Local options for transforming the public rental sector

Empirical results from two cities in Hungary

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Local governments in Hungary are now responsible for resolving the difficult issue of privatizing publicly-owned rental housing. Using empirical data from two Hungarian cities, this paper considers local objectives – financial solvency and the ability to meet housing responsibilities – and concludes that while rapid, give-away privatization presents financial and equity problems for cities, there is another workable approach to handling the rental stock.

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The unique feature of the housing policy in the previously centrally-planned economies (the so-called 'East European housing model'[1]) was not the high proportion of public rental housing. In fact, these countries varied substantially from each other in this regard: around 1988, for example, the percentage ranged from 9% in Bulgaria to 70% in Russia.[2] The distinctive element of this housing model was instead the political and economic control exercised over the different sectors of the housing system. Enterprises, cooperatives, people themselves (in self-help form) were allowed to build houses but most aspects of these activities were regulated by the political system. Compared to these sometimes indirect methods, political control could most directly be effected over the public rental sector.

The big political changes of 1989–90 will of course in time influence all areas of public policy. The topic of this article is public rental housing policy and our focus is the new decision maker in rental policy: the local government. We analyse the transformation of the public rental sector in Central and East European countries (focusing on the case of Hungary), and examine the main options for the local governments in this process, particularly with regard to the privatization of public rental units.

The first section examines the process and problems of changing the socialist version of rental policy to other, more market-adapted forms. At the end of this section two case study cities are introduced and the principal characteristics of their public rental sectors are described. In the second section the analysis turns to the question of the magnitude and financial regulation of privatization. The criteria for the choice between the main options (rapid, 'give-away' versus 'go-slow', market-price privatization) are defined and hypotheses are formulated on the basis of which the options can be evaluated. Empirical data from the

[1]József Hegedüs and Iván Tosics, 'Conclusion: past tendencies and recent problems of the East European housing model', in B. Turner, J. Hegedüs and I. Tosics, *The Reform of Housing in Eastern Europe and the Soviet Union*, Routledge, London, 1992.

[2]Data available in Thomas Kingsley and

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two very different local housing markets are used in the third section to evaluate local public housing policy. The concluding section summarizes the results of the analysis and formulates recommendations for local housing policy in Hungary.

Changes in the conditions and regulation of public rental policy

Public rental sector in centrally-planned economies

The most important features of the regulation of public rental housing in centrally-planned economies (CPEs) have been valid in all these countries since consolidation of the socialist system (although, as mentioned, the relative size of the sector varies sharply):

- the landlord was the 'state' (represented in most cases by the local state-owned maintenance company);
- rents were regulated at the central (national) level, being set low for political reasons;
- no individual (means-tested) subsidies were necessary, because of the low rents and subsidized utility costs almost everyone could pay;
- protection of tenants has been extremely strong, to the point that their rights became 'owner-like', it was virtually impossible to lose a tenancy contract even in the case of non-payment of rent;
- in the allocation process political (merit) and social considerations were mixed;
- managers of the stock were the monopolistically organized local state-owned maintenance companies (in Hungary, the IKV); and
- no private rental sector was allowed to function (or where private rentals existed they were as strictly regulated as their public rental counterparts).

Hungary, which was in many respects ahead of the other CPEs in economic reform (eg in the privatization of its economy and decentralization of decision making from central to local level) did not differ from the other countries in the main features of its rental policy. Hungary did bring new elements into the East European Housing Model (for example loosening tight control over incomes, making possible self-help and later even market forms of new construction) but did not differ substantially with regard to control over the state rental housing sector.

There is no space here for a detailed discussion of the problems of the public rental sector in former CPEs. Foreign experts[3] and domestic analysts[4] have made it clear that the central problems were twofold: subsidies were too large (ie in the public sector rents were too low, in the owner-occupied sector the interest rate subsidy was too high) and were at the same time badly targeted (ie families in better, bigger units received larger subsidies). The bureaucratic institutional structure of maintenance was also an important problem but somewhat less important – even the most effectively organized competitive maintenance system would have been unable to perform adequate maintenance funded by the low rents. Another important problem was the existence of ownership rights of tenants (the right to exchange, and to inherit public rental units) which were connected with the massive rent subsidy: by increasing rents and means-testing allowances ownership rights would have gradually disappeared.

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Raymond Struyk, 'Eastern Europe's social housing: the progress of privatization', paper prepared for the meeting of the East European Housing Policy Working Group of the European Network for Housing Research, on 'Eastern and Western Practices of Privatization Related to the Housing Sector', Budapest, 27–29 March 1992, p 5; and M. Berezin, O. Kaganova, N.B. Kosareva, and A. Prytkov, 'Housing privatization in the Russian Federation', paper prepared for the meeting of the East European Housing Policy Working Group of the European Network for Housing Research, on 'Eastern and Western Practices of Privatization Related to the Housing Sector', Budapest, 27–29 March 1992, p 8.

[3]See, for example, Robert Buckley *et al*, *Housing Policy Reform in Hungary*, Report No 9031-HU, The World Bank, Washington, DC, May 1991, pp 11–18; Bertrand Renaud, *Housing Reform in Socialist Economies*, The World Bank, Washington, DC, 1991, pp 39–50.

[4]See for example Hegedüs and Tosics, *op cit*, Ref 1, pp 325–328.

Changing conditions of the public rental sector

In most East European countries changes in the public rental sector originated in the political transformation of 1989–90. In Hungary most of these processes started somewhat earlier, around the middle of the 1980s.

The main characteristics of the economic reform could be summarized as follows:[5] decontrol prices,[6] replace price restrictions and quantitative controls with modern tax and financial systems,[7] decentralize government and privatize state owned assets.[8] Parallel to the economic reform a stabilization programme has been introduced in order to restructure government expenditures.

