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# Housing Reform in Socialist Economies

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Bertrand Renaud

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Bertrand Renaud is housing finance adviser in the Infrastructure and Urban Development Department of the World Bank.

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## ABSTRACT

This paper summarizes the main conclusions of the Seminar on Housing Reforms in Socialist Economies held in Washington, D.C. on June 12-13, 1990. The seminar was initiated to discuss the transition from socialist systems, where government control and public ownership dominate, to market-based housing systems. This transition to markets is new to everyone, and eight leading questions shaped the agenda: (1) Is there agreement about the ultimate goal of housing reform? (2) How significant is housing reform to overall economic reform? (3) Is there a choice between gradual and radical reform in terms of speed and scope? (4) Is there a minimum package of reforms that is generally applicable and should be implemented rapidly? (5) Is there a desirable sequencing of reform in the housing sector, and why? (6) What are the indirect, market-oriented policy instruments necessary to replace past direct administrative interventions by the state? (7) What kinds of new institutions must be created to support and structure housing markets during the transition? and (8) How can the momentum of reforms be preserved and monitored? A significant consensus emerged at the seminar, and it was agreed that a reform framework based on the proceedings would be prepared to assist individual countries in formulating their reform programs. This framework would also help to assess the World Bank's approach to its operations in particular countries.

The paper consists of two main parts. Part I: The Legacy of Central Planning and Transition Issues for Housing was prepared prior to the seminar and sets the stage for the development of a reform framework in three ways. First, it evaluates the legacy of Soviet-type central planning and previous reform experiments and describes critical differences between socialist housing systems and market-based housing. Then it examines in some detail the complex characteristics of housing as an economic good, their implications for market-oriented reform, and the redesign of social housing policies. Finally, it summarizes prevailing conditions in six major problem areas for managing the transition to a market-based system. This set of six reform areas is addressed in the framework itself. Part I is analytical rather than operational, and readers familiar with both socialist economies and the housing sector may choose to proceed directly to Part II.

Part II: Framework for Housing Reform in Socialist Economies presents the results of the seminar and provides a concise reference point for development of the national reforms according to each country's specific conditions. There is broad agreement that the inefficiencies, distortions, and inequities in current housing systems have created a situation that is incompatible with a market economy, so that housing reform is indispensable if overall economic reform is to succeed. Taking into account the diversity of macroeconomic conditions and the significant differences in housing conditions faced by socialist countries, the framework identifies priority issues and indicates directions for change in four main functional areas: (1) clarification and adjustments of property rights and the scope for privatization of publicly owned housing; (2) reduction and elimination of distortions in rents, prices, and subsidies; (3) the development of sound and viable market-oriented finance mechanisms during a difficult transition when economic conditions have been considerably degraded in many socialist countries; and (4) the reorganization of housing production to include three key dimensions: the need to encourage diversification in the building industry, the urgent reform of the urban planning system, and the new role of local governments in the management of publicly owned assets.

## ACKNOWLEDGMENTS

This paper reflects extensive discussions and the contributions of seminar participants from six socialist countries: China, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia, as well as the views of international experts and senior World Bank staff attending the seminar. Comments on earlier drafts of Part II from Hans Apitz, Douglas Diamond, Henryk Hajduk, Andrew Hamer, Parvez Hasan, Christine Kessides, Michael Murray, Marko Simoneti, Jan Sulmicki, Margret Thalwitz and Eva Valterova are gratefully acknowledged. Mary McNeil provided editorial assistance in preparing the final version of this paper. Elizabeth Durst assisted in the production of tables, graphs, and the final preparation of the manuscript. However, responsibility for the views and interpretations herein rests with the author and should not be attributed to the World Bank, to its affiliate organizations, or to any individual acting in their behalf.

Bertrand RENAUD is Housing Finance Adviser, Infrastructure and Urban Development Department, Policy, Research and External Relations, the World Bank.

