Spring 2012

HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance

IUHF

www.housingfinance.org

- Pro-poor affordable housing: the issues we know, the answers we need
- An Overview of the housing sector in developing countries with a focus on India's reforms
- The demand for housing in Port- Au-Prince, Haiti
- Investment in housing: demand versus supply side subsidies
- A review of recent developments in the Irish mortgage market and an assessment of the future prospects
- "Managing Risk" in the Delivery of Housing Finance: Australia's Mortgage Lenders

International Union for Housing Finance

Housing Finance International

Housing Finance International is published four times a year by the International Union for Housing Finance (IUHF). The views expressed by authors are their own and do not necessarily represent those of the Editor or of the International Union.

ISSN: 2078-6328
Vol. XXVI No 4

Contents:

➔ **Subscriptions:**
Individual Regular Annual Rate €135;
Individual Three-Year Discounted Rate €360.
Institutional Regular Annual Rate €155;
Institutional Three-Year Discounted Rate €420.

For further details, please contact Anja Gruhn (gruhn@housingfinance.org)

International Union for Housing Finance
Rue Jacques de Lalaing 28, B 1040-Brussels - Belgium
Tel: +32 2 231 03 71
Fax: +32 2 230 82 45
www.housingfinance.org
Secretary General: Hartwig Hamm

Investment in housing – the case for demand-side subsidies

↳ By Wolfgang Amman

European countries have shares of rental housing between below 10% in several CEE countries and above 60% in Switzerland. The EU average is between 25% and 30%. But statistical data are tricky because of uncertainties regarding the nature of cooperative housing in some countries and the classification of (informally) rented owner-occupied apartments (Amann, Mundt, 2011; Andrews, Caldera Sánchez, Johansson, 2011).

Facing these disparities, it is difficult to define a necessary or desirable share of rental housing for individual countries. Supply of sufficient rental housing has comprehensive social and economic rationale. It is not at all only for the accommodation of those who cannot afford owner-occupation. It is definitely easier to transparently allocate social assistance in rental apartments than in own property. Rental housing fosters labour mobility and adequate accommodation at different stages of the life cycle. In mature economic environments it may be economically rational for tenants to rent instead to buy. Rental housing is an important investment opportunity for institutional and private investors and is hence an important asset class. Rental housing is much easier to manage, maintain and refurbish, compared to owner-occupied housing. It has therefore advantages in terms of the sustainable development of our built environment.

As it is hardly possible to define an absolute objective of a reasonable share of rental housing, the concept of consumer choice may apply. If tenure status is the result of a rational choice by households, a reasonable equilibrium should appear. The consumer choice concept promises high economic efficiency. But a rational choice is only possible if a sufficient and attractive supply of different housing opportunities exists in the market.

Owner occupation of property is in many countries strongly promoted by tax benefits. Owner occupied property is also perceived as an insurance against political and economic risks. This is particularly visible in transition countries. The ambition to own property makes families scrape money from any source and to invest pecuniary and labour resources to an astonishing extent. Hence, rental housing is a rational alternative only for specific groups of the population in a specific economic environment. It may become a priority consumer choice for big parts of the population in economically mature and politically stable countries. In a more vulnerable environment, rental housing is an alternative primarily for young households, migrants to the boom regions and the poor.

Countries may benefit from the economic and social advantages of growing rental housing sectors, if they establish friendly framework conditions. One is the regularisation of informal rents in the existing housing stock. Formal rents have to be protected from unfair competition from informal rents. Another framework condition is the establishment and empowerment of management and maintenance schemes for all housing sectors. A third condition is a reduction of tax benefits for owner occupied property.

But first and foremost, rental housing must be economically rational for target households. A simple calculation illustrates the point. If we assume the economic conditions of a typical Western European country (e.g. Germany or Austria), we may calculate with construction costs of 1,500 €/m² and costs of building land of 300 €/m² useable floor space. If we finance such a building with a mortgage loan of 20 years with a fixed interest rate of 7%, the monthly annuities will be not less than 14 €/m². Adding reasonable fees for management, maintenance and a refurbishment fund, with VAT and energy, it adds up to 20 €/m². An average household of the second income quintile in a typical Western European country has a disposable household income of monthly € 2,000 (EU-SILC). Hence, a 70m² rental apartment would require 70% of that income. This is obviously not reasonable. Certainly there are several options to reduce annuities and other costs. We may extend the maturity of the loan to 25 years, succeed in obtaining finance with only a 6% interest rate, invest some cheaper own equity, reduce the endowment of a refurbishment fund, or introduce indexed mortgage payments. But even under these conditions it is difficult to fall below 14 €/m² in total, or 50% housing cost ratio for our sample household.

The perception of a politically reasonable maximum housing cost ratio has increased over time. Today, in most countries an average of 30 to 35% is perceived as affordable (Chiquier, Lea, 2009). In our simple calculation this level may be achieved only with substantial public support. Housing costs should be reduced to only 8.50 €/m², either with supply side or demand side subsidies. One reasonable model with a combination of both could look as follows:

- A municipality provides building land at a low cost, e.g. half of the mentioned value (in return the municipality may get a right of allocation).
- The interest rate for the remaining investment is reduced to around 3% (average over total financing). This may be achieved with public soft loans, or grants in combination with commercial loans, or guarantees.
- With indexation the resulting rents may be reduced to around 10 €/m² (without energy costs).
- Additional assistance may be allocated with means-tested housing allowances.

