-occupancy), and not to the ownership status of the unit.

Table 5.1
Tenure Distribution: Occupied Dwelling Units in 2002

		Dwellings occupied by 1 household				Dwellings occupied by 2 or more households							
	total	total	owner	tenant	other situation	total	owners	owners and tenants	owners, tenants and other situations	owners and other situations	tenants	tenants and other situations	other situations
number of occupied dwellings	7165792	7029809	6551585	312798	165426	135983	36136	5197	114	87607	3748	1159	2022
number of households	7315891	7029809	6551585	312798	165426	286082	74872	10995	371	184501	8433	2570	4340
number of persons	21345033	20543844	19202158	909361	432325	801189	210076	25962	1004	522290	22149	7525	12183
number of occupied dwellings	100.00%	98.10%	91.43%	4.37%	2.31%	1.90%	0.50%	0.07%	0.00%	1.22%	0.05%	0.02%	0.03%
number of households	100.00%	96.09%	89.55%	4.28%	2.26%	3.91%	1.02%	0.15%	0.01%	2.52%	0.12%	0.04%	0.06%
number of persons	100.00%	96.25%	89.96%	4.26%	2.03%	3.75%	0.98%	0.12%	0.00%	2.45%	0.10%	0.04%	0.06%

Source: INS

Note: This table shows the distribution of occupied dwelling units. The number of occupied dwellings is smaller than the number of households because each occupied dwelling unit can contain more than one household.

The rental stock is much larger as a share of all housing in urban areas than in rural areas. Most policymakers are probably more interested in the urban rental stock than the rural rental stock, because it is in urban areas where mobility and affordability problems are most noticeable. The figures presented thus far have referred to the entire country, and they are not representative of urban areas. The figures for the country overall are influenced downward by high owner-occupancy rates among rural residents. For example, 83 percent of the 4.4 percent of rent-paying tenant households in the country are in urban areas (Table 5.2). In high-rise buildings, which are not common in rural areas but make up a large share of urban units, approximately 16.3 percent of the occupied stock was rented in 2002.[31]

Table 5.2
Tenure Distribution of Households in 2002

	Number				Percentage		
	urban	rural	total		urban	rural	total
Private households from dwellings	3956426	3359465	7315891		100.0%	100.0%	100.0%
households living alone in a dwelling, as:	3838516	3191293	7029809		97.0%	95.0%	96.1%
owner	3481578	3070007	6551585		88.0%	91.4%	89.6%
tenant	259294	53504	312798		6.6%	1.6%	4.3%
at a public owner	144267	34849	179116		3.6%	1.0%	2.4%
at a private owner	98777	15966	114743		2.5%	0.5%	1.6%
at a private company	16250	2689	18939		0.4%	0.1%	0.3%
other situations	97644	67782	165426		2.5%	2.0%	2.3%
households sharing a dwelling with one or more households, as:	117910	168172	286082		3.0%	5.0%	3.9%
owners	33497	41375	74872		0.8%	1.2%	1.0%
owners and tenants	8324	2671	10995		0.2%	0.1%	0.2%
owners and other situations	64123	120378	184501		1.6%	3.6%	2.5%
owners, tenants and other situations	259	112	371		0.0%	0.0%	0.0%
tenants	7188	1245	8433		0.2%	0.0%	0.1%
tenants and other situations	2060	510	2570		0.1%	0.0%	0.0%
other situations	2459	1881	4340		0.1%	0.1%	0.1%

Source: INS

Note: This table shows the tenure distribution of households. There can be more than one household in a dwelling unit. Therefore, the number of households exceeds the number of occupied dwelling units.

While it is difficult to precisely estimate the size of the rental stock, it is clear that the various official national estimates in the 4 to 7 percent range are not high enough when referring to urban areas. Enumerating rental properties is even more difficult because a grey market exists in which rental properties are not reported to census officials

[31] PRC Bouwcentrum International, "Sustainable Refurbishment of High-Rise Buildings and Restructuring of Surrounding Areas: Draft," Report for the European Housing Ministers' Conference held in Prague, Czech Republic 14-15 March 2005, October 2004, p.102.

because the landlords wish to avoid paying taxes. Starting with the official tenure statistics available from the 2002 census (Table 5.2) and making adjustments for rental units that are "invisible" because they are vacant or part of the grey market, it is reasonable to assume that the share of the urban housing stock consisting of rental units is in the 11 to 15 percent range. Moreover, this would have been before the boom in investment purchases of apartments in 2003-4, which could have resulted in many more rentals. These figures may surprise some policymakers who must consider the possibility that there is not a serious supply problem, or at least one that is big enough to indicate some sort of market failure.

Within the private sector, rental units become available through several processes that may or may not involve new construction. Existing dwellings can quickly shift between the rental and owner markets, as well as between the residential and commercial property markets. In Bucharest, for example, new construction in the office sector has caused some flats which were being used for offices to be converted back to residential units. When market rents are attractive, extended families that own more than one unit will move in together and rent out one of their apartments. Households that buy newly constructed villas or nicer flats sometimes rent out their old units. Households that have left the country for work are also a source of rental units. A small number of investors have purchased newly constructed luxury flats and villas to rent out to expatriate clients from abroad. It is important to understand that there are many ways that the rental stock can significantly expand even without new construction of rental buildings.

The government, through several types of social housing construction programs, has been the only major developer of rental housing over the past decade (the government role in rental housing development is discussed in more detail below). With the exception of a few luxury developments, private sector developers have not yet found it profitable to build units for rent. Relatively low rental and purchasing prices in the existing housing market have discouraged such construction, but this situation might change in the near future as the prices of existing units approach those of newly constructed units. Market rents tend to stay in line with sales prices, with monthly rent typically in the range of 0.5% to 1.0% of the market sales price of a unit (depending in how much the owner/landlord is hoping to earn from appreciation in value).

Even though private developers have yet to enter the rental construction business for middle-income people, they are keenly aware of the problems they are likely to face based on their experience in constructing homes for sale. These problems include, for example, obtaining infrastructure from local administrations and utility companies, settling restitution claims, and encountering unfair competition from government-sponsored construction.

The current tax treatment of rental properties might be a factor in discouraging private sector investment both in new construction and rehabilitation. Although rental income and other forms of income are treated on an equal basis with respect to the tax rate, the amount of rental income that is taxable does not allow for the full deduction of expenses. This creates an "uneven playing field" that places rental investments at a disadvantage compared to other business investments that fully allow such deductions. Also, because rental investments can be lumpy (for example, rehabilitation costs), the ability to deduct rental expenses from non-rental income in the current tax period, and/or to count expenses against taxable income in future tax periods, can increase the attractiveness of rental investment.[32]

Because the private sector has not been active in rental construction activity, it has given relatively little thought to issues related to the long-term operation of rental properties, such as maintaining adequate rents and potential difficulties in evicting tenants. Basic landlord and tenant responsibilities are described in the 1996 Housing Law. The Law also covers topics such as leases, eviction conditions, and principles of setting rent. This last topic is aimed at local administrations--not the private sector (for which there is no rent control).

There is considerable confusion in the literature about the extent and nature of rent control within the publicly-controlled stock. Government Emergency Ordinance 40/1999 (as amended by Law No. 241/2001) establishes two rent ceilings (25 percent of net family income or the net average wage, whichever is less, and 15 percent of net family income) for properties subject to restitution. The 15 percent ceiling appears to apply to new leases, whereas the 25 percent ceiling seems to be applicable to lease extensions. Landlords subject to rent control can receive some compensation in the form of tax breaks on land and buildings during the contractual period. If a tenant in a unit subject to restitution qualifies for social housing, the local authority pays the difference between the applicable rent and the social housing rent (no more than ten percent of family income as specified by the 1996 Housing Law).[33] Note that Ordinance 40/1999 only governs properties subject to restitution. In this report the term "social housing" includes dwellings subject to restitution.

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[32] See H.J. Dubel, W. Jan Brzeski, Ellen Hamilton, "Rental Choice and Housing Policy Realignment in Transition: Post-privatization Challenges in the Europe and Central Asia Region," Washington, D.C., The World Bank, Policy Research Working Paper 3884, April 2006, pp. 51-52.

[33] This description is based on several sources: Larisa Dragomir, "Romania-Tenancy Law Report," Florence: EUI, no date; Valeriu Stoica, "Law On the Protection of Tenants," Committee for Private Property, no date; United Nations,"Country Profiles on the Housing Sector: Romania," Geneva: Economic Commission for Europe, 2001.

ANNEX C: STATE INTERVENTIONS IN OWNER-OCCUPIED HOUSING

C. 1 Past Subsidy Schemes

After the general withdrawal of the state from the housing sector and the privatization of the state rental stock, there seems not to have been any significant interventions until 1994, when the state started to provide support for the completion of partially completed building projects leftover from prior to 1989. Soon thereafter, the state intervened to provide a limited number of relatively low-rate housing loans through the state savings bank, the CEC.

C. 1. 1 Uncompleted Houses Scheme

Given that, as of 1989, the state was delivering over 40,000 housing units per year, it is not surprising that many partially completed units were in various stages of being built when the old system ended. These "uncompleted houses" have been subject to a special program of support from the central governments and local governments. The scheme seems to work through the local government, which is responsible for contracting to complete the construction and to allocate the unit to a buyer.

These units come with at least two subsidies. One is a specific discount of 30% of the construction costs, to be paid to the local government by the MTCT. The second is a below-market interest rate, 5% in RON, payable on the installment payments due over 20 years to cover the other 70% of the construction costs, less a 10% downpayment. When inflation was high in the 1990s and early 2000s, the real value of such installments disappeared rapidly.

These subsidies, combined with no charges for the serviced land, would suggest a deep level of subsidy to these units, on the order of at least 50% of the market value of the inputs. However, the "market value" of the output may be less than that of the inputs because of poor location and design, i.e., the aspects that made so much of the housing built under the old system undesirable.[34]

Thus, it is not known how deep the subsidy is relative to true market value of the units nor how the units are allocated by the local governments. In total, there seems to have been 10,000 or more units completed in this manner, but the flow of additional units is now declining to only a few hundred per year.