Local governments (re-elected in Autumn 1990, six months after the first free general election) were in the forefront of the changes: they regained political independence[9] and their financing changed substantially. For example, while municipal finances are relatively stable compared to state-owned enterprises, they remain heavily dependent on central transfers which have not kept pace with increasing local responsibilities and whose magnitude is uncertain, as it is determined at the beginning of each year in the central Budget Act. Local governments were also given the right to levy local taxes (the conditions of which, however, were centrally determined) and became entitled to share personal income tax (PIT) revenue generated on their territory in 1987, but the percentage they received was cut from 100% to 50% and then to 30%, always lagged by two years. In September 1991 the ownership of the public rental stock (and of public utility companies) was transferred from the central state to the local level.

Due to the changes mentioned above, most decisions on public rental policy were transferred from the central to the local level. In principle local authorities became free to:

- change (increase) rents;
- introduce housing allowances;
- assign one part of the local public rental stock for sale while putting the other on the prohibition list;
- determine the magnitude of sales discount of the market price for units for sale;[10]
- change the institutional system of housing maintenance (in order to increase efficiency, decrease maintenance costs); and
- introduce local taxes.[11]

However, due to rapid moves by the national government to increase central budget revenues (introducing and increasing all possible taxes on the population and lifting utility price controls to a large extent) the financial burden on the population increased dramatically, not leaving very much room for local government-initiated price increases. As a result, local governments often perceive themselves as having only nominal decision-making freedoms. Nothing happened, for example, in the course of 1992 with regard to rental and allowance policy. To increase rents is difficult, partly because of the increased central taxes and the sinking living standard of the majority of population and partly because of political reasons (local politicians are hesitant to increase the burden on their voters). Housing allowances, on the other hand, seem to constitute a too difficult and costly system to work out and introduce on a local level, while regional equity issues cannot be handled locally at all.

[5]James R. Alm and Robert M. Buckley, *Privatization by Local Government in Reforming Economies: A Net Worth Perspective*, The World Bank, Washington, DC, 1992, p 2.

[6]This was not automatically introduced in the case of public rents and fees for public utilities – rents were decontrolled one to one and a half years after decontrol of most other prices and there are some public utilities whose prices are still controlled (eg electricity and gas).

[7]In Hungary the personal income tax (PIT) was introduced in 1987, value-added tax (VAT) in 1990, the decentralization of the banking systems effected in 1988.

[8]Privatization of housing has been possible since 1969 and became important politically around 1987–88 when sales restrictions were eased and sales discount increased. Privatization has been introduced as national policy in the form of selling flats to the sitting tenants under favourable financial terms (at almost giveaway prices).

[9]The previous party control of local government decisions was totally eliminated, county councils were dissolved and a new system of 'Commissars of the Republic' was introduced with a much more indirect control over the functioning of local governments. In a country of 10 million citizens as many as 3100 independent local governments are functioning (each having a mayor and an assembly). According to many experts decentralization went too far in many respects, resulting, for example, in Budapest in jurisdictional fragmentation: the city of 2 million inhabitants got a two-tier government structure, having 22 independent district governments and one capital-government (see details on the problems of this administrative system in Alm and Buckley, *op cit*, Ref 6, p 5; David Dowall, Katharine Mark, and Iván Tosics, *Assistance in Urban Planning and Development. Report of Field Mission to Budapest*, The Urban Institute, Urban Land Institute, Metropolitan Research Institute, Washington, DC, October 1992; József Hegedüs and Iván Tosics *et al*, *Az önkormányzati gazdálkodás finanszirozási kérdései Budapesten (Problems of Local Government Finance in Budapest)*, Metropolitan Research Institute, March 1993).

[10]One very important aspect of sale, however, remained centrally regulated: local governments must allow the buyer to pay up to 90% of the sales price on installment at a low fixed interest rate.

[11]The framework for local taxes, however, has been laid down with substantial constraints: it is not possible, for example, to introduce an effective property tax because exemptions in current central regulation cover all but about 5% of residential stock.

Table 1. Volume of public rental units and pace of privatization.

	1980–85	January 1990	January 1992	Percentage sold 1985–92
Szolnok (no)	8 800	7 150	5 100	42.0%
Share of total stock (%)	30%	25.1%	18.0%	
Budapest (no)	432 000	412 000	356 000	17.6%
Share of total stock (%)	60%	52.6%	44.5%	

Table 2. Quality indicators of public rental stock (January 1990): flats according to number of rooms (%).

	One room	Two rooms	Three or more rooms
Szolnok	21.0	68.0	11.0
Budapest	42.5	42.8	14.8

It is also not easy to re-formulate privatization policy. Because of the previous practice of selling public stock at very low prices, it is politically difficult to change privatization regulation (ie to decrease the sales discount). Most local governments apply the previous, central regulation for sales terms. There is a substantial differentiation, however, in the extension of the 'prohibition list' (the list of buildings not available for privatization), which by default has become the principal mechanism available to local governments to limit sales.[12]

The local housing market in Szolnok and Budapest

Local governments in Hungary – even in the urban areas – differ very much with regard to the size of public rental stock. Our two case study cities – Budapest, the capital, a city of 2 million, and Szolnok, a city of 80 000 100 km to the east – reflect this difference: the public rental sector is a much larger share of the total stock in Budapest than in Szolnok. This will give us the opportunity to test this paper's hypotheses on substantially different local housing markets (Table 1).

Before 1990 the decrease in the share of the public rental sector was mainly the result of changing priorities in new construction (owing to economic recession the volume of new construction of public rental units decreased very sharply). Since 1990 privatization has played a larger role in the shrinking of the public sector.

Within Budapest there is a huge difference between districts with regard to the share of the public sector. This is highest in the case of inner districts (around 80–90%) and much lower in the hilly Buda side and in the single family house dominated outskirts on the Pest side (10–30%) – Tables 2 and 3.

The difference in the public stock of the two settlements can be seen from the data: the overall quality is better in Szolnok, where the majority of public stock can be found on new housing estates, while a substantial portion of the Budapest public stock is in old buildings in a rundown condition. The quality advantages of the Szolnok housing stock are, however, 'counter-balanced' by the very homogenous structure of this stock (more than two-thirds of all rental units have two rooms) which acts as a heavy constraint on mobility.