## **PREFACE**

Housing conditions in reforming socialist economies have become a major economic, social, and political issue. The housing system affects household living conditions, labor motivation and mobility, and enterprise efficiency. Moving to market mechanisms to improve the operations of the housing system has become the objective of many socialist countries. However, the transition from an administrative system to housing markets is an agenda of unusually broad scope that is new to everyone. To arrive at a first understanding of these major reforms, the World Bank organized an international seminar in June 1990. The present paper builds upon the results of this seminar and outlines a framework for housing reforms. It is clear that housing reform is an important component of overall economic reform. Given the large size of the housing sector, this reform naturally will take time. This paper reflects the World Bank's interest in the ultimate success of housing reform.

Louis Pouliquen, Director,  
Infrastructure and Urban Development Department





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## **Part I:**

# **THE LEGACY OF CENTRAL PLANNING AND TRANSITION ISSUES IN HOUSING**

## **I. INTRODUCTION**

1.1 The World Bank's interest in housing reforms in socialist economies goes back to work initiated in China during 1988. The risks associated with these housing reforms already were high, given the size of China's population and its huge potential for urban growth. At that time, the World Bank's member centrally planned economies (CPE) represented about 25 percent of the world's population. There was no uniform Bank strategy regarding CPE countries. Work in socialist countries tended to be country-specific. The CPEs were considered to be a diverse group of countries at different stages of development that were following seemingly different paths of reform. As the work in China progressed, the World Bank began some limited comparative work with other socialist countries. It became increasingly apparent that housing systems in socialist economies shared important generic features that had been correctly understood before the World Bank could become involved in extensive policy work.

1.2 The importance of housing reforms in socialist economies rose dramatically in 1989 with the historical shifts that took place in Eastern Europe and the Soviet Union. Today, the problem is that the transition from a socialist to a market-based economy is new to all of us. The danger is that routine policy advice based on past experience will be provided not because it is well suited to a socialist economy in transition, but because it is familiar.

1.3 As a result, policy analysis and research on housing reforms in socialist economies has broadened to include a focus on the transition to a market-based system. Three main objectives exist:

- (a) To analyze recent experience in socialist countries and on-going economic, financial, and institutional reforms related to the housing sector.
- (b) To determine the extent of a consensus on the sequencing of reforms during the transition from a centrally planned to a market-based economy.
- (c) To identify critical areas for technical work to support housing reforms.

## The Importance of Reform in Socialist Economies

1.4 Most of the political and social ideologies that feed present public debates about industrial and social development go back to the first half of the nineteenth century. The year 1989 was a watershed for Europe and to some degree for Asia. Two hundred years after the French Revolution, the world seems to have reached the end of the great confrontation between Marx and Tocqueville about what would or should be the mores, the modes of thinking, and the political organization of an industrial society.

1.5 With the accumulation of new problems and facts, analysts now need to refine their analytical tools. The demise of the centrally planned, Soviet-type economy and of "democratic centralism" are quite clear. However, in our evaluations and recommendations for the transition, we should be aware of the constant danger facing social analysts: that of always being "partial," i.e., both "incomplete" and "biased." Many analysts have a tendency to notice mostly the positive features of the societies they prefer and the dark sides of those toward which they do not feel sympathetic.

1.6 When it comes to choices, most European countries are committed to a return to Western political and economic norms. However, it is much too early to tell what kind of system will really emerge in socialist countries.

1.7 For an institution like the World Bank, the risks of reform are specific and immediate in a large economic and social sector like housing. The Bank is often dealing with economies that are either stagnant or in decline, and that have a record of past reform failures. Domestic expectations and international attention are high. The tolerance of the population toward new failures is expected to be low. The Bank should therefore be concerned about the social acceptability and sustainability of various reform proposals.