C. 1. 2 CEC Subsidy Scheme

[34] A report by the MTCT for the UNCHR entitled "Adequate Housing- as a component of the right to an adequate standard of living" (January 2002, p. 24) describes some problems experienced with the completion program, including instances there has been no demand for the apartment because of bad locations (rural). Apparently this resulted in program changes including converting the units to young people rentals or other social housing.

The scheme involved the state paying the difference between a fixed rate of 15% on a ROL loan with a term of 20 years and the "market rate" (defined by law as the average rate paid on ROL time deposits, plus a margin of 5%). This scheme was notable in the sense that it was the first time that policy was designed specifically for those under the age of 35. It was also notable that the rate was not so low in absolute terms (often the political selling point is a rate such as 5-7%), but was still very low relative to inflation. Most importantly, it was far lower than the rate on bank deposits, and thus it was profitable for qualified borrowers who would have bought a home without the subsidy to utilize the scheme. Because of this, it is very unlikely that the scheme did anything but enrich those who qualified for it.

Despite the high stated rate and probably because the rate on the loan was lower than the rate available on bank deposits, the scheme was quite popular, with 11,000 loans being originated just in 1997-98. Fortunately for the state, interest rates have declined sharply since 1998. Otherwise, this scheme would have been very expensive.

Another notable aspect of this scheme is that the loan could be used to purchase either a new house or an existing house. Not surprisingly, especially when considering young households, almost all of the loans were used to purchase an existing house. Especially at that time (as noted above), existing homes were much less expensive than new ones, and so only the very wealthiest young household interested in buying a home larger and more luxurious than the ones existing already would want to buy a new home.

A last important aspect of the scheme was that all who met the eligibility requirements still could not necessarily get a loan. There was a certain number of such loans under the scheme provided annually in the budget. In each subsidy scheme since then, there has been a limit on the total subsidy provided in aggregate each year, and thus, similarly, not everyone who was eligible receives a subsidy. This protects the state budget from excessive spending. It also implies that the way that the funding is rationed is at least as important as the nature of the subsidy, as far as assessing the effectiveness of the scheme.

It appears that the allocation procedure under the CEC program was mostly based on a waiting list, and not on differentiating finely between applicants in different circumstances. This may have been more fair than some schemes, if there was not manipulation of waiting lists, but it also means that the social impact of the scheme was very low.

The scheme was modified in 1999 to require that 70% of the funds be used to buy new apartment or houses. This probably would have been difficult to execute, given the much higher prices of new homes. But budget considerations during the year caused the scheme to be canceled entirely before the 8,000 loans" budgeted" for were granted.

C. 1. 3 National Housing Agency Ownership Scheme

In 1999, the government made a policy decision to end the subsidy scheme through the CEC and focus on the construction and delivery of new houses through a new state-owned enterprise, the National Housing Agency (NHA; Agentia Nationala pentru Locuinte (ANL) in Romanian). This entity would work with local governments to use serviced land owned by the local government to build and finance housing, both low-rent flats for young people and new flats and villas for all the first-time owners among general public. The rental program is discussed later in this report.

Essentially, this institution was established to serve as a direct channel for state assistance to the housing sector. The NHA operates under the authority of the Ministry of Transport, Construction and Tourism, has a national network of territorial offices and collaborates with builders, financial institutions, local and central administration authorities and foreign organisations.

Operational Details. The NHA scheme for ownership changed frequently over its short life of 5 years.

Phase 1: 2000-2001.

Initially, as it waited to be able to deliver completed houses, it appears that the NHA focused on "pioneering" the use of mortgage lending under the terms of the Mortgage Law enacted in 1999. It offered loans on the following terms: 7% in euros for 25 years if the borrower were under the age of 35, 9% for 20 years if 35 or older. These credits were, in principle, open to use in all forms of construction or acquisition of housing, or even refurbishment. The funding was rationed according to a formula which emphasized not owning a home already and how much of a nonpayment the applicant could make.

Phase 2: 2001-2003.

The extensive eligibility for low-rate loans was ended in 2001, and lending became restricted to new construction sponsored by the NHA (Build-to-Sell program) and to first-time owners of houses, with allocation favoring those under age 35 and married. It appears that the cost of these units was 50% or more less than those on the private market, due to the free land and utilities provided by local governments and other indirect subsidies enjoyed by the NHA. In 2001, when the government ended the exemption of housing construction from the VAT of 19%, the NHA added a discount of 20% to compensate, further expanding its advantage over free market suppliers

Phase 3: 2003-2005

In 2003, the NHA determined that their subsidized lending scheme was no longer needed, given that the banking sector was now entering the mortgage market. As a result, they ended that part of the package. However, with the other large subsidies involved, they had no difficulty selling all the houses that they could produce.

Phase 4: 2005-

In 2005, the build and sell scheme was formally ended, not voluntarily but only after having been deemed by the Competition Council (Romanian or EU?) to constitute inappropriate competition with private sector builders. However, there are about 1000 units in the pipeline to be completed according to the terms of the scheme.

It is not known how many units were contracted for under each specific phase of the NHA programs for owners. It is known that the finance phase (2000-2003) led to the origination of about 2,000 loans for a total of about EUR 28 million. (These were of an average size of about EUR 14,000 because one of main weights in granting these was size of downpayment. The official minimum downpayment was only 10%, but the actual average was 40%.)

It is also reported that about 1700 units were completed so far under the last three phases, and another 1000 are expected to be completed, for a total of 2700 units over 6 years or so, a pace of delivery averaging 450 per year, only about one-tenth the level of output from the NHA rental program recently. This relatively low rate of activity in the ownership program presumably reflects the preference for local government to acquire units of municipally-owned rental housing instead of contributing the same land and infrastructure towards a build-and-sell scheme.[35]

Economic and Social Impact. What impact were these programs of the NHA likely to have had?

The first program was essentially a deep interest rate subsidy scheme. At the time, market rates in euros were over 15%, and thus even a 9% rate was a deep discount. The rate on bank deposits in euros was close to but not over 7%. As noted above, to the extent that the deposit rate is above the rate charged on a subsidized loan, it is highly likely that much of the lending will be to people who already have access to funds to buy housing, but would profit from keeping those funds in the bank and using the funds from the program. This motivation partly applied to those under 35, but not to those older, who would pay 9%.

Because the program was not an entitlement, there was a point system used to determine who received the funds. Apparently, at least one aspect of that system was to give preference to those who already had more funding of their own. This sharply reduced the credit risk involved in the scheme, but probably shifted the funds to those with higher incomes and more funds already.

How much was the subsidy? In retrospect, with the sharp decline in euro interest rates since then, the subsidy was not so much. It appears that euro loan rates fell from 15% in 2001 to 9-10% in 2005. The subsidy element for those under 35 may have approximated the following pattern: 8% in 2001, 6% in 2002, 5% in 2003, 4% in 2004, and 2% in 2005

[35] It should be noted that the local government is retaining ownership of the land under the ownership scheme, and in theory could charge a new lease amount or take over the house at the end of current lease.

and onward (unless rates in euros come down further). The present value of such a subsidy would be about 30% of the value of the loan. This would have applied to about 50% of the price of the house. Thus, as a share of the value of the house, the subsidy was worth about 15%.

This was a smaller subsidy compared to any other subsidy discussed here, although still significant compared with a typical income (about one year's earnings). The NHA believes that this lending also helped to promote mortgage lending at a time when it was not being practiced.

This impact on mortgage lending practices has been increased by the fact that all of these phases of the NHA program require that the beneficiary receive a mortgage loan. This may seem to be an unusual requirement, in a situation where most houses were being bought and sold on a cash basis. But it appears that the mortgage loan is used, in effect, by NHA for construction-period financing. Then the beneficiary is free to pay off the loan once the house is built.

The subsidies have been larger in the three other phases of the NHA owner programs, but may have had more of a specific impact. A rough estimate of the subsidy amount would be at least 50% of the value of the housing being sold. This is because the value of the land and on-site and off-site infrastructure, combined with free development management and risk bearing (i.e., no profit), would be about 50% of the value of a housing unit. With the addition of the below-market financing for most of the sale cost (in Phase 2), the total subsidy would be at 65% or more, compared to a fully market-based acquisition.

The social value of providing such a subsidy depends on how it is rationed, and what extra effects it produces. In this case, it is likely that some, if not most, of the units would not have been built in the absence of the subsidy. The beneficiaries of the program were young and relatively moderate income and thus not otherwise able to afford to buy a new unit. Thus, it is likely that the units were net additions to the housing stock of Romania, an increment that has some social value by reducing the pressure on prices. On the other hand, an increase in housing supply could have been effected with a smaller subsidy. The main effect of program was probably to redistribute wealth to the lucky young households.[36]

How were these households selected? There was a point scale, that essentially limits the group of potential recipients to those who are under 35, without owning a home currently, and are married or with a child. There is no further differentiation of social deservingness. This may be why there has been significant criticism as to favoritism in the allocation of NHA subsidies (which is done by local governments).

[36] On the other hand, the net gain to the beneficiaries was not always so high, because there have been significant delays in the production of the houses, due to the complex process of utilizing land and infrastructure to be supplied by the local government.

Although there may be little in the way of direct social benefits from this program, it may be necessary to consider the political benefits, as a measure to indicate to the public that the political system understands their frustrations with the new system of market-based housing and is willing to provide at least some "lucky" households a much better price.

In fact, the ownership program of the NHA was typical of the sort that governments create when they or the electorate feel that high interest rates are stopping the development of needed new housing. In other cases also, a state agency is tasked with organizing and contracting for the construction of new housing and also with providing and servicing deeply below-market loans for such housing. Such a scheme assures that there will be more than enough demand, because the house itself benefits from a subsidy in the form of free land and utilities and the availability of finance when no other finance is being offered. In addition, the finance is at rates below the rates available on bank accounts, assuring that even those who do not need it will use it.

However, this approach to housing policy is in danger of developing an expectation on the part of the public that the state should continue to shoulder a significant part of their housing cost, and not just for the poor.