The data listed give only a first impression of the two local housing markets. More details can be found in the papers already cited. What distinguishes Budapest is its dual administration: the housing stock was transferred to the districts while public utilities remained the responsi-

[12]According to a decision by Hungary's highest court, the local government must sell any unit to any tenant if the building is not on the prohibition list.

Table 3. Quality indicators of public rental stock (January 1990): flats containing bathroom or toilet (%).

	Both bathroom and toilet	Either bathroom or toilet	No bath or toilet
Szolnok	87.7	3.6	8.7
Budapest	78.0	8.0	14.0

Table 4. Main options for local governments in housing policy.

Privatization	Keep public rental rents low	Increase public rental rents
At low sales prices	I	II
At higher sales prices	III	IV

bility of the capital. The jurisdictional fragmentation can be seen in the fact that all 22 districts are entitled to introduce their own housing policy, including the possibility of different rent levels, subsidy methods, and so on. Privatization methods are already very different. Not only is coordination between the districts a problem, so is the somewhat tense and complicated relationship between the capital government and the district governments. In Szolnok no such tensions exist. Instead, the homogeneity of the public rental stock and the relatively high utility costs cause problems – the number of families in arrears is high and until now the city has had neither a good subsidy policy nor an eviction strategy to solve the problem.

Main options for transforming public rental stock and criteria for evaluation

Local housing policy: a model of the main options

From the discussion above it is clear that in the new situation local governments have the primary responsibility to determine housing policy and the main areas of regulation are: (1) rents and allowances; and (2) rules for privatization. (The change in the institutional system for maintenance and the regulation of property rights can be regarded as less important than the rent policy and privatization decisions.) The main options for local governments in housing policy can be analysed according to the following model,[13] which simplifies decisions into two choices: to raise or not to raise rents and to sell units to tenants at high or low prices (Table 4).

In the course of the first two years after the political transformation all local governments have fallen into options I or III. In the case of option I, rents[14] and sales revenues[15] are extremely low (and insufficient to cover actual expenditures of operating and maintaining the rental stock, not to mention necessary renovation and renewal). This means that this option will lead even in the short run to the disappearance or financial bankruptcy of the rental sector (there is no hope of a central budget subsidy). As will be seen in Tables 5 and 6, the estimated yearly deficit in Szolnok is around 7 700 HUF/unit or 40 million for the whole city; comparable figures for Budapest are 12 100 HUF/unit and 4.3 billion HUF for the city.

Option III would help to increase revenues through higher sales prices, although incentives to buy at higher prices will remain weak while rents are low (many people are reluctant to give up the comfort of low rents for the uncertain alternative of ownership). Alm and Buckley have analysed this option, calculating the necessary level of sales price of saleable units to finance the maintenance of the remaining local rental stock.[16] However, they did not take into account the still existing central regulation of sales,[17] nor did they consider the low buying incentive while low rents exist, as they did not address the issue of rent levels at all.

Importantly, the translation of housing policy to the local level makes it subject to local political pressures and the constraints of the local budget. It is a working premise of this paper, therefore (backed to some extent by discussions with several Hungarian local governments) that the financial balance-sheet of the rental sector (sales revenue plus rents minus operating and maintenance costs) is a critical factor in policy decisions.

[13]Developed in József Hegedüs, Katharine Mark, Raymond Struyk, and Iván Tosics, *The Privatization Dilemma in Budapest's Public Rental Sector*, mimeo, 1992, p 18 (this article will also appear in Hungarian as 'Privatizációs, dilemma a Budapesti bérlakásszektorban', Szociologia, forthcoming).

[14]In the case of a typical 53 metre^2 full-comfort public rental unit in Szolnok rent is around 1 200 HUF (5% of average family income) while utilities are around 5 000 HUF (21% of average family income).

[15]In a typical situation – when there was no major renovation in the last 15 years – tenants of a public rental building are offered the chance to buy their units at a sales price constituting 15% of the market value of the units. Tenants can choose whether to pay cash and receive a further 40% discount or on installment, paying only 10% of the sales price in cash and repaying the remaining amount within 35 years at a fixed 3% rate of interest. In the case of a typical 53 metre^2 full comfort public rental unit in Szolnok the market value is around 1 million HUF, so that tenants could either buy for 90 000 HUF or for 15 000 cash and 600 HUF per month installment for 30 years. (The average monthly family income was around 23 500 HUF.)

[16]Alm and Buckley, *op cit*, Ref 6, p 12.

[17]Because local governments are forced to give buyers the right to pay most of the price in installments (at low fixed interest rates) the highest revenue they can receive in cash is 10% of the market value.

Table 5. Volume of public rental units – the two options for privatization.

	January 1992	Option II	Option IV
Szolnok	5 100	1 400	5 000
Budapest	356 000	121 000	342 000

Note: Option II: everyone buys who declared an interest. Option IV: only those who declared an interest in buying even under less favourable sales conditions can buy.

It is becoming clear for more and more local governments that the problems of the public rental sector cannot be solved by options I and III, ie without increasing rents. We must emphasize again that until now the alternative has been only a theoretical option, because raising rents is politically very costly. To date only one local government in Hungary, the City of Szolnok, has decreed an increase of rents, which took effect on 1 May 1993. However, because of the growing deficit in the local budgets, the expected passage of the national Housing Act,[18] and the recently passed Social Act (which makes compulsory the introduction of housing allowances) other cities in Hungary will follow suit.[19]

With rent hikes a necessity, the real options for local housing policy are between option II – rapid, give-away privatization – and option IV – the go-slow, market-priced privatization – while in both cases rents are increased and housing allowances introduced to protect lower-income families.[20] In option II every tenant is entitled to buy his/her flat at a giveaway price, while option IV reduces the number of sales through much higher sales prices. On the basis of empirical investigations in Szolnok[21] and Budapest (Budapest Rental Housing Survey, BRHS)[22] we are able to assess the volume of remaining public rental stock under different conditions of sale: all survey respondents who declared an interest in buying under current sales terms were considered to have purchased their units in order to simulate option II; only those who said they would buy even under less favourable sales terms were considered to have purchased units for option IV (Table 5).