Under such conditions rental housing will be economically rational for many households and consumer choice will establish a rental sector. But is it also economically rational also as public policy? This question has ambiguous answers. Subsidies for owner-occupied housing may stimulate new construction at lower public costs. But it is impossible to solve all social issues with owner-occupation. In many countries the middle classes are served with owner-occupation and free-market rents and vulnerable groups with municipal housing.

This leads us to the principal question of dual rental markets vs. integrated rental markets, which has been intensively discussed in housing research for many years (e.g. Kemeny, 1995; Kemeny et al., 2001; Kemeny et al., 2005; Amann et al. 2012; Mundt, Amann, 2010). Promotion of ownership to the middle classes and municipal housing to the poor will lead to dual rental markets. Integrated rental housing markets appear, if large rental sectors produce supply accessible for major sections of the population with rents only slightly below free market levels. Proponents of the former argue lower public costs, as only small social housing sectors require State funding. This argument could be disproved, as housing policy schemes with a focus on residual social housing mostly provide other benefits to higher income groups, such as allowance schemes and in particular tax benefits for owning property. Public expenditures for housing are very difficult to assess. Public soft loans, grants, annuity grants, allowances, tax rebates or guarantees have quite different cash flow effects and influence housing consumption differently. It is therefore hardly possible to calculate consistent discounted net present values for different subsidy schemes. Nevertheless, some indications show that countries with integrated rental markets, such as Austria, the Netherlands or some Scandinavian countries do not have higher public housing expenditure rates compared to countries with dual rental housing markets (PRC, 2005; Amann, Mundt, 2011).

The rental model proposed above allows for affordable housing with only moderate public expenditures. Under present financial market conditions, financing with 3 to 4% interest rate with no further public assistance is feasible e.g. with the Dutch Guarantee Fund Model (see e.g. Priemus, 2008) or the Swiss model of an intermediary organisation issuing bonds for affordable housing (Lawson et al., 2010). Other interesting capital market instruments to allow for low financing costs are the Danish mortgage bond (UNECE, 2005) or the Austrian housing bond (Lawson et al., 2010).

Low financing costs further require a low risk institutional setting. In several Western European countries, e.g. Austria, limited-profit housing associations (LPHA) have developed into financially mature organisations. With their strong equity base, a vacancy risk close to zero and a kind of implicit State guarantee, they are first class borrowers with very favourable market financing conditions. Within such a framework specialised housing organisations may provide rental housing which is affordable for the majority of population. If supply of affordable rental housing is sufficient, additional housing allowances are required only for the most vulnerable households to quite a limited extent. Austria, as an example, provides housing allowances to only 6% of households.

Such models of affordable rental housing work not only for prosperous Western European countries. With similar results they may be applied to transition countries. For many countries in South East Europe and of the Commonwealth of Independent States (former USSR), lower construction costs, lower legally defined maintenance fees and higher inflation rates allow for rents of approx. 2,50 €/m², which fits the much lower incomes in those countries (Amann, 2009).

With these arguments we have already partly answered the question, whether demand-side or supply-side subsidies produce better results. Following liberal market theory, the best way to achieve optimum housing provision in terms of allocation and affordability is the least possible State intervention into market functioning. With this approach the problem of low income households may be solved most efficiently by increasing their purchasing power with housing allowances. Debates on the superiority of the one or the other model have a tendency to argue in black and white. They often include arguments about the deficiencies of the other model, which only become evident, if implemented in a pure form. Market liberals argue against distortions of budget funded public housing, which is almost free almost for everybody. Keynesians by contrast decry market failures, socially unbearable price developments, segregation and altogether the social coldness of markets. As a matter of fact, hardly anywhere the one or the other model is implemented in its pure form.

As discussed above in the context of dual vs. integrated rental markets, the argument of proponents of demand-side subsidies that such systems are less costly to the public, can be falsified. It is politically hardly possible to limit assistance to most vulnerable households only. Pressure from the ballot-box inevitably leads to promotion of schemes also for the majority of population, often with expensive tax rebate schemes for owner occupied property.