NHA is no longer organizing for the development of additional ownership housing on a subsidized basis, but is offering its services to private land owners. Such an activity tends to attract hidden subsidies and has the potential for re-introducing an element of unfair competition with the private sector.

C. 2 Current Subsidy Schemes for Owner-Occupied Housing

The current government has been relatively restrained in the creation of new schemes for the subsidization of housing or housing finance. The result is that there is only one major rental scheme in operation currently (the social rental for young people) and one ownership scheme, the Housing Savings Banks, and both were started under the previous government. As noted in Section VII, this situation may be good for the economy but may leave a political vacuum that will be filled by new schemes.

C. 2. 2 Housing Savings Banks (Bausparkassen)

As in several Central European countries, Romania has also adopted a version of the German and Austrian system of separate contract-savings banks for housing, Bausparkassen. These institutions are designed to collect savings deposits at a below-market rate and recycle the low rate on their funding into low rates on their loans.

In principle, if the only goal of the systems was to reward those willing to save at a low fixed rate by giving them a loan at a low fixed rate, such a scheme could be offered by any regular bank and without subsidy. However, such an approach has been tried and found generally unattractive to the public, mostly because of the illiquidity of the savings during the period of accumulation and the inflexibility of the timing and amount of the credit. Thus, in the Bauspar model, subsidies are added to the scheme and it is administered by specialized institutions. The possible social rationales for the system are discussed below.

Operational Details. The Romanian building society system can be summarized as follows:

Main Act:	October 2002, first operations in June 2004
Regulations:	MTCT regulates and supervises the premium payment. The NBR regulates and supervises building societies themselves, following certain special regulations and restrictions, modeled mainly after ones in Germany.
Yearly Premium:	In 2004 - 2005, 30 percent of savings but limited to the monthly average gross salary per economy. Starting with 2006, 15 percent of savings but limited to EUR 120. For persons under 35 years or with children, the premium may vary between EUR 135-150.
Minimum Saving Period:	18 months to get housing contractual loan (currently at 6 percent) if 40 - 50 percent of contracted sum is saved. Interim loans are available at a market rate. Saving for 5 years required to cash the premium without use for housing, but only 2 years with housing use.

Other relevant aspects of the system include:

(1) Interest and premium on savings are exempt from taxation (interest on regular deposits is subject to taxation).
(2) Parameters of the state premium are embedded in law, with Parliament action needed to change it.
(3) Even though the maximum premiums are stated in euros, the savings and any credits are stated in RON. Thus, the comparable interest rates for saving or credits through regular banks are those for RON.

The first building society in Romania was set up in late 2004 and a second in mid-2005. Both of them have German and Austrian Bausparkassen participation.

Table C-1. Activities of the Building Societies in Romania

	2004	2005	2006 (est.)
New Contracts	22,919	50,429	100,000
Open Contracts (est.)	20,000	70,000	160,000
State Premiums (mil. EUR)	2	5.7	13.0

In 2004, the maximum subsidy was achievable by saving RON 2760, and RON 3240 for the second year (2005). In 2006, this maximum will be between RON 2800 and RON 3500. With interest and premium, this would provide total savings of between RON 6700 and RON 8400 after two years. If this is saved by a person under the age of 35 and with no children (maximum premium is 135 euros), and matched with a loan of the same size, the total will be almost RON 15,000 and if a spouse also establishes a savings contract and takes out a loan, a couple can acquire a total of as much as RON 30,000 towards a housing investment. This is about EUR 8,500 at the current exchange rate, large enough to significantly assist with the acquisition or major renovation of a flat.

If the contract is kept for 5 years by this couple, this amount of savings plus credit would be about EUR 22,000.

Savings, Loan, or Investment? Thus, the scheme is well designed for helping households create a pool of funds for housing purposes. However, if the premium is too high, it also creates a very attractive investment for general savings. It is also explained below how it can provide a large subsidy to the repayment of mortgage loans.

A Bauspar Account as an Investment

Save EUR 900 euros (EUR 75 per month) over the course of one year.
Receive an interest of 3% on those funds as they are paid in.
End up with EUR 912 at the end of the year.
BUT get a premium of EU 135 (15%) at the end of the year, so the total is EUR 1047.

This is the equivalent to earning a rate of interest of 31.4%.
Why is this more than 15% or 16%? Because, on average, only half of the amount is in the account during the year (in fact, all of it can be put in at the end of the year).

However, one cannot remove the savings yet….so continue for a second year and then withdraw funds and start a new account.

The net effective interest rate falls to **16.9%** (because the previous amount is earning only 3%). The actual rate can be higher (up to 22%) if the savings and withdrawal process is optimized.

As shown in the box, the current state subsidy of 15%, combined with the current rule against taking the funds out in less than 18 months, creates a return on investment that is much higher than another other investment vehicle. And this return is exempt from taxation.

How should such a scheme be analyzed, as an investment scheme or as a housing subsidy scheme? Indeed, it is complex to fully appreciate all of the potential eventualities, both from the perspective of the budget analyst, the policy analyst, the Bausparkassen themselves, and certainly the customer. This is one reason why the savings institutions prefer to be able to offer a large enough subsidy to make it more than worthwhile to the public and themselves to deal with the difficulties of understanding the product and uncertainties as to its profitability.

But, in our opinion (partly based on the experience in Central Europe), many, if not most, households will view it as a relatively short term investment or savings vehicle.[37] In other words, they will focus on completing the contract is 18-24 months, rather than savings over 5 years in order to qualify for a large low-rate loan after 5 or more years. In addition, most households with any amount of significant cash assets already, i.e., 1,000-5,000 euros, either within that household or the larger circle of immediate family (parents or adult children) will look closely at the option of combining contracts for several people, including minor children within the first rank relatives. Thus, they will look at the product as involving contributions to accounts of up to 2-4,000 euros per year over several contracts.

What do the numbers look like in this case? Under the current regulations, a family of 2 spouses (assumed to be under 35) and 2 children can open 4 accounts and receive, in March 2007, the maximum of EUR 560 in premium by depositing an amount of EUR 3733 in December 2006.[38] This amount could be new savings or simply drawn from an existing account in a bank. If the family deposits a similar amount at the end of 2007, it will have in its account a total of EUR 8,587, plus the 3% interest paid by the Bausparkasse, by March of 2008.

The household will then be free to withdraw the full amount soon thereafter (the exact timing varies across the Bauspar institutions and with certain other parameters). Depending on the exact days of depositing and of withdrawal, the effective rate of return on these savings would range from 17-22%.[39] This can be compared with a rate of 5-6% currently payable on bank accounts.

Economic and Social Impact. The main public policy argument being made in Romania is that the system is an ideal method of supporting renovations in existing housing, both through the savings premium and the credit.[40] There may yet be some truth to that, but, in our opinion, it will not be the principal reason for opening such accounts unless several modifications (discussed below) are made. As it is currently configured, we expect that the system will be used primarily as a good investment opportunity.

Does this mean that the money that is going into the accounts will not be new savings, but rather just being moved from another account (i.e., an investment of existing funds)?

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[37] One of the authors has written extensively on the operations of the Bauspar systems in Germany, Central Europe, and Lithuania. These reports are available at www.fanniemaefoundation.org/programs/jhr/pdf/jhr_0301_ch4_Germany.pdf on Germany, http://www.polandhousingfinance.org/Poland/PDF/HFTransition.PDF for Central Europe, and wbln0018.worldbank.org/ECA_Urban/AR/SecDoclib.nsf/fd3f251023ca1bdc85256896006bf440/13c9e9eba8ac87f885256ce2004590ae/$FILE/Doug's%20FINAL%20REPORT.doc on Lithuania.

[38] The regulations award the premium based on the total savings during the year, even if deposited on the last day.

[39] This rate of return would have been 40% if the premium had not been reduced from 30% to 15% for 2006.

[40] Bausparkasse promoters have adopted this line of argument after the claim made in Central Europe that it would boost construction was unfulfilled.

In theory, the higher rate of return available on these accounts could elicit a higher rate of new savings. This may happen to some extent, but it does not override the fact that many households, especially those with higher incomes, have a few thousand euros in cash savings already (or could save such an amount anyway at ordinary rates). In that case, they will simply find these accounts an attractive investment once they understand the product.

Because of this, there can be a negative effect on the term structure of liabilities in the commercial banks, as funds that would normally be kept as time deposits in the banks are instead placed in the Bauspar system. This is the case in the Czech Republic, where 40% of all time deposits in domestic currency are held in the Bauspar system and 84% of all deposits of 1 year or over.[41]

This aspect of the system creates an awkward situation for the banking sector. Commercial banks and even investment funds will not be able to compete with Bausparkassen for medium and longer term savings if the rate of return on the Bauspar accounts remains as high as it is currently.

Even if the accounts are seen primarily as an investment, the withdrawal of the funds and the premium (before 5 years) requires that they both be spent on a housing purpose. This seems to imply that the housing sector will benefit from the subsidy. But logic does not support this in many cases. If a household is planning to make certain housing expenditures anyway (e.g., repay its mortgage, enclose a balcony) and these expenditures are larger than the invested funds, then the household can view the subsidy as just giving it more money to spend on other things. Only if it was planning to spend less than this, then it may feel encouraged to spend more on housing, but the total of all of these increases in the country may be very small compared to the cost to the state.

It should be noted that the definition of “housing purpose” is specifically broad enough to cover nearly all such possibilities, ranging from the acquisition or construction of a housing unit to simply the painting of one's home, purchase of a sink or bathtub, and, importantly, repayment of another housing-related loan.[42]

This last use of the funds should be emphasized. In fact, the Bausparkassen themselves, when they make a interim loan after just 18 months, put some of those funds aside to be placed into the participants savings accounts so that they can earn the state premium. In other words, the Bauspar scheme provides loan funds in order to earn the premium on what, in theory, are savings (the loan rate is 8-9% while the rate on the “savings” is 15% or more, so this is worthwhile). Those who borrow from regular banks may also find it

[41] Source: Czech National Bank, December 2005. In the Czech Republic, only 12% of deposits are held in foreign currency.