It is important to note that approximately one third of the public stock would not be sold even at the lowest possible sales price (these are the lowest quality units and/or units with low-income tenants). On the other hand very few tenants would buy their flats at increased sales prices.

The following section examines options II and IV in detail.

Setting up criteria to evaluate the main options

In the Hungarian context, privatization is entirely a local decision, in which the local government must take into account its financial and political pressures. On the one hand local governments are facing a financial crisis, with diminishing and uncertain transfers from the central government and insufficient ability to tax. On the other, they have new responsibilities in housing policy, including the ownership of the rental stock, responsibility to set rents and – in the near future – to provide housing allowances (as mandated in the Social Act, passed in the last days of 1992). Local governments must also be accountable to their constituents with respect to equity and affordability in the housing sector. As discussed above, local governments have shown themselves to be quite sensitive to political pressures, which have centred around rent levels and privatization policy.

We shall thus examine the main local housing policy options (differing in the privatization strategy) with respect to two objectives – financial solvency and the ability to meet housing responsibilities. We formulate six hypotheses which fall into these two groups. To meet the first objective, the local authority must balance the financial viability of the local budget and ensure more efficient maintenance, ie the improvement of the future condition of the housing stock. To meet the second, the government must ensure that the financial burdens being placed on households, in particular the middle class, are not too large. Further-

[18]The passage of the Housing Act has been repeatedly postponed since January of 1991, and a new version of the law is now under discussion by parliament and slated for passage by mid-1993.

[19]At present Hungary is the only country in Eastern Europe in which local governments have the right to raise rents.

[20]In the following models it is assumed that rents are being increased to three times current levels and gap-formula housing allowances are introduced to protect the poor.

[21]Empirical works were financed by the city of Szolnok; evaluation was prepared by the Metropolitan Research Institute and The Urban Institute in the framework of the Technical Assistance Program for the City of Szolnok sponsored by USAID.

[22]This survey was part of the HABITAT/World Bank Housing Indicators Program and sponsored by USAID. Empirical works and evaluation were carried out by Metropolitan Research Institute, Budapest and The Urban Institute, Washington.

more, local government must worry about the equity of the housing system, and the availability of affordable housing.

In the next section we formulate the hypotheses, in each case in a form to support option II, ie rapid privatization. In order to test the value of giveaway privatization as opposed to the higher-price privatization we will test the five hypotheses with data from the two Hungarian localities, the cities of Budapest and Szolnok.

Financing the housing sector

Housing in the local government budget

As already discussed, under current conditions (low rents, low sales prices) the balance of housing-related revenues and expenditures is negative – even though most local governments have minimized expenditures by terminating almost all maintenance activities. The most frequent argument for housing give-aways addresses precisely this point: '. . . the current operation of public housing loses money in all PCPEs [previously centrally-planned economies]. Giving such "assets" away would increase government revenues even if no taxes on private housing returns or capital were collected'.[23]

Hypothesis 1: Rapid give-away housing privatization results in decreasing local government deficits in operating public housing, compared to the option of slow, market-priced privatization.

Efficiency of housing maintenance

One of the arguments in favour of privatization is that home-owners have much stronger incentives to maintain their homes. This is not entirely clear-cut for a number of reasons: with the owner-like property rights tenants have enjoyed in Hungary over the last 40 years, it may be that they have treated their flats as owners would. Also, low prices may induce tenants to buy who do not have the resources to undertake home-ownership, or do not wish to assume the maintenance responsibilities.

Hypothesis 2: Private ownership increases the incentive to improve housing maintenance.

Equity issues and social responsibilities

Who pays the increasing price? The problem of the sinking middle class

A World Bank report[24] shows that social expenses in Hungary are high with regard to GDP and – partially in connection with this – only a minority of social expenses are targeted, with the majority being received by middle- and upper-middle-class households. The thrust of this report is questioned by several Hungarian experts;[25] many of them criticize the aim that social expenses should be means-tested and subsidies allocated to low-income families only.

The core of the sociological interpretation of this debate can be found in the argument about the 'sinking middle class'. This viewpoint starts from a supposition about the distribution of income according to which Eastern European societies are characterized by a narrow upper layer and a (relatively) narrow lower layer and a wide middle class. The argument is then that the majority of subsidies are given to the middle class under the premise that the means to pay for social services (such as housing, education and health care) are not 'built into incomes'. Hence

[23]Robert Buckley, Patric Hendershott, and Kevin Villani, 'Rapid housing privatization: pay the special dividend and get on with it', paper prepared for the First AREUEA International Conference, Los Angeles, 22–24 October 1992, p 4.

[24]Kessides *et al*, *Reform of Social Policy and Expenditures*, World Bank Report No 9349, World Bank, Washington, DC, 1991.

[25]See, for example, Zsuzsa Ferge, 'Megjegyzesek a Szocialis Torveny koncepciojahoz (Remarks on the Concept of the Social Law)', *Esely*, 1992/3.

if social subsidies are withdrawn from the middle class, large numbers of people will be impoverished.

The counter viewpoint is that withdrawal of social subsidies independently of income levels would not push the majority of the middle class below the poverty level, but that through more effective (aimed) distribution it would give much more significant support to those who are really in need.

Hypothesis 3: Market-price privatization will place a heavy financial burden on a large portion of the middle class.

Level and targeting of subsidies in the housing sector

It is well known that the current rental subsidy system is extremely inequitable, because the more heavily subsidized high-quality units are mostly occupied by the higher income households.

Hypothesis 4: Giveway privatization leads to a less inequitable housing system than exists under the current rental system.

Role of local government in the housing market

Privatization directly affects the volume of public rental housing and thus the role of the public rental sector within the local housing market. According to one view the social role of local governments can effectively be taken over by indirect methods (housing allowances) which make it unnecessary to have publicly-owned rental housing. Moreover, publicly-owned housing has a history of being badly run and many feel its role could be more efficiently filled by the private rental sector. The opposite view suggests that there is a minimum necessary size of public rental sector and it would be a mistake to decrease the size of the public rental sector below this limit.