1.8 Before discussing a policy framework, we might want to first review three basic aspects of socialist housing reforms:

- (a) The legacy of Soviet-type central planning and previous reform experiments.
- (b) The unique characteristics of housing as an economic good in market-based economies and the need for a clear understanding of their implications for market-oriented reforms.
- (c) The scope and components of reform in socialist economies and what makes their transition more significant than housing reforms in market economies, which do not require restructuring the entire housing system.

## II. CENTRALLY PLANNED ECONOMIES AND THEIR HOUSING SYSTEMS

### A. Central Planning: Theory and Reality

2.1 The basic principles of the theory of central planning have often not led to expected results. The claims of central planners have proven to be unrealistic and their methods unsustainable outside the sphere of a war economy or post-war economic reconstruction. The following problems have emerged:

- (a) Central planning could not coordinate all decisions on economic activities according to the preferences of the state and at the same time achieve full employment.
- (b) By emphasizing planning on the basis of physical quantities and using money only as a secondary tool, central planning did not succeed in balancing nominal and real resource flows in the economy over time.
- (c) Contrary to claims, prices have not been flexible enough to clear markets under erratic and poorly informed administrative guidance.

The distortions which pushed CPEs toward a series of reforms were:

- (a) Imbalances in physical flows, which arose either because of politically determined targets that were objectively infeasible, given the resources at hand; a planning process that was constrained by time, relevant information, and computational capabilities; or, simply, poorly trained and incompetent planners.
- (b) Monetary and financial imbalances, which were due to slack use of bank credit and fiscal subsidies, the priority given to the achievement of physical targets over evaluating the economic rationale of projects. Inflation then took three forms: "open inflation," as it is known in market economies; "hidden inflation," when an inferior product with different characteristics is substituted for the original one and is sold at the same or at a higher price; and "repressed inflation," when neither price nor quantity adjustments are possible and consumers are forced into involuntary savings.
- (c) Administratively set prices have been exceptionally inflexible in spite of prolonged imbalances between supply and demand conditions and regardless of underlying production costs. As a result, when changes are sought after long periods of time they must be great and are therefore politically and socially very difficult.

- (d) Because imbalances on official markets could not be worked out through flexible prices or continuous adjustments in quantity, all centrally planned economies have important grey and black markets. Tolerance toward this "second economy," its size, and its contribution to some household incomes has varied from country to country.
- (f) The shortage of consumer goods causes households to alter their behavior in other markets, including the supply of labor and savings. Disequilibrium in consumer markets is generating large intermarket spillover effects that will make monitoring and managing of housing reform more difficult.
- (g) In the 1980s, most centrally planned economies allowed nominal wage increases at a rate higher than the growth of the physical output of goods and services, causing a high level of open inflation, a permanent sellers' market, and shortages. This monetary overhang is destabilizing the economy.

#### B. Gradual or Radical Reform: A Look at Previous Attempts

2.2 Because a pure centrally planned system is difficult to sustain, reforms are not new to socialist economies. After major initial achievements in many countries, the generic features of central planning have produced a rather typical pattern of economic reform that can be simplified into distinct stages:

Stage 1: This is the original period of pure central planning. When economic difficulties arise, blame often is placed on external factors such as wars, a hostile outside world, sabotage, bad weather, or poor crops.

Proposed remedies are essentially political: either negative (purges, trials, police action) or positive (public campaigns, also known as "agitprop," and build-up of heroes of socialism).

Stage 2: Pure central planning continues. However, the blame for poor results is now placed on internal factors such as bad organization, lack of discipline, and low standards of management.

Proposed remedies are essentially administrative and include reorganizations, personnel changes, increased central supervision, more detailed central instructions, more paperwork, and thicker operations manuals.

**Stage 3:** While staying within the directive planning system and "democratic centralism," the focus now shifts to economic mechanisms. Reform recognizes an economic sphere that should be allowed to function according to its own logic. This stage has known two phases:

First, poor results are blamed on the incentive system. The principle of the plan is not considered at fault, only its implementation. Remedies therefore are to change the plan indices to encourage better quality, greater efficiency, and more innovations.