[42] It is clear that it will be easy to provide a “housing purpose”, because the private ownership rate is over 97 percent, most homeowners have some significant maintenance expenses, and repaying existing housing loans or funding the housing expenditures of first-degree relatives qualifies for both the savings premium and a subsidized loan. Indeed, some have suggested that it may not be difficult to arrange false invoices for repairs equal to the amount. The Bauspar institutions are not required to investigate such documents.

advantageous to borrow extra in order to place those funds in a Bauspar account, earn the premium, and then withdraw the funds to pay off their mortgage loan.

This discussion has emphasized so far the attractions of the product as an investment vehicle. However, holding the funds to maturity in the Bausparkasse does entitle one to a similar size loan, repayable over a time period generally longer than the savings period. The rate on the loan, currently being fixed at 6% for new contracts, is attractive because it is lower than for similar credits on the market. But it is fixed at the time of setting up the contract, and there is a chance that market rate loans will be available at similar rates in several years.[43] Thus, it is likely that most people would focus on the accounts as investment vehicles first with the knowledge that the credit entitlement may be attractive at the end.

The attraction of the accounts as an investment depends greatly on the state premium. The initial premium was set a very high level, partly because interest rates were high and, following the same strategy that had been successful in Central Europe, to get the public supportive of the scheme as rapidly as possible. But with the accession of the new government in 2005, one of the first policy steps it took was to start a review of the Bauspar scheme. This created uncertainty that delayed widespread marketing of the scheme, but did eventually lead to preservation of the scheme at a new premium more in line with the new lower interest rates that currently prevail. However, as indicated above, the system still provides a much higher level of return than other investments, simply because it is the only investment that is so subsidized.

Finally, it must be asked why there are any advantages to delivering loans for renovations through such institutions, instead of banks. The Bausparkassen will sometimes claim that the banks charge much higher rates for small loans or will not provide them, but the expectation would be, and the reality is, that commercial banks want to serve every facet of the consumer credit market. If their products are more expensive, that is because they do not get subsidies. There is nothing about the structure or operation of a Bauspar system that makes their loan inherently cheaper to deliver.

Should Romania Keep the Bauspar System? In summary, the weaknesses of the Bauspar system include the following:

1. The operational costs are high, because extra costs are associated with the operation of the specialized institutions.
2. There is no direct budget limit on how much it costs, i.e., the program is open-ended. Moreover, much of the cost each year depends on past contracts and the premium amount is set in a separate law that is politically difficult to change as budget and interest rate circumstances change
3. The effective "subsidy" delivered depends on the course of interest rates over the next 5 years. If rates go down further, the actual subsidy to renovations or other

[43] This is what happened in the Czech Republic. Very few loans have been taken out because rates on regular mortgages were as low or lower. Meanwhile, the Bauspar banks were locked into paying more on the savings than what banks were paying. There has been a profitability crisis in the system.

housing uses will be small, while the subsidy to those putting funds in as an investment will be high.

4. In general, most subsidy goes to it as an investment product, not a loan product, and families with 5,000-10,000 euros to invest get very large benefits (current rate of return is 17-22%).
5. There is little evidence that the system increases housing production or renovations, nor is it actually used by many people to establish their credit worthiness.[44] Most housing uses that permit receipt of the premium after a short savings period will be routine, and the use can be anywhere in an extended family. It is even difficult to assure that the use is really for housing purposes, since there is no inspection.
6. If they receive a large subsidy, Bausparkassen can distort the financial system, with an unfair advantage to attracting savings deposits and giving small loans.
7. Any valid social goal of the system can be met more efficiently through other, more direct schemes, such as cash grants or direct subsidies of interest rates on loans (see below).

If there is relatively little social or economic value in a Bauspar system, why did several Central European countries adopt it during the 1990s? A review of the historical record shows that the basic answer is that the systems were strongly marketed by the Bauspar companies in Germany and Austria. In all cases, the promoters worked through Parliamentarians to enact it, rather than through governments, which generally rejected such schemes as potentially too costly. There were many arguments made in its favor, especially emphasizing the promotion of new construction and savings, both of which were high priorities in those countries at the time. Generally, these arguments have not been borne out in practice. But in all the countries but Hungary, the schemes rapidly became enormously popular with the public as an investment, and have grown to be the major investment vehicle for large parts of the population, as well as enormous burden on the state budgets.

From the point of view of effective public policy, there are three questions to be answered:
(1) what are the social and economic effects?
(2) are these worth the expenditure of funds that could be used in other ways?
(3) are there better ways to achieve the same goals?

Based on the analysis above and experience in Central Europe, there are few valuable effects of the scheme, other than a great popularity with the middle and upper-middle class as an investment vehicle. If the effects are not strong, then it is clearly not worth much in expenditure, other than as a popular policy. This popularity aspect of it has not yet been achieved in Romania, but probably would have appeared if the premium had not been reduced when it was.

[44] These statements are based on the actual operations of these schemes elsewhere in Central Europe.

The implication is that the scheme should be phased out. Such a step is not unheard of. Poland phased out a special version of the Bauspar after finally defeating the forces pushing the Austrian-German approach. Basically, the state would need to offer the Bausparkasse low rate funds to provide loans who truly want a them. Such a step would be much less expensive than even funding the program as it stands for another year.

If the program is not phased out, and the premium is not reduced, the annual burden on the budget may grow rapidly. What cost only EUR 6 million in 2005 can cost 60 million in 2007, and EUR 100 million in 2010 (it cost over EUR 500 million in the Czech Republic in 2003 but only EUR 24 million for Hungary (this has gone up since then)). As it grows in popularity, it tends to become more difficult to control the cost through adjustments in the premium.

If this were to be done, it is very likely that an alternative program would need to be launched. This program should be designed to be more effective and more subject to budgetary control. How it should be designed depends on just what the government really wants to achieve through it.

If it seems not desirable or feasible to end the Bauspar program, the next best course would be to cut the premium further, to 10%. This would still leave the program capable of achieving what its proponents claim for it, namely giving Romanians a good opportunity to save and get a loan for doing renovations.[45] But it would reduce the attractiveness as an investment (to a rate of return of 6.7% after 5 years). It may turn out that there are too few who are interested in participating on that basis to keep the system profitable enough, but then at that point it should be folded into the banking system as a specialty product or ended.

If the premium can not be cut because it is so visible, another approach to the same goal would be to require a longer period of savings (say 3 years; Hungary requires a minimum of 4 years), even with a housing purpose for withdrawal. This would not affect those who sincerely want the system to provide a low rate loan and a return on savings a little better than in the banks, but would reduce the excessive rate of return on the accounts[46].

C. 3 Proposed Subsidy Schemes for Owner-Occupied Housing

C. 3. 1 Parliament's 20% Subsidy Scheme.

Recently, the Parliament passed a proposal originally made by several Deputies to create a new scheme for the application of a 20% discount for the purchase of newly

[45] This perspective was adopted by policymakers in Hungary, and sharply limited the growth of the system.

[46] In addition to the programs noted here, there has been at least one tax based subsidy scheme offered for housing. From 2000 until the tax reforms of 2005, there was a deduction for tax calculation for expenses associated with renovations in multi-family apartment buildings, up to RON 1500. This small amount was not enough to encourage the public to deal with the requirements related to approvals of renovations and verification of expenditures and the subsidy was not taken up in any significant way.

constructed houses. The scheme seems to essentially extend the sort of subsidy offered previously by the NHA in response to the application of VAT to its ownership houses. Very importantly, it would apply only to those houses built by developers (specialized entities) and also it would apply to the total value of the house, not just the direct construction (which was the basis of the NHA discount). Also, the subsidy would be available to all purchasers of such eligible houses, not just those who did not previously own a house.

There are several aspects of this program which are not clear. The most important is whether the program is an entitlement, such that all buyers and houses which meet certain criteria benefit from the subsidy, or is the total amount of subsidy limited in any given year, and thus to be allocated in some way. It seems likely that it is intended to be limited to the budgeted amounts each year, and thus an allocation process will have to be specified.

Secondly, what exactly is intended by the term "specialized development entity" and can it be turned around so that it applies to almost all newly constructed houses? Presumably, this term is intended to be defined in regulation and probably refers to entities for which the VAT tax is collected because expenditures are reported. If it can be defined in such a way, it implies that only those who pay the VAT will benefit. But it is difficult to know in advance how many housing units will be eligible.

Third, it is unclear what the social purpose of the program is. Is the goal to boost the business of housing developers or to boost housing construction in general or to compensate for the application of the VAT to housing, a step that the Minister of Finance refuses to modify or rescind?

Fourth, the scheme also requires that the beneficiary take a loan but this seems to be oriented to paying for the construction costs in advance. This could be a problem, however, if some young people can not get a loan approved and instead are relying on funding from parents. Perhaps, though, it is fair to exclude such possible beneficiaries.

What is likely is that this step is a good example of the sort of schemes that are developed by those in the political sphere in response to a perceived void in the state's support for the housing sector. It is an example of the sort of poorly designed and loosely motivated policies that can arise when the government itself does not offer a sufficiently generous and politically attuned program itself.

Taking the program at face value, it may strongly support a shift of housing production away from the traditional mode of self-construction and towards greater reliance on organized construction companies, and perhaps specifically to large scale developers. The extent of this shift depends on the extent that self-builders are currently able to evade VAT and employee taxes with self-building (i.e., by paying workers off the books) and the extent that developers and contractors do fully pay such taxes. These are empirical facts that need to be investigated.

As it stands, the program would specifically benefit households with above average incomes and living in the larger cities where such large scale, organized development is more viable. But it does depend greatly on the details of the allocation mechanism. Does it focus the subsidies on young first-time owners? Not explicitly, instead settling for excluding those who already own a house of more than 100 square meters. Will there be size and price limits? The scheme provides for a house value limit of EUR 100,000, a fairly generous cap. Will rural builders be able to get around definitions of "specialized entities?" Will it be limited to 20% on the amount that is subject to the VAT?