Hypothesis 5: Give-away privatization results in a small public rental sector which corresponds better to the changing role of the public sector in a market-oriented economy.

Empirical data on the possibilities of a new rental housing policy

Hypothesis 1: Rapid give-away housing privatization results in decreasing local government deficits in operating public housing, compared to the option of slow, market-priced privatization

Our analysis examines a rental sector balance sheet for Szolnok and Budapest, comparing the current situation to that in options II and IV. For the option II (rapid privatization) figures, it was assumed that units are sold to all those who responded in the respective household surveys that they would buy at current or better terms (ie a lower price); for option IV (go-slow privatization at higher prices) it was assumed that units are sold only to those who responded that they would buy even if sales terms were worse than at present. The balance sheets do not include privatization revenues: the aim is to look at the rental sector remaining after privatization in order to examine the way in which rental revenues are able to cover the costs of maintenance and a housing allowance on a sustainable basis (although many local governments currently rely upon even the meagre revenues of low-price privatization to tide them over current financial difficulties). In the calculations we assumed a 200% rent increase[26] and the introduction of housing

[26]The 200% figure is still lower than current private rents in Szolnok (although information about these is scarce) it also seems likely that they can be expected to decrease as public rents increase and the private sector expands, so that by next year the new municipal rents may well be quite close to market prices.

Table 6. The 'economy' of the local public rental sector: the case of Szolnok (HUF/unit/year).

	Current	Option II	Option IV
Rental revenue	12 132	34 206	37 281
Cost of housing allowances	–	16 474	10 958
Maintenance costs	19 889	19 128	18 966
Balance per unit	–7 757	–1 396	7 357
Balance per year for city	–39.6 M	–2.0 M	37 M
Number of units	5 100	1 430	4 998

Table 7. The 'economy' of the local public rental sector: the case of Budapest (HUF/unit/year).

	Current	Option II	Option IV
Rental revenue	10 723	26 466	32 054
Cost of housing allowances	–	11 386	8 023
Maintenance costs	22 842	21 236	22 848
Balance per unit	–12 119	–6 156	1 183
Balance per year for city	–4 314 M	–745 M	404 M
Number of units (thousands)	356	121	342

Note: The difference between option II and option IV is underestimated in the case of Budapest because the ecological position within the city is not taken into account in calculating the rent increase. (In option II the unsold flats would be those yielding the lowest potential rents.)

Table 8. Sensitivity analysis: the level of necessary rent increase (in percentage of current rent) to break even in the remaining public rental stock.

	Szolnok	Budapest
Option II (giveaway privatization)	+ 250%	+300–350%
Option IV (higher-price privatization)	+100%	+150–200%

allowances. The latter was calculated based on a gap formula which covers the difference between 35% of household income and the 'maximum social rent' (the unit size norm for each household multiplied by the calculated rent norm).[27] In the case of Szolnok, where new rents have actually been calculated, the actual new (quite sharply differentiated) rents were used; in Budapest, current undifferentiated rents were simply increased three-fold. Maintenance costs were based on recent anaysis of actual costs to maintain rental units in Szolnok. Some differentiation in maintenance cost was made for units in better or worse condition (Tables 6 and 7).[28]

In both cities, option II results in a much smaller rental sector than option IV. In Szolnok, it is less than a third the size. But because the households who buy tend to be those who are better off, the cost of funding allowances when the rental sector is small takes a relatively bigger chunk out of revenues. The result is that under option II in both cities, even with a threefold rent increase the rental sector requires a substantial subsidy after give-away privatization. Rapid privatization does not improve the financial position of the city as much as go-slow privatization – especially in the case of Budapest, where a huge deficit remains even in the case of a much smaller rental sector.

As mentioned above, although local governments have come to realize that rents must be raised, the political costs have made it difficult to follow this course of action. Because of possible political resistance to raising rents, we have experimented to see how sensitive these results are to the magnitude of rents (Table 8).

We can conclude that the first hypothesis is not true, ie giveaway privatization fails to have a substantial positive effect on the local budget. What inhibits the confirmation of this hypothesis is that some of the housing cannot be given away because of its poor condition. Because the local government will be stuck with this stock and thus with a permanent drain of resources, giving away the good stock will diminish the rental sector's ability to be self-financing.

All this has been shown above by looking at the rental sector's self-sufficiency in an environment in which rental policy can be changed. That is, increased rents are taken to be the only revenues, used to finance both maintenance costs and housing allowances. Alm and Buckley tackle the problem by looking at the sector's net worth, assuming that rental policy does not change, ie that rents continue at

[27]For a more detailed explanation of the design of the housing allowance system used, see József Hegedüs, Raymond Struyk and Iván Tosics, *Integrating Rental Housing with the Private Market: Designing Housing Allowances for Hungary*, Urban Institute Press, Washington, DC, 1991.

[28]Toni S. Baar, 'Operating cost study: an analysis of the costs associated with the management of municipally-owned rental housing in Szolnok', December 1992. Normative maintenance costs were modified according to the condition of the building (very good condition: 20%, good condition: 60%, bad condition: 140%, very bad condition: 180% costs compared to the average condition). In this way deferred maintenance has been taken very roughly into account.

low levels. Their analysis reaches similar conclusions by calculating the (non-zero) price that must be charged for the saleable stock in order for privatization revenues alone to offset maintenance costs on the non-saleable stock. Their suggestion corresponds to option III and it is important to recognize that in the absence of a rent increase the necessary increase in sales price to reach balance is very substantial (although in fact it could not be carried out under current regulation of sales of public housing[29]).

Hypothesis 2: Private ownership increases the incentive to improve housing maintenance

A recent paper[30] addresses this issue for Budapest by looking specifically at owner and renter satisfaction with maintenance and their willingness to pay for better maintenance services. Survey results do not unambiguously support hypothesis 2.