It is later accepted that it is not the scope or contents of central planning that must be changed, but the situation faced by economic agents themselves. Structural remedies now consist of adopting dual solutions between plan and market, such as the New Economic Mechanism in Hungary or "socialism with Chinese characteristics" in China.

The result is a hybrid system that is "neither plan nor market".<sup>1</sup> The market remains a "bird in a cage."<sup>2</sup> Politically, society is increasingly tired of confrontation, but each episode of "normalization" increases the "divide between them and us"<sup>3</sup> and the "restoration of order" becomes more difficult.

**Stage 4:** Eventually, the goal shifts to the total reform of the political and economic system. It is a synthesis of change from above and from below, from within and from without. But where does the transition lead to? A modern mixed-economy? Social expectations play a very large role, and a central question about the future is "whether after decades of anesthesia, the pace of self-organization of civil society can match the pace of disintegration in the communism system."<sup>4</sup>

The housing sector has been caught in a reform treadmill for decades, and there are significant differences in the way it operates across socialist countries today. Yet these differences across socialist housing systems are limited when those with market-based housing systems are more fundamental.

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<sup>1</sup> Tamas Bauer, "The Hungarian Alternative to Soviet-Type Planning," paper presented to the Round Table on the Hungarian Economy and East-West Relations, Bloomington, Indiana, March 1982.

<sup>2</sup> Chen Yun, senior economic advisor to Deng Xiaoping, who maintains a strong interest in central planning promoted this formula.

<sup>3</sup> Bronislaw Geremek, Polish historian, leader at the Government-Solidarity Roundtable, Warsaw, 1989.

<sup>4</sup> Janos Kis, in Jacques Rupnik, The Other Europe, New York: Pantheon Books, 1989, p. 261.

**C. Critical Differences Between Socialist Economies  
and Market-Based Housing Systems**

2.3 Central planning and socialist doctrine have had a profound effect on the organization of the housing system. Before discussing problems associated with the transition to a market-based system, it is useful, if not imperative, that the microeconomic foundations of a socialist housing system be clearly understood. A brief review of the main differences between a socialist housing system and a market-based housing system is needed for effective analytical dialogue on policy issues. The parallels between the two systems also help clarify initial conditions in a centrally planned economy.

**HOUSING SYSTEMS: SOVIET-TYPE ECONOMIES versus MARKET ECONOMIES**

FEATURE	SOVIET-TYPE ECONOMY	MARKET ECONOMY
1. BASIC CONCEPTS OF GOODS AND SERVICES	<p><u>"Commodity" goods</u>: these are products that come into being as the property of particular agents who exchange these goods through a process of bargaining.</p> <p><u>"distribution" goods</u>: in a socialist or communist society, products come into being as the property of the whole society (property of the state). They are distributed according to rules and policies established on a social level by the state.</p>	<p>Goods and services are considered equally valuable in meeting consumer needs. Often goods are divided into: capital goods, durable goods (which produce a flow of services over time), and consumer goods.</p> <p>In the case of housing, serious attempts are made by policy analysts to confront the <u>special characteristics of housing as an economic good</u>: these characteristics are durability, heterogeneity and spatial fixity.</p>
2. RATIONALE FOR ALLOCATION	<p>Housing is considered a <u>"distribution" good</u>. It should be <u>uniformly allocated</u> to every member of society according to needs. Housing is allocated on a point system with some priority modifications. Housing should not be a source of personal profit in socialist economies.</p>	<p>Housing is a <u>private good</u>, which households acquire according to income. Providing <u>the same amount of housing to everybody is not considered an appropriate social goal</u>. To the extent that incomes vary so will housing differ. There is a two-part structure to housing policy. The majority of people are served by the market. Income redistribution for housing as a "merit good" for lowest income groups is an accepted social goal.</p>



### 3. IDENTIFICATION OF NEEDS

Housing is part of "social consumption", which is met by the work unit (in China the danwei) or other organizations. Social consumption components include public child care, education, health benefits, housing, pensions, communal feeding, transport, entertainment, and cultural services.