The social benefits would be associated with some encouragement of additional construction of housing. If applied to almost all new construction, it may easily have the undesired effect of permitting builders to raise prices on new construction for several years until competition and greater supply drives prices back down. This latter effect also depends on the supply of serviced land.

C. 3. 2 Draft MTCT 20% Program

Apparently in response to the Parliament's action, the MTCT has drafted an alternative program as a substitute. It would embrace the general approach of offering a 20% subsidy for new houses built by a developer, but target this subsidy in three key ways. First, it would be limited to those who do not nor have ever had a home before. Second, the beneficiary would need to be under 35 years of age. Third, it would come with relatively severe restrictions on the size of the house, and income, and price, and no earlier subsidy (presumably excluding previous occupants of rental housing for young people).

This proposal also includes a requirement that the beneficiary take a mortgage loan.

These restrictions are a major improvement in the social efficiency of the program, such that less of the subsidy would go to people who would have done the same thing anyway, i.e., a greater proportion goes to people who would not have considered building or buying a new home

But in general what is the rationale for such a program and how can it be improved?

One of the first rationales is that a program fulfill a basic political need for a perceived response by the elected officials to what is perceived by a significant share of the public to be a problem. In this case, presumably there are several problems being addressed simultaneously, an attractive attribute. There is the concern about the price of housing in general (by boosting new construction), there is the concern about the access to housing by younger people (by focusing it on first time owners) and there is the perception that housing should not be VAT taxed (by offering discount that is about the same in % as the VAT). In addition, it does not hurt politically that the program shifts interest towards houses built by developers. To some extent, this may be fair because they bear higher costs due to having to pay social taxes on more of their labor costs.

The weaknesses of the proposal are with respect to other political agendas. It does very little directly for people with below average incomes. At least in urban areas, where the developers are more likely to be operating, these people are very unlikely to be in the market for a new home as their first home. Only the unusually high income person would take such a step instead of buying an older home. In fact, there needs to be some safeguards that it is not used by truly higher income young people to buy expensive but smaller new flats in the central city. This may be addressed by the clause that permits MTCT to set price limits per square meter.

On the other hand, any program that effectively encourages the construction of additional new housing can be seen as effectively helping to limit the rise in the prices paid for older flats by thousands of others. As noted above, such a hypothesis depends on the effective supply of new houses being reasonably flexible. If, instead, the presence of the subsidy simply permits developers to charge more for their houses, instead of building more of them, this is not productive.

One weakness of both schemes is that there is an absolute limit on the size or vale of the unit. Such "knife-edge" limits can distort housing markets significantly, with no units priced or sized within 10-20% of the limit. It may better to start a phase out of the subsidy at a lower level (say 80 square meters) and then eliminate the subsidy when it is reduced to less than half of the maximum amount (e.g., 5% at 100 square meters).

How can these schemes be systematically compared?

Impact on budget: If both are limited in funding, i.e., not entitlements, the impact on the budget would depend on that budgeting. Given the much wider potential eligibility under the Parliament scheme, it may cause greater pressure for a large budget amount, and thus that scheme must be counted as probably more expensive. If either is an entitlement, then that scheme could be hugely more expensive, and the broader the scheme, the more expensive. However, it appears that the MTCT draft scheme would not have that many potential beneficiaries, and so could operate almost as an entitlement.

Impact on housing market: The more narrowly targeted scheme must have a larger impact on the market, per RON spent. The Parliament scheme permits many people who could plausibly already buy or build a new house to simply save money in the process or to buy a larger one. The MTCT one focuses on those who, on average, are much less likely to be in the market for a new house, and thus, to the extent they use the scheme, they are more likely to have been coaxed into buying a new house because of the scheme.

In either case, if indeed the supply of new housing is too inflexible (as it will be in the short run and may be also in the long run), the net effect of both might be to raise house prices.

Impact on younger people. Here again, as long as the programs are not entitlements, the MTCT scheme must have a larger effect on young people's housing because it takes many more people (per RON) out of the market for existing housing and puts them into the market for new housing. This movement of buyers could reduce pressure on the market for older housing. Because the scheme also favors those with the economic capacity to buy a new housing unit, there is a favoritism to those who have skills that might be drawn to emigrate.

C. 4 Alternative Subsidy Schemes for Owner-Occupied Housing

VAT exemption: A lower rate of VAT on the new construction of housing could be a potent tool towards reducing the price of new housing. Moreover, because the price of older housing has now risen up towards the cost of new housing, any reduction in the price of new housing would tend to also feed back towards lower bids on the stock of existing homes. However, to achieve this effect, this would essentially be an entitlement program for all purchasers and builders of new housing, not just first-timers and not just homes built by developers. In other words, it would be very expensive and non-targeted to just those who might be considered socially in need of assistance.

The Minister of Finance may have a more philosophical basis for rejecting such a program. By working through a VAT exception, a sector can subsidized without having to go through an annual budgeting exercise where the amounts of subsidies can be scrutinized. The VAT reduction becomes an invisible or implicit subsidy, and those are not as subject to as much scrutiny or prioritization as the normal budget is.

Interest Rate Subsidies: A very popular approach to housing policy is to have the state either provide low-rate funds or to pay part of the interest that people pay to financial institutions for housing-related loans. This is done in almost all countries in at least some cases and was done in Romania from 1997 to 2001.

There are several shortcomings to such an approach, but there are also advantages and it may be appropriate in some cases. The shortcomings include:

4. Most of the cost of such schemes, usually 90% or more, is in the future and not accounted for in the current budget. This becomes a burden on future budgets that can no longer be changed.
5. If the subsidy is large enough to really save people money and permit a much larger loan, it makes the rate so low that the borrower has no incentive to repay early, and maybe an incentive to delay repayment as long as possible (e.g., if the rate is only 5% for 20 years, then it may be better to keep money in a bank rather than repay the loan early).
6. Such a subsidy usually ignores that the household income will rise over time, and thus the subsidy is much larger than it needs to be to permit the household to repay a bigger loan. Any subsidy that reduces the rate for 20 years into the future is inherently very inefficient.

But such subsidies may still be attractive because the public finds such a program easy to understand and to see how much it benefits them. Also, because most of the cost is hidden in the future, such a policy is convenient when the budget is tight, since the effect can be obtained now while the cost is paid over a long future time (this sort of effect is a major source of Hungary's budget deficit).

They also have an advantage over tax subsidies because the eligibility for it can be more refined through regulation and that the number of such subsidies to be awarded in a year can be limited (it is not open-ended like a tax subsidy is).

A viable solution in some cases is to offer such a subsidy in a manner where the subsidy declines over the first 5-10 years and to try to calculate in the budget the present value of these future costs and set them aside this year.

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Attachment: Letter from Raiffeisen Banca pentru Locuințe

(please see dicsussion just above to see the authors' views on the assertions in this letter)

To: Ms. Mariana Ioniță, Director General, Direcția

CC: Mr. Iuliu Bara, Consilier Ministerul Transporturilor, Constructiilor si Turismului

Dear Ms. Ioniță,

We would like to thank you for inviting us to participate in the roundtable discussion of preliminary results of the report "Housing Policy and Subsidy Review" in Romania.

During the discussions, it was our understanding that the preliminary conclusions of the report do not have a complete approach for the collective saving-crediting activity for housing purposes (hereinafter referred to as "bauspar system"). We consider that, irrespective of personal beliefs or assumptions, the report should present an evaluation of different financing systems, highlighting the arguments for and against for each system, based on which a decision can be taken regarding which system or combination of systems should be promoted.

Bauspar system is present in Europe, both Western and Central and Eastern part, for a long period of time and its beneficial results cannot be purely ignored or minimized.

Bauspar system is one of the most important loan providers in housing finance in countries like: Germany (37% from the total volume of housing loans), Austria (25% from the total volume of housing loans) or Slovak Republic (50% from the total volume of housing loans).

Generally, any financing mechanism may have certain advantages and disadvantages and obviously the bauspar system does not make exception from this reality. We will outline below some statements about the bauspar system presented in a paper issued by the Economic Commission for Europe (Geneva), within United Nations, called: ***"Housing***

Finance Systems for Countries in Transition, Principles and Examples", as well as from the experiences registered by other bauspar banks.

General overview

Bauspar system is popular among countries in transition. The existing schemes vary from one country to another: systems adopted by Czech Republic, Slovakia, Hungary and Croatia are similar to the German/Austrian model (establishment of separate financial institutions, Bausparkassen) while in Poland and Slovenia they are administrated by universal banks. The Slovak and Czech Republics introduced the bauspar systems in 1992 and respectively in 1993, Hungary in 1997 and Croatia in 1998.

Please find below some of the conclusions drawn in respect of the results of applying the bauspar system:

- <u>It provides for a more efficient allocation of funds to smaller projects including renovation and modernisation.</u>

Banks are institutions with numerous business lines, expensive branches network and costly, complex systems. Banks by definition have to focus on the business segment which provides the biggest profits. Bauspar companies in turn are very focussed (savings, housing loans) and therefore transparent organisations with a clear core business and dedicated to stick to this core business.

A key element for many local economies and the budget seems to be the renovation effort of existing housing. The more increased need for renovation if Romania is supported by the mentality of Romanians strongly orientated to the ownership of their houses which is reflected by the owner-occupied housing of more than 90% of the housing stock. The bauspar system is a strong contribution to the general housing infrastructure, to the quality of individual flats, helps to save energy through better thermal renovation (and therefore helps to save energy cost to the state budget) and gives work and jobs to the small companies in the region where the houses are located, including small towns and villages.

The average loan under a bauspar contract is rather low (in Romania, lower than EUR 10,000) which corresponds to the costs of renovation and modernization projects. According to available figures, nearly 70% of all bauspar contracts are created for this purpose. Due to the rather small amounts involved in projects like renovation and modernization, the mortgage banks are generally not interested in this type of housing lending as it is not profitable for them.

Therefore, the bauspar system covers very well the segment of renovation and modernization of the existing housing. Furthermore, the bauspar system shows very low default rates, around 0.02% of total lending business, therefore it may be considered a tool for lowering the credit risk in the economy.