First, while owners are more satisfied with maintenance than renters,[31] it is also true that 75% of them have private management firms (as opposed to 3% among renters). In other words, their satisfaction may be due to their greater control over maintenance, while renter dissatisfaction may be due to the inefficiency of IKV, which is not attributable to their tenure *per se*. As there is not a substantial difference in cost between IKV and the private firms, quite possibly private management of district-owned rental flats could lead to increased levels of satisfaction.

Second, owners pay more than renters for maintenance (an average of HUF 1116/month for condo fees and contributions to the rehabilitation fund as opposed to average rent of HUF 884/month), but it is possible that precisely those willing and able to pay more were those who bought their units first and are now owners. In other words, mere ownership will not necessarily change the willingness of current renters to spend more on maintenance.

Third, renters who are willing to pay more for better maintenance were found to be those whose incomes were higher, and who paid a lower portion of their income on housing expenses. Specifically, 29% of renters in the highest quartile, and only 9% of those in the lowest quartile expressed a willingness to pay more. (Only 10% of renters in the highest expenses-to-income quartile, and 28% in the lowest, would pay more.) Among owners, only 24% of those in the highest quartile would pay more for better services. This may be because owners feel management services are already good enough, but recall that only 31% of owners expressed full satisfaction with maintenance. These results do not provide evidence that owners are more willing to invest resources in good management. All this means that there is no evidence that privatization of housing is an effective way to improve maintenance. Rather, results suggest that the quality of the maintenance firm (eg through access to private firms) may be a more effective solution.

The position of tenants differs in at least two aspects from that of owners: they cannot decide about their rent level or about the maintenance company. In Szolnok an experimental programme was begun to change this within the framework of renting, ie by offering tenants the opportunity to influence the selection of maintenance company. This may be a useful model for increasing both renter satisfaction and housing maintenance without home-ownership.

[29]For one of the Budapest inner districts it was estimated that in order to cover the upkeep of the remaining rental sector the sales price of units sold would have to be 25% of market value. Under current circumstances buyers are entitled to buy the property for 10% of market value (and a monthly repayment at a low, fixed interest rate) even if the local government does not give any discount. (Most local governments give discounts of between 85 and 70% of market price.)

[30]Hegedüs, Mark, Struyk, and Tosics, 'Tenant Satisfaction with Public Housing Management: Budapest in Transition', 1992.

[31]Only 32% of owners – compared to 73% of renters – described themselves as dissatisfied with current maintenance, while 10% of renters and 31% of owners proclaimed themselves 'fully satisfied'.

Table 9. Financial burden (housing expenditures compared to income) on the different income groups before and after rent increase. The case of Szolnok: by income group, percentage of income spent on housing.[a]

	Current rents	Proposed rent increase
Lower 25% of income distribution		
Below 20%	1	13
20–35%	26	30
35–50%	29	40
Above 50%	34	27
Total	100	100
Middle 50% of income distribution		
Below 20%	39	9
20–35%	60	72
35–50%	1	17
Above 50%	–	1
Total	100	100
Upper 25% of income distribution		
Below 20%	98	65
20–35%	2	34
35–50%	–	1
Above 50%	–	–
Total	100	100

[a]In Tables 9–12 the proposed rent increase is a three-fold increase, to be implemented in conjunction with a housing allowance programme. The lower 25% of income distribution marks families below 14 000 HUF adjusted income per month; the upper 25% families above 30 000 HUF adjusted income per month, 'Adjusted' means that wealth is included in income: above the first 100 000 HUF 10% of wealth is added to yearly income.

Hypothesis 3: Market-price privatization will place a heavy financial burden on a large portion of the middle class

The positive effect of option II on middle-class families is clear (it is easy to show that the majority of potential buyers belong to the middle and upper class of tenants). The other side of the coin is to look at the rent-paying capacity of middle-class households. Tables 9–12 show the allocation of the increased financial burdens for all renter families in the surveys.[32]

It must be noted that these figures do not show the transfer of implicit expenses for maintenance, including the burdensome bill for deferred maintenance. The new owners will not necessarily pay those costs, but as owners, they now 'own' them.

From the data it can be seen that the proposed threefold rent increase and the introduction of housing allowances do not create big problems for the middle- and upper-income strata of current tenants. Even though most of them will have to pay more they will still be paying a much lower percentage of their income for housing than the lower-income households.

Nevertheless, it is obvious that give-away privatization is financially advantageous for most of those who are able to become owners. Not only are their expenditures potentially lower, but also they can be sure that as owners their expenditures will be spent on their own building and not to cross-subsidize lower-income households.

Hypothesis 4: Give-away privatization leads to a less inequitable housing system than the currently existing rental system

The inequity of both the current subsidy system and any give-away scheme is inescapable. An earlier paper using the results of the Budapest survey[33] showed that while privatization has diminished the inequitable distribution of the *rental subsidy* present in the previous rental system[34] as higher income households leave the rental sector, a second subsidy, the *value gap* (a measure of the windfall gain that accrues to the privatizing tenant), goes disproportionately to better-off buyers: by 1992, the top income quartile had received 40% of the value gap while lowest quartile received 17%. The changing distribution of both subsidies is illustrated in Table 13. The equity issue is further complicated because the privatization process has been underway for quite some time in Hungary, so that a change in privatization terms would also be viewed as unfair by those planning to privatize.

A recent paper that advocates rapid give-away privatization in reforming centrally-planned economies suggests that a voucher system could dissipate the inequity inherent in a give-away programme,[35] but in a country giving away less than 20% of the housing stock (the size of the public rental sector in Hungary) it would be difficult to achieve equity and affordability simultaneously.[36] Only in localities – such as Budapest District VII – where the rental stock is a very high proportion of total stock, might this be possible. However, this sort of scheme is difficult to imagine implementing on a local level, and is probably unthinkable now that privatization is so far advanced.