Each individual household decides on its own needs and tries to meet them through the market. Social housing policies also recognize that government must deal with heterogeneous groups of people and therefore differing needs.

### 4. MACROECONOMIC DETERMINANTS OF HOUSING INVESTMENT

Residual allocation in the central planning process. In national accounting, housing is not a distinct sector: it is part of "capital construction" as "non-productive construction."  
The costs of "social consumption" are paid from state budget resources and enterprise earnings. Household subsidies, including housing subsidies, tend to become very large.

Decentralized decision-making process. The level of investment reflects population structure, income level, and vacancy rates. It is most directly influenced by interest rates and the rate of return to housing compared to other investments.

### 5. STRUCTURE OF DEMAND

Planner sovereignty and "standardization of demand": no consumer choice. The system is supply driven; housing needs are met by the work units of the local housing bureaus. They are met through "socially scientific rules": one-room, two-room, and three-room units. Standards are expected to be uniform throughout cities. Socialist urban planners do not use basic concepts of demand analysis and affordability. Their work is guided by physical norms and demographic projections. This was done to facilitate industrial housing production.

Consumer sovereignty: housing system is demand driven. In practice, housing markets are highly differentiated in terms of income and according to location.

## 6. PRICING OF HOUSING

Pricing is centralized. Rents are normative and have little to do with the economic cost of providing housing services. Socialist countries are proud that rents are very stable: rents have been frozen in the Soviet Union since 1928; in Bulgaria and Czechoslovakia since 1967; in Hungary rents changed only in 1949, 1967, and 1983. Little or no attention is paid to spatial factors in pricing. Both the consumption of housing services and the production of new units are heavily subsidized. This creates excess demand for housing and significant intermarket spillovers. Simultaneously there is excess consumption and permanent shortage.

Pricing is decentralized to the individual unit level: the only way of pricing heterogeneous, spatially differentiated good. Cost recovery is critical to the self-financing of the sector. Rent control, while locally practiced, is rejected by economists as an effective way to meet social needs because it rapidly builds up shortages. Many societies prefer nondisruptive rent supplements or direct provision for limited social groups.

## 7. FINANCING OF PRODUCTION

With low wage policy and social consumption goods, households own few assets. They spend a very low share of their expenditures on housing. In reforming socialist economies, housing receives capital grants, subsidized credits, and subsidies. In addition, enterprises receive various subsidies and tax rebates for maintenance.

Housing is the dominant asset of a household portfolio. In a well-run market system, housing essentially is a self-financing sector. Ex-ante and ex-post saving flows through mortgage repayments and thus play a key role in the financing of housing.

## 8. TENURE SYSTEM AND OWNERSHIP OF THE URBAN HOUSING STOCK

Property income has been eliminated (rent, interest, profits). Ownership is a residual of pre-revolutionary days. Most people rent. Occupancy permits have indeterminate duration and imply strong property rights. There is confusion regarding rights to structures and rights to land. Private property, both economically and spatially, in a free market sense has been marginalized in cities. Private ownership through cooperatives can be extensive but is usually subject to significant restrictions and administrative controls. "Commodity housing" reforms mean "individual" ownership.

Two major forms of tenure: ownership based on titles and rental based on fixed-term clear contracts that are renewable. Ownership rates in Western countries range between 42% (Germany) and 64% (United States and United Kingdom). Most renters rent from private owners. Some countries like the United Kingdom have gone through an intensive phase of privatization of the public stock in the 1980s.

9. PUBLIC SECTOR ROLE  
AND EFFECTIVENESS

Major gaps exist between the expression of macrosocial preferences and objectives and microinstruments