- The state premium mechanism represents a capital mobilisation (increase of saving process) for housing purposes.

As regards the saving process, Romania is still far behind many other countries. It can be concluded that this is already a critical situation: within the period of 1990 – 2001, the average saving rate in Romania (18%) was by 4 percentage points under the average saving rate of the countries in transition (21.95%) and almost by 6 percentage points under the EU average saving rate (23.32%). Furthermore, the difference between the saving rate and investment rate was also high (6.38%), over the average rate registered by countries in transition (5.38%) and over the EU average rate (4.42%).

It can be therefore concluded that Romania needs to stimulate the increase of the saving process, by all possible financial instruments. This role is undertaken by the state premium mechanism which is available under the bauspar system.

- The state premium mechanism represents a moderate burden to the state budget.

The experiences registered by countries like Slovak and Czech Republic (countries where the bauspar system is very successful) demonstrate that there is only a moderate and constant burden on the state budget in both countries. For instance, in Slovak Republic the state premium varied between a 0.33% from the state budget in 1993 to 1.24% from the state budget in 2001. In Czech Republic, the state premium varied between 0.07% in 1994 to 1,32% from the state budget in 2001, as presented below:

State	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Slovak Rep.	0,33 %	0,82 %	1,25 %	1,73 %	1,23 %	1,24 %	1,07 %	0,95 %	1,24 %
Czech Rep.		0,07 %	0,25 %	0,46 %	0,70 %	0,86 %	1,04 %	1,20 %	1,32 %

- It provides for a shift from short term savings to long term loans at a fixed interest rate. The state thus contributes to the stabilization of the economy and to the curbing of a possible inflation.

Bauspar companies have also an educative effect of saving. This saving supported by the budgetary subsidy in the form of a state premium to the savings helps to build up net worth of lower income families with the opportunity to receive a housing loan at a fixed rate for very long period of time (these families will not be able to receive the mortgage loan as they will not be considered good risk by the banks).

- It provides for a country wide coverage versus the banks' concentration on big cities and towns.

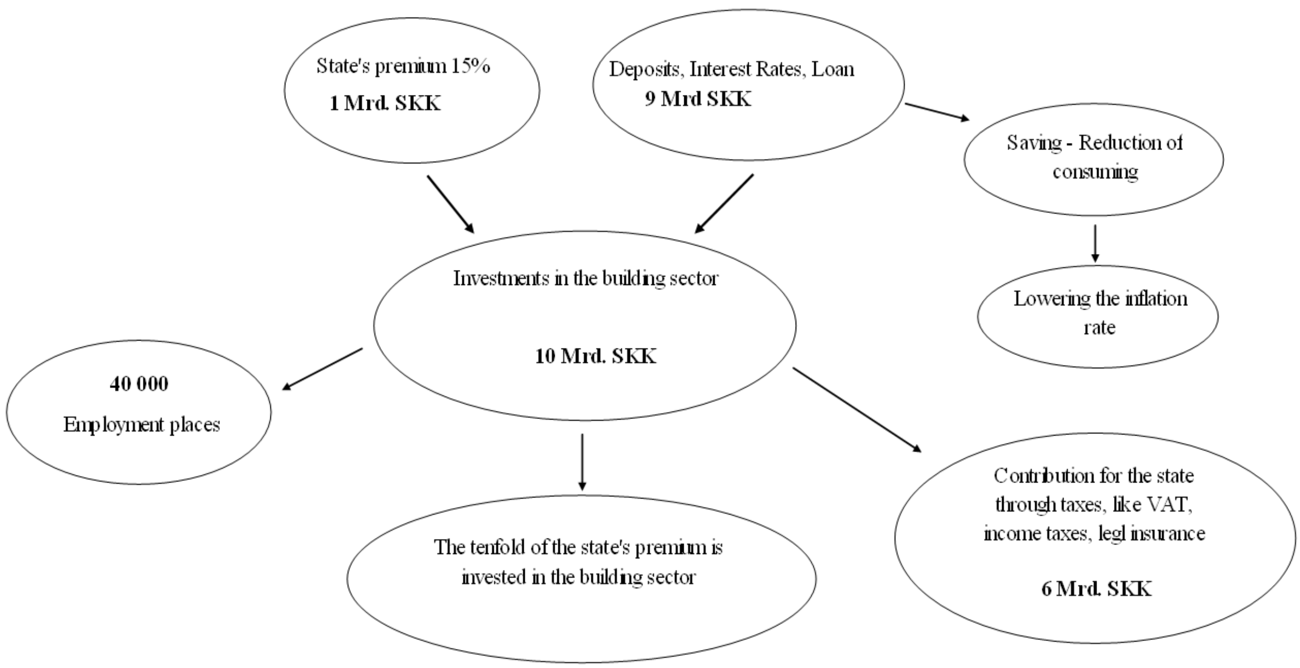
Banks operate through branches and agencies while Bauspar banks operate through agents. The agent network provides for a country-wide coverage down to little villages.

This ensures work and jobs to local smaller companies and not only the big ones in bigger cities. Therefore it satisfies more the needs of families also in rural areas where the families are bigger with less alternatives for loans in these regions.

- <u>It is a stronger multiplicator to the budgetary spending, providing for budgetary income which exceed the subsidy spending. The premium may therefore represent a profitable investment for the state.</u>

The bauspar system determines the development of the construction industry and its related activities which generate an increase of the budgetary incomes coming especially from taxes (i.e. salary tax, social contributions, income tax, profit tax, etc.).

Based on the available information from Slovak Republic, 1 (one) monetary unit invested by the Slovak state under the premium form to the bauspar system, generates a 6 (six) monetary units income for the Slovak budget, as presented below:



As a conclusion, for any particular country, it is advisable to have more than just one housing finance scheme in place; in order to mobilize a maximum amount of funds dedicated to housing, a combination of systems is preferred. Each system assumes a certain function within the market so that systems complement one another.

Thank you for your assistance and we are at your disposal for further discussions regarding the characteristics of the collective saving-crediting activity for housing purposes.

Yours faithfully,

Mircea Ionuț Costea
President Raiffeisen Banca pentru Locuințe S.A.

ANNEX D: STATE INTERVENTIONS IN RENTAL HOUSING

The government's primary approach to the rental sector has been to directly engage in the construction of new flats to build up the social housing stock. Over the past decade, two social rental programs were initiated and remain active. One is an older program targeted on poor and needy households and is operated by the MTCT. The newer program is targeted on young people who may or may not be poor and is run by the ANL. Although they are operated by different entities, both programs are governed by the 1996 Housing Law as amended, and the major differences differ mostly with regard to the intended beneficiaries.[47] These programs have only begun to produce a significant number of completed units since 2000 (Table 5.3). Very little social housing was built between during the 1990s.[48]

The social rental stock is a major component of the rental market. Over half of all rent-paying tenant households (as reported to the Census) in both urban and rural areas live in units owned by a public entity (Table 5.2). The social housing new construction programs have been adding to a supply of existing units that the government still controlled after privatization took place. This social rental stock that the government held immediately after privatization took place was generally not attractive from the government's perspective because much of it consisted of units that tenants refused to privatize or units that were subject to restitution claims. Some prospective owners likely refused to privatize units that were in very bad condition, and hoped to be offered better units. Some poor tenants may have desired to avoid the financial burdens of ownership and preferred to remain under state care. In cases where units are subject to restitution, the government is renting the units to tenants until the ownership status of the property is resolved.

The evolution of the rental sector in Romania has followed a pattern observed throughout South Eastern Europe that some analysts refer to as "residualization" or "marginalization."[49] This term refers to a privatization process that leaves behind a small residual social rental stock in relatively poor condition. Local administrations then become responsible for this housing, which is relatively costly to operate and maintain, and contains a concentration of disadvantaged households.

Romania is unique in that most other countries in the region have largely discontinued state subsidies for the construction of new public housing. Decentralization throughout

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[47] It is unclear if there was a separate short-lived rental construction program targeted on moderate-income households around 1997 to 1999. It appears that the MTCT executed a new social housing construction project that was financed with a USD 60 million foreign credit. This project involved the construction of 1,372 units in 74 apartment blocks, in 72 settlements. The work was contracted to Company Mivan Kier Ltd (a UK firm). If all of this credit was disbursed for this project, the cost per unit would be at least USD 43,732.

[48] See Cosima Rughinis, "Containment and Sympathy: Social Housing and Roma Residents in Romania," Budapest: Center for Policy Studies, April 2004, p. 7.

[49] See, for example, Sasha Tsenkova, "Trends and Progress in Housing Reforms in South Eastern Europe," Council of Europe Development Bank, Paris, 2005, p. 88. Also, see Dubel, et al., op cit., p. 31.

the region has shifted housing responsibilities towards municipalities, but few local governments possess the resources to engage in significant new construction by themselves.[50] By combining central and local budget resources, Romania has started to make noticeable additions to the publicly-owned rental stock, particularly since 2000.

D. 1 Construction of new social and necessity rental housing

The oldest social rental program was authorized by the 1996 Housing Law and is operated by MTCT, which acts as the developer. Through new construction and the rehabilitation of existing buildings, this program produces housing that is intended to benefit poor households and households with short-term emergency housing needs. Housing intended to fulfill emergency needs is referred to as "necessity housing." The social rental housing for poor people component and the necessity housing component are treated as separate sub-programs for planning and budgeting purposes.

The necessity housing component differs from the social housing for poor people component only with regard to targeting. The social housing for poor people is only available to households with monthly incomes below a limit determined annually by the local administration. The necessity housing is available to households, regardless of their income, who need temporary housing because their homes have become unusable due to reasons such as natural disasters and rehabilitation work.

Local administrations are involved in the program in several ways. Local administrations request units from MTCT and provide the land and infrastructure for projects. When MTCT is finished building or rehabilitating the rental units, the local administration takes over ownership, and is then responsible for operating and maintaining the completed flats. Local administrations are responsible for allocating the flats, taking into consideration the recommendations of social commissions that analyze housing applications.