Hypothesis 5: Give-away privatization results in a small public rental sector which corresponds better to the changing role of the public sector in a market-oriented economy

In Hungary – as in most PCPEs – there is an extremely small private

[32]Because of the low level of privatization at the time of the survey results can be evaluated as representing option IV.
[33]Hegedüs, Mark, Struyk and Tosics, *op cit*, Ref 13.
[34]Before 1992, 32% of rent subsidy went to the highest income quartile.
[35]Buckley, Hendershott, Villani, *op cit*, Ref 23. The vouchers would represent some portion of the value of the publicly-owned housing stock and would be distributed to the entire population according to a 'politically-determined formula'. Vouchers would be tradeable so that those unable to buy would receive financial compensation.
[36]In this case an individual household would receive a voucher equal to less than one-fifth of the value of its unit; this is no longer a giveaway programme for individual tenants. If only tenants were given vouchers – so that the vouchers would cover the full cost of the unit – the system would be unfair to all those who do not live in public rental units.

Table 10. Financial burden (housing expenditures compared to income) on the different income groups before and after rent increase. The case of Szolnok: by income group, percentage of families paying less or more than at present.

Lower 25% of income distribution	
Less than currently	67
0–20% more than currently	15
21–50% more than currently	12
51–100% more than currently	4
More than 101% more than currently	–
Middle 50% of income distribution	
Less than currently	11
0–20% more than currently	17
21–50% more than currently	46
51–100% more than currently	21
More than 101% more than currently	5
Upper 25% of income distribution	
Less than currently	1
0–20% more than currently	2
21–50% more than currently	74
51–100% more than currently	14
More than 101% more than currently	9

rental sector. This means that at present the public rental sector provides virtually the only rental housing available, and thus cannot be evaluated only in terms of its role as social housing.[37] Housing demand is normally met by private rentals, public rentals, and owner-occupied housing. Because of current constraints in the Hungarian housing system – primarily disincentives to private landlords (strong tenant protections and low public rents) and a shortage of affordable finance – the public rental sector faces an unusually broad spectrum of demand. We believe this role for public rentals will diminish as a private rental sector emerges, but in the short term the cost will be high if there are no rental units available.

In the case of the city of Szolnok, calculations were prepared[38] to estimate the minimum size of the public rental sector, based on estimates of the different aspects of demand for housing, such as number of homeless, households on the waiting list, and households due to be evicted. It became clear that the current size of the public sector, around 18% of the total stock, is already at the minimal level. One could argue that according to the current regulation tenants' rights are too strong (for example, tenants exchange units and units can be inherited) and therefore the local authority does not have full access to public rental flats – although some local governments have developed methods to vacate units and allocate them to families in need. In any event, privatization would eliminate all possibilities for the social use of the existing public rental stock in the needed volume. Option II would lead to a situation in which the number of public rental units would be only around one third of the minimum necessary, while construction of new public rental units would not be possible with no revenue generated from sales.

It is much more difficult to prepare similar calculations for Budapest, where all aspects of local housing policy are handled by the districts. It is unquestionably true that in some Budapest districts (especially the inner Pest districts with a share of public rental stock around 70–90%) privatization seems to be inevitable. In work undertaken for one of those districts, the minimum necessary size of the public rental sector was estimated at around 50–60% total stock.[39]

Conclusion

These years of rapid change in the East European model of housing policy are very important in determining the fate of the public rental sector. In our opinion, the key factor has been the devolution of responsibility to local governments. Once housing policy becomes a local decision, it becomes subject to the principal influences that face Hungarian cities today: tight budgets and sharp political pressure. These are particularly keen now with diminishing central transfers, undeveloped local taxation powers, and deteriorating standards of living. The abdication of the central government from setting housing policy has changed the nature of objectives and of the possible solutions.

Local governments in the decision-making position

Local governments face a fundamental problem of governance: how to obtain the resources to provide public goods and to protect those in greatest need. Hungarian local governments are in a very difficult position: they have been given large responsibilities and few resources

[37]Even so, it should be noted that give-away privatization would result in a much lower level of *public* rental housing than usual in European countries.

[38]Toni S. Baar, Katharine Mark, Jeffrey P. Telgarsky, Iván Tosics, Katalin Zsámboki, *Proposal for a New Housing Policy Strategy for the City of Szolnok (Javaslat Szolnok új helyi lakáspolitikai startégiájának kialakitásához)*, mimeo, Metropolitan Research Institute and the Urban Institute, Budapest, September 1992.

[39]József Hegedüs and Iván Tosics, *A VII. kerületi bérlakások eladása és a bérlakáspolitika alternativái (The Sale of Public Rental Housing in District VII of Budapest and the Alternatives of Public Rental Policy)*, mimeo, Metropolitan Research Institute, Budapest, December 1991.

Table 11. Financial burden (housing expenditures compared to income) on the different income groups before and after rent increase. The case of Budapest: by income group, percentage of income spent on housing.

	Current	Proposed rent increase
Lower 25% of income distribution		
Below 20%	5	36
20–35%	43	29
35–50%	41	20
Above 50%	11	15
Total	100	100
Middle 50% of income distribution		
Below 20%	65	25
20–35%	34	59
35–50%	1	15
Above 50%	–	1
Total	100	100
Upper 25% of income distribution		
Below 20%	100	88
20–35%	–	12
35–50%	–	–
Above 50%	–	–
Total	100	100

as their taxing powers are still quite limited. Housing is their largest asset (valued in Budapest, for example, at over HUF 300 billion). On the other hand, with the uncertainty of central budget subsidies, local revenues from the housing sector must be increased to cover costs.

In this article we examined public housing privatization options for local authorities. On the basis of extensive data and empirical analysis we tried to show that give-away privatization is not the only choice and, in fact, has many disadvantages. Careful privatization close to market price, together with housing allowances, rent increase and institutional changes in housing management constitute a new model for the rental sector in which the sector can be self-financing (apart from the problem of deferred maintenance) and does not cause further financial loss for the local government. Furthermore, a viable public rental sector will provide housing for low-income households and others who seek the advantage of renting.