The simple calculation provided above shows another aspect. Of course it would be possible to bridge the gap between the market-based 14 €/m² to the affordable 8.50 €/m² with demand side allowances and leave the supply side to the free-market alone. This would have equal public costs, if free-market housing providers and specialised affordable housing organisations work with similar effectiveness (from the point of view of the public interest, not primarily of business performance). Certainly market competition is a strong driver for effectiveness. And certainly a command economy produces inferior results. However this question cannot be answered in black and white, but requires differentiated consideration. Today's social housing organisations differ a lot from the stereotype of socialist housing cooperatives of former days. The best of them have developed into highly professional enterprises in a competitive market with high volumes, a strong equity base and consumer orientation. The public service obligation of affordable rental housing provision to households in need (EU jurisdiction) may be achieved with supply-side subsidies to such organisations at lower public costs for the following reasons:

- Housing allowances in a free-market environment have a strong tendency to push up prices and create windfall gains. This may result in a reciprocal effect of rising rents, increasing demand for allowances and a further upturn of prices (Mundt, Amann, 2009). This can be avoided with housing production on a cost coverage principle.
- Usually such organisations are protected against outflow of capital. (Limited) profits have to be reinvested in housing construction and housing refurbishment. This results in accumulated undisclosed reserves. Growing financial maturity improves the market power of such companies towards financing and construction services.
- Many of these organisations have a very long business history with a very clear core competence. Economies of scale may reduce costs.
- In some countries, effective schemes of audit and control of social housing organisations are in place. Such schemes reduce risks and contribute to knowhow exchange. Thorough public supervision has effects on the capital market similar to a public guarantee.

All these aspects contribute to a reduction of financing costs without financial implications for the public. Additionally, supply-side subsidy schemes have immediate effects on new construction, whereas with housing allowances such effects depend on price elasticity of supply. Subsidies on bricks and mortar allow for immediate implementation of ambitious energy and ecological standards. This is much more difficult with demand-side subsidies. In terms of public costs supply-side subsidies are on a par or better than demand-side subsidies. But they additionally offer important positive externalities. But at last, the two models can be combined.

Within a comprehensive legal scheme of checks and balances, ownership of such specialised housing organisations may not be limited to municipalities, funds or charity organisations, but be open to individuals, to the financing sector or real estate companies. The EU ruling on Services of General Economic Interest (SGEI) provides an effective framework. It seems to provide great potential for new business cases between State and market.

As a result of our considerations we may summarize that affordable rental housing requires State commitment. But this commitment goes beyond financing. It also includes the establishment of low risk housing organisations, a stable economic environment and an appropriate legal framework. Well established housing promotion schemes may go with moderate public expenditure. Housing subsidies have very complex effects. Nevertheless, subsidies of bricks and mortar seem to be more beneficial than demand side subsidies, but the latter may well be combined as means-tested addition with the former. Services around affordable rental housing are not at all allocated in a non-competitive or off-market habitat. Quite the contrary, in the context of integrated rental markets they operate in a very competitive environment which includes associated financing and construction services. Specialised affordable housing organisations may develop a new and very promising business case even for private owners, under the EU ruling on Services of General Economic Interest.

Sources:

Amann, W., Hegedüs, J., Lux, M., Springler, E. (2012): Financing Social Housing, in: Hegedüs, J.; Lux, M. & Teller, N. (Ed.): Social Housing in Transition Countries. London u.a.: Routledge.

Amann, W., Mundt, A. (2010): Indicators of an Integrated Rental Market in Austria. In: The Housing Finance International Journal, Winter 2010.

Amann, W., Mundt, A. (2011): Berichtstandard Wohnbauförderung 2011 (Wien: IIBW, by order or the Municipality of Vienna, publication in process).

Amann, W. (2009): New policies to facilitate affordable housing in CEE. In: The Housing Finance International Journal, December 2009.

Andrews, D., Caldera Sánchez, A. and Johansson, Å. (2011): Housing Markets and Structural Policies in OECD Countries (OECD Publishing).

Cecodhas (2011): Housing Europe Review 2012. The nuts and bolts of European social housing systems (Brussels, Cecodhas Housing Europe).

Chiquier, L., Lea, M. (2009): Housing Finance Policy in Emerging Markets (Washington, The World Bank).

Kemeny, J. (1995): From Public Housing to the Social Market, Rental Policy Strategies in Comparative Perspective (London, Routledge).

Kemeny, J., Andersen, H.T., Matznetter, W. & Thalman, P. (2001) Non-retrenchment reasons for state withdrawal: developing the social rental market in four countries. Institute for Housing and Urban Research Working Paper 40 (Uppsala, Uppsala University).

Kemeny, J., Kersloot, J., Thalmann, P. (2005): Non-profit Housing Influencing, Leading and Dominating the Unitary Rental Market: Three Case Studies, Housing Studies, Vol. 20, No. 6, pp. 855-872.

Lawson, J., Gilmour, T., Milligan, V. (2010): International measures to channel investment towards affordable rental housing (Sidney, Australian Housing and Urban Research Institute).

Mundt, A., Amann, W. (2009): Evaluierung der Subjektförderung in Wien (Wien: IIBW, im Auftrag der Stadt Wien).

PRC Bouwcentrum International (2005): Sustainable Refurbishment of High-Rise Residential Buildings and Restructuring of Surrounding Areas in Europe. Report for European Housing Ministers' Conference held in Prague, 14-15 March 2005 (The Netherlands, PRC). Priemus, H. (2008): Real Estate Investors and Housing Associations: A Level Playing Field? The Dutch Case, in: European Journal of Housing Policy, Vol. 8 (1), S.81-96.

UNECE (2005): Housing Finance Systems for Countries in Transition. Principles and Examples (Geneve, United Nations Publications).