Based on the number of units completed, this program is small compared to the rental program for young people. Table 5.3 shows that between 2001 and 2005, about 3,500 rental units were completed for poor people, while no units were completed for necessity housing. This amount is less than a fourth of the number of units completed during the same period under the program for young people. The budget allocations in each year include funds for new and ongoing work, and should not be used for computing average unit costs. In the case of necessity housing, the funding in 2003 through 2005—years in which no units were completed-- provided the basis for the 128 units that are expected to be completed in 2006.

[50] Tsenkova, op cit., p 91.

Table 5.3
Social Rental Programs - Annual Completions and Central Government Funding (000s ROL): 2001 to 2006

	Rental Housing for Young People		Rental Housing for Poor People		Necessity Housing	
Year	Units Completed (a)	Allocated Resources (000s ROL)	Units Completed	Allocated Resources (000s ROL)	Units Completed	Allocated Resources (000s ROL)
2001	106	508,406,852	441	661,600,000	0	0
2002	2,096	2,379,619,662	607	693,200,000	0	0
2003	4,937	3,369,913,665	1,339	338,700,000	0	5,603,000
2004	4,272	3,991,608,000	926	202,383,000	0	34,616,000
2005	3,435	1,925,150,000	190	323,500,000	0	99,960,000
Total (through 2005)	*14,846*	*12,174,698,179*	*3,503*	*2,219,383,000*	*0*	*140,179,000*
2006 (proposed)	2,000	1,541,000,000	unknown	600,000,000	128	38,640,000

Source: ANL and MTCT

Notes:
(a) At the end of 2004, 9,792 units were in various stages of completion.
During 2005, about 6,817 units were being financed.
During 2006, about 4,500 units will be under construction and about 500 new units will be started.

There are some signs that local administrations might be shifting their priorities away from housing for young people to housing for poor people. The nearly doubling in funding proposed for the rental housing for poor people component in 2006 is the initial response to a sharp increase in requests for this type of housing from local administrations. For 2006, the number of requests reached 7,680. Local administrations appear to be responding to the need to resolve restitution cases and to assist older residents.

The subsidies for this program come in two forms. The first is a capital subsidy, which is the cost of constructing the flats. The construction cost includes the value of land and infrastructure contributed by local administrations. Exemptions from various government fees can also lower costs. Funding for this capital subsidy comes from the central and local budgets, and may include funds raised through international borrowing.

The second type of subsidy is an operating subsidy. The rents charged by local administrations for social housing are determined annually and depend on the location and local conditions (Article 32 of the Housing Law). By law, the rents cannot exceed 10% of the average net monthly income during the previous twelve months, where monthly net income is defined each year by the government (Articles 8, 42, and 44 of the housing law). It is not clear if rents for necessity housing will be set at the same level as rents for other social housing. Income is not a criteria for obtaining necessity housing so these people might be able to pay more depending on the nature of the emergency that placed them in social housing.

Another type of subsidy exists if social housing tenants do not pay their rent. One study found that about a third of the rent due in large cities, and about a quarter of the rent due in smaller cities, was in arrears.[51] Despite low rents, the "marginalization" of the social housing stock produces a concentration of poor households who have had difficulty paying rent.[52]

D. 2 Construction of new rental housing units for young people

The program for the construction of social housing for young people received its first funding in 2001 from a pool of USD 120 million, with the goal of building around 6,500 low-rise apartments for about 16,000 young people. This ongoing program surpassed its original goal by the end of 2003, and by the end of 2006 program activity should reach nearly 17,000 completed units with several thousand more units under construction (Table 5.3).

The target group is defined as young people between the ages of 18 and 35, inclusive. Eligible applicants should not have owned a home or previously lived in social rental housing. They should be permanent residents of the area in which the apartment is built, and have a job in the same area. As part of their allocation process, local administrations use a scoring system that assigns points on the basis of certain criteria. The scoring system tends to give the most weight to the age of the application, educational attainment, and special categories like young people with adopted children and young people from special protection centers. It gives medium weight to factors such as eviction from a restituted house or living in severely overcrowded conditions. It gives relatively little weight to factors such as marriage status and number of children. Because the program is subject to the laws governing social housing, local administrations must enforce a maximum income limit. The law, however, does not specify the basis for calculating this limit, which means it can be almost anything.[53]

The lack of sharp income targeting is intentional and is a reflection of government priorities. The eligibility criteria and scoring system are consistent with policies aimed at encouraging well-educated young people to set up new households and stay in the

[51] Ibid., p. 92. This report refers to material contained in M. Lux, "Housing Policy: An End or a New Beginning," Budapest: Local Government Initiative, Open Society Institute, 2003.
[52] Ibid., p. 126.
[53] The 1996 Housing Law previously linked income eligibility to the income limits for receiving social welfare benefits. Article 42 states, "Families with a monthly average net income achieved during the last 12 months below the monthly net income level per family, *for which social welfare is granted according to the law*, increased by 10 %, have access to a social dwelling, with a view to leasing (sic, *emphasis added*)." This Article was amended in 1999 to read, "Families or persons with a monthly average net income, achieved during the last 12 months, by at least 20% below the monthly net income per family member or, as the case may be, per person, established according to the provisions of Art. 8 par. 2, have access to a social dwelling, with a view to leasing (sic)." Article 8, paragraph 2, simply states, "The quantum of the subsidy is established in relation to the monthly net average income per family member, according to the rules approved annually by the Government."

country. This point is reinforced by the existence of a special sub-program that targets young doctors and other specialists who have insufficient incomes to purchase a home or rent a privately-owned home in the area in which they work. Public officials do not strenuously argue that the social housing for young people program is for poor households. They simply note that a separate social housing program exists to serve the poor.

ANL manages the construction of the flats, and then transfers the completed flats to local administrations, which are responsible for owning, operating, and maintaining them. The rules for setting rents are the same as under the other social rental program. Rents can be no more than ten percent of monthly net income. Local administrations are responsible for paying the difference between the collected rent and the rent necessary to cover the full cost of operating and maintaining the dwellings.

As with other social housing programs, the subsidies for this program consist of capital subsidies and operating subsidies. Based on the first group of buildings built under this program, early experience of this program in which about 6,500 apartments were built for about USD 120 million, the average construction cost per unit was at least about USD 18,462. The funding package for this project included a USD 60,000,000 loan from the Development Bank of the Council of Europe that was matched by a USD 35,160,000 contribution from the state budget, and a USD 24,840,000 contribution from local budgets. It is not clear if the local contribution includes the value of land and infrastructure. It does not appear that the ANL or local governments have to pay back the borrowed funds used for construction. This is clearly not a sustainable financing arrangement as the government cannot endlessly borrow for extremely deep housing subsidies.

As with other social housing programs, the rents charged by local administrations are determined annually and vary according to local conditions. The rents have been set very low (typically, less than 50 euros per month, commensurate with the limit of 10% of net income). While the law limits rent to no more than 10% of net monthly income, it does not appear that local administrations have tried to maximize the potential revenue they could collect from relatively better off young, well-educated households. The current policy seems to allow beneficiaries to live in the units for at least five years. For illustrative purposes, assume that the market rent for similar units averages 250 euros per month, and that the average rent is 200 euros per month. This translates into a 2,400 euros per year subsidy, or 12,000 euros over five years. This conservative example shows how the cumulative rent subsidy can approach the 20 percent credit offered to young people who buy homes with mortgage credit.

The extremely low rents threaten the ability of local administrations to operate and maintain the units over time. For example, assuming a unit has a comprehensive construction cost of 20,000 euros per unit and an annual depreciation rate of at least 3 percent, the amount of money needed sustain a project over the long run would be about 600 euros per year, or 50 euros per month. Routine operating and maintenance fees might cost around 20 to 30 euros per month, meaning that the monthly rent would have to be set in the 70 to 80 euro range simply to prevent the deterioration of the dwelling.

The discussion of financial and physical sustainability just presented applies equally to all of the social rental housing programs. Every program is characterized by extremely deep capital and operating subsidies, and each has insufficient cost recovery mechanisms to ensure long-term sustainability. In virtually every transition country in which widespread privatization of state-owned housing took place, local and central governments experienced at least a temporary sense of relief from the huge financial burden of operating and maintaining units that had suffered from a high degree of deferred maintenance. Romania is in danger of recreating a state-owned stock that will quickly deteriorate without an inflow of additional government resources.

In the case of the rental units for young people program, the low rents pose an additional problem. The beneficiaries are likely to find the subsidy so attractive that they will not want to move out when they become older or richer. It is not clear will happen to beneficiaries once they are no longer eligible to live in a subsidized unit (for example, if they become too old). Will local officials have the political will to force people out of these units? Already there is discussion among politicians and government officials of the possibility of selling the flats to the tenants after a certain amount of time. To do this would be to dismiss the entire premise of the rental program. There are much cheaper and direct ways to subsidize homeownership.

It is worth noting that this program does not do a good job of accomplishing some of the commonly cited goals of social rental housing. It does not, for example, increase labor mobility. Eligibility is largely limited to people who are already members of the local community, so there is no improvement in labor mobility for these households. The housing stock grows due to new construction, but in a limited kind of way because newly constructed units do not necessarily free up existing units for others. The program is likely to facilitate new household formation by reducing “doubled up” households, which occurs, for example, when grown children move out of their parents home. No vacancies are created when children move out of their parents home.[54]

D. 3 Large Scale Social Rental Schemes

The government is interested in expanding social housing by bringing in other producers. They seem to envision a Western European-style social rental housing sector in which the private sector gets involved in the provision of rental housing on a non-profit basis.[55]

[54] It can also be argued that ANL activity in the rental sector can slow the development of the private sector rental market. As in the new construction for sale market, rental developers must compete with ANL for access to serviced land. Also, by focusing on professional young people, the ANL takes away some of the best potential customers for the private rental market. By expanding the rental supply, the ANL also suppresses market rents that could encourage more rental housing production by the private sector.