This option – option IV – means that local authorities will retain the better stock and charge higher rents on it (or sell it at market price). These are the only mechanisms available for the local governments with which to cross-subsidize the poorer stock, since at present it is not possible to tax residential property. From the municipal viewpoint, it makes sense to use rents or privatization revenues to 'tax' the better off households in order to subsidize the poorer stock. Moreover, this new rental policy will spur the emergence of a private sector: higher public rents will create a supply response and demand side subsidies (housing allowances) will enable tenants to move to privately-owned units.

Thus, in our view, the double task of local governments of raising revenues and better targeting subsidies can only be solved with a market-price privatization strategy: give-away privatization would mean foregoing the collection of either sales or rent revenues from middle-income groups, ie targeting subsidies even less than previously.

This conclusion is in general true for both regional submarkets in our analysis. More detailed analysis enables us to show the effect of local circumstances – mainly the current share of the public rental sector, its condition and inhabitants – on the decision of how much to privatize. From a financial point of view proportionately more flats could be sold at close-to-market prices in Szolnok than in Budapest while still maintaining a self-sustaining rental sector (Table 7 shows the rent increase necessary in the remaining public sector would be lower and therefore more sustainable to carry out in Szolnok). From a social perspective, however, in Budapest further privatization seems inevitable owing to the large size of the current public sector while in the case of Szolnok mass privatization would undermine the potentially viable public rental sector. Thus even in choosing one of the main options (that is, higher-price privatization as opposed to give-away privatization) there are further questions regarding how close the sales price should be to the market value in order to determine the number of public units to be sold.

The interest of the local population

The evaluation of the two main options from the point of view of the local population is quite different. Those who would like to buy their unit clearly see the benefits of give-away privatization: they become homeowners for little money, and are then free of future payments to the municipality. A crucial advantage of ownership is that owners know

Table 12. Financial burden (housing expenditures compared to income) on the different income groups before and after rent increase. The case of Budapest: by income group, number of families paying less or more than at present.

Lower 25% of income distribution	
Less than currently	68
0–20% more than currently	22
21–50% more than currently	9
51–100% more than currently	1
More than 101% more than currently	–
Middle 50% of income distribution	
Less than currently	5
0–20% more than currently	10
21–50% more than currently	50
51–100% more than currently	35
More than 101% more than currently	–
Upper 25% of income distribution	
Less than currently	–
0–20% more than currently	1
21–50% more than currently	28
51–100% more than currently	71
More than 101% more than currently	–

that all their expenditures – condo fees, contributions to the reserve fund, loans for renovation – will be spent on their house, and will not be subject (as rents would be) to be used to cross-subsidize other units in worse condition, or to fund housing allowances for those with lower incomes. The option of market-price privatization, on the other hand, would mean a higher burden for most of these families.

There are, of course, also groups of the local population whose interest is against give-away privatization: those who would never buy (because of the low quality of their homes or their low income level) and those who, lacking other options, would like to enter the local public rental market (homeless, new low-income households, or those moving to be near new jobs). These families would indirectly benefit from higher sales prices and higher rents: their housing expenditures would decrease as a consequence of the introduction of housing allowances and their ability to enter the public rental housing sector (or exchange flats within this sector) would improve as a consequence of the out-movement of some middle-class families and generally increased mobility.

In fact, however, there is a huge difference in the political power and level of organization of these two different interest groups. Potential beneficiaries of give-away privatization have a much more direct interest and, because of their higher position in the local political hierarchy, they also have a bigger influence on local politicians. These households are therefore in general much more active in demanding housing sales at a low price than the other groups in arguing against it.

What should local governments do?

From our analysis it is clear that economic and social considerations favour option IV (market-price privatization). Political aspects, on the other hand, favour option II (give-away privatization) as a tool for becoming popular with the politically active part of local population, ie the voters. Recently the second argument seems to have prevailed;[40] in Budapest, for example, more local governments have decided to continue give-away privatization. The other option is politically more

[40]At the present, of course, this is demonstrated through the choice of the *low-rent level* version of option II (ie option I) by local governments as opposed to the low-rent level version of option IV (ie option III).

Table 13. Privatization process and the equity issue in the Budapest public rental sector.

	January 1990 rent subsidy	Option IV Rent Subsidy	Value gap	Option II Rent subsidy	Value gap
Low income (below 25%)					
Per unit (HUF)	46200	44244	483955	37572	364785
m (b HUF)	4.6	3.7	7.3	1.5	21.5
% of total	21.6	22.7	16.5	31.3	15.6
No of units	99432	84449	14983	40409	59024
No of sample	219	186	33	89	130
High Income (above 75%)					
Per unit (HUF)	66048	63312	707509	63672	600472
m (b HUF)	6.7	4.9	17.7	0.8	53.7
% of total	31.7	22.6	40.3	16.7	38.9
No of units	102157	77185	24972	12713	89444
No of sample	225	170	55	28	197
Total sector					
Per unit (HUF)	53208	50496	596138	43728	477073
m (b HUF)	21.3	16.5	100	100	100
No of units	400000	326447	73553	110783	289217
No of sample	881	719	16	244	637
% rental/sold	100.0	81.6	18.4	27.7	72.3

difficult and also raises technical problems (working out a new rent system and a new housing allowance system). Even so, quite a substantial number of local governments have stopped low-price privatization and seem to be ready to introduce new elements in local housing policy.

At the moment there is only one local government, Szolnok, which has made a decision clearly favouring the more difficult option of local housing policy – voting both to raise rents and to postpone all public housing sales until the expected Housing Act gives them more control over sales terms. The results of their decision and also the question of how many other local governments will follow this example depends very much on the future of the political cooperation of the central government with the local governments.

There is an urgent need for a central regulation establishing a loose framework which would create optimal conditions for local governments to implement a version of public rental housing policy which best fits local circumstances. Central guidelines would restore some of the political buffer that the absence of a national law has removed in the last two years, as well as providing guidance and the beginnings of possible consistency among local governments. The central regulation should be accepted as soon as possible and must give local decision-making rights on rent levels and the regulation of privatization. However, it must also contain compulsory minimum social safety prescriptions (housing allowances) and a block-grant type central subsidy system which will help to equalize to some extent the situation of local governments with very different economic backgrounds.