[55] Portions of this discussion of European experience with social housing are adapted from a review prepared by Raymond J. Struyk for the Lithuanian Housing and Urban Development Foundation. This

Traditionally the target group for this type of housing in Western Europe has been in the 40th to 70th or the 50th to 80th income percentile ranges. However, in recent years governments have been encouraging social housing providers to accommodate poorer households than those suggested by these ranges.

One basic issue that is rarely discussed is why this sort of public involvement in the housing market is appropriate. It seems to be a special feature of Western Europe that may have grown over time in reaction to a history of popular and political dissatisfaction with private landlords. (Such schemes for middle-class rentals do not exist in the US or most non-European countries.) Notably, prior to World War I, most of the middle- and working-class housing in almost all large cities in Western Europe (and the US as well) had been built by private investors and held out for rental. The impact on the wars on rents, the use of rent controls, and the rise of strong rights for tenants had the effect of marginalizing that source of rental housing and creating a void after WWII to be filled with "social rentals" to varying degrees across countries. In several cases, such as Britain and Holland, the "social sector" effectively shut down the private supply.[56]

The appeal of non-profit social housing is derived from the belief that the organizers of such housing are operating for the public good (in contrast to the untrustworthy private landlords), and that they will reinvest their net income and use the subsidies they receive to offer units to moderate-income families at low rents on a continuous basis. Governments generally provide support to non-profit social housing providers through capital subsidies and operating subsidies, often a combination of both. Across Europe, a wide variety of private organizations engage in social housing production and management on a non-profit, or limited profit, basis including for example: housing associations, housing cooperatives, trade unions, employee groups, religious organizations, and private developers. To simplify the presentation, we will refer to all of these as non-profit social housing providers. In reality, there is little agreement on the definition of "social housing" even without the added complication introduced by the term "non-profit."

There is a close connection between the type of funding mechanism and the target group. If the target group is in, say, the middle portion of the income distribution, it might be possible to use deep capital subsidies alone to obtain rents that are low enough to be afforded by this group. The problem with this approach is that rents are typically set at the same price per square meter for all tenants. Because this price is set at a level that is affordable to the poorest households in the target group, it means that richer households

material was included in Katsura, et al. "Program Evaluation and Redevelopment Study," The Urban Institute, Washington, DC, January 2003.

[56] Rent control was widely used after WW I. to protect the tenants against the rent increase justified by inflation. As a consequence of freezing the rent, private investment into rental sector halted. Until the end of the 1960s the public housing policy focused on supporting housing supply in the public sector (municipal and cooperative), while the private rental sector was under the rent control. (The private rental sector in Germany was different where a soft rent control was used from the beginning.) From the 1970s there has been a change in the housing policy: the role of the private rental sector in housing policy has been re-thought. Abolishing the rent control was one of the conditions of the revival of the private rental sector. (Lind, 1999)

within the target group devote less of their incomes to rent. In addition, over time, it is not unusual for incomes to rise, yet tenants with incomes that exceed those of the original target group are not required to move out. This lack of effective targeting has prompted Western European countries to reduce capital subsidies and begin setting them so that the they only bring rents down to a level that is affordable by the richest people in the target group. A means-tested rent subsidy given directly to tenants (i.e., a housing allowance) is then used to make housing affordable for the poorer households in the target group.

It is important to understand that non-profit housing in Western Europe has undergone tremendous changes in recent years due to various problems and pressures, including a demand for tighter targeting on low- and moderate-income households. Most countries have shifted away from large capital subsidies and some have forced social housing developers to seek market-rate financing. Complexities such as variable rate financing and multiple subsidy sources have caused governments to struggle to find a combination of capital and operating subsidies that will allow them to achieve their goals.

There is no consensus on the best way to provide social housing. The literature is full of comparative analyses that point out the advantages and disadvantages of various approaches, but no approach emerges as being clearly superior.[57] Social housing provision is simply one of those topics for which it is much easier to identify problems than it is to devise solutions. Part of the difficulty involves conflicting goals:[58]

- targeting on poor groups and groups with special needs (e.g., elderly, handicapped, immigrants, single parents) versus reducing social segregation;
- targeting on lower-income households versus reducing budget expenditures;
- providing low rents and secure tenure versus encouraging labor mobility and meeting transitional lifecycle-related housing needs;
- increasing unit quality versus lowering costs;
- increasing the supply of affordable rental units through publicly supported production versus encouraging the private sector to produce more units; and
- applying downward pressure on market rent levels versus discouraging neighborhood decline.

These examples of conflicting objectives illustrate the difficulty of designing a coherent social housing policy. Keeping rents low in order to target on the poor and needy can have undesirable consequences with respect to social integration, mobility, neighborhood stability, and private sector development. The situation of every country is unique, thereby making it difficult to recommend an "off-the-shelf" model to follow.

[57] For example, United Nations Committee on Human Settlements, "Social/Affordable Housing—A New Challenge for the ECE Countries," Geneva: Economic and Social Council, July 2002; Martti Lujanen, "Social Housing and Its Role in Housing Policies," Finland, Ministry of the Environment, 2004; Jozsef Hegedus, "Social Housing Experiences in East-European Transition Countries," Hungary: Metropolitan Research Institute, 2004; and Tsenkova, op cit.

[58] Some of these goals were drawn from Lujanen, op cit.

What we can learn from the experiences of other countries are general principles and trends. These include:

1. General design and implementation principles.
    a. Implementing social housing strategies requires highly skilled organizations and professionals. Performance deficiencies can reduce or eliminate the cost advantages of non-profit organizations. In Western Europe many non-profit organizations have a lot of experience and are efficient developers and housing managers that are capable of handling a sizeable volume of units.
    b. The government should clearly articulate its social housing goals and develop quantifiable outcome measures. It should acknowledge possible conflicting goals.
    c. The subsidy mix should vary according to the incomes of the target population. To reach poor people, capital subsidies usually must be supplemented by operating subsidies (e.g., housing allowances). The depth of the relatively untargeted capital subsidies should be minimized.
    d. Rents should be adjusted upwards as family income grows.
    e. New programs should be tested on a pilot basis and be properly evaluated.

2. Desirable traits of a financing package.
    a. <u>Simplicity</u>. The number of subsidies should be kept as small as possible. Program complexity makes programs difficult to monitor and creates opportunities for abuses.
    b. <u>Transparency</u>. Easy to understand subsidies are preferable to hidden or indirect subsidies.
    c. <u>Flexibility</u>. Social housing operators can rarely predict changes in interest rates, inflation, and incomes. Such changes can affect the financial health of projects, and a subsidy package might have to be redesigned to prevent projects from failing.
    d. <u>Minimization of long-term budget commitments</u>. The long-term nature of some subsidies, such as interest rate subsidies, can limit the ability of the government to respond to changes in priorities, as budgets in the distant future can be tied up by commitments made today.

There are countless possible social housing subsidy schemes, and this makes it important to understand the principles of a good program design.

There is one non-profit social housing program in Centralo Europe that should be mentioned as it has received a fair amount of attention in various reports on social housing. Poland's TBS (housing association) program is based upon a French model, and was responsible for about 10,000 new units in 2001, which represented about 10 to 15 percent of all new construction. The World Bank has suggested that there should be an in depth evaluation of this program, although it appears that some analysts have already taken a basic look at the program. The program has received some criticism not because of its performance, but because it has diverted resources from municipal housing construction. One analyst concluded that the TBS program was able to provide good quality housing, but even the controlled rents were too high for many poor households. A key subsidy element is provided by the state in the form of a low-interest loan. Other financing sources can include tenants, local government, and the non-profit entity.

D. 4 Other Options

It is important to ask if a larger scale rental production program aimed at low- and moderate-income households is desirable at this point. It is not entirely clear that the market has failed to provide rental housing to the groups that require it. As we have argued above, the rental stock is over 10% of the urban housing stock and growing, The rental stock is already being expanded by the development of new, privately financed, owner-occupied housing. In recent years, the amount of new construction by the private sector has been roughly five times the size of government rental unit production. Private sector construction of all kinds is facilitated by supporting the development of credit markets and leveling the playing field with regard to taxation and access to land and infrastructure. There may be less costly alternatives to a new social housing initiative for meeting rental needs in the near future.

One alternative to new construction is for the government to purchase existing units directly from the market. This idea is alive today in cities like Bucharest, but real estate brokers proposed it to the government as far back as 1999.[59] The real estate brokers saw this as a situation where everyone could win: the seller gets cash, the broker gets a commission, and the government obtains a rental unit for less than the cost of constructing a new unit. If the seller uses the sale proceeds to purchase or rent a newly constructed unit, this approach also expands the housing supply. This approach might work better in some cities than others now that prices of existing units have risen closer to new construction prices. While the government might have some success in obtaining units that are already of acceptable quality, it should be prepared to invest a modest amount of funds to bring acquired units up to a minimum standard. The most affordable units are likely to have some flaws and the program should not be designed so that it excludes the possibility of acquiring units that are less than perfect at the time of acquisition.

A housing allowance scheme is another alternative to the direct construction of rental units. The appropriateness of this approach depends on whether the availability of rental housing is a demand problem or a supply problem. By a demand problem, we mean households do not have sufficient effective demand to induce suppliers to offer units for rent. A supply problem implies that there is a cheaper way to construct rental housing that will bring it within the reach of households. For housing allowances to work as an alternative to a new construction program, there must be a supply of private rental units

[59] The idea was reported in 1999 in Sally Merrill, Harold Katsura, and Carol Rabenhorst, "Prospects for Housing Finance in Romania," Washington, D.C.: The Urban Institute, December 1999. Dubel, et al., ibid.

that are available to rent. Also, the cost of the subsidy and administration of the housing allowance program must be favorable when compared to the cost of new construction.

The most problematic aspect of a housing allowance scheme in Romania is that it relies on filling the gap between the cost of private rentals and what a beneficiary can afford to pay. The latter amount is usually determined as a share of income,. But with the large amount of gray income that seems to exist in the Romanian economy currently, little confidence can be placed in the repotted income. Indeed, if someone is receiving such an allowance, they now have even greater incentives to hide their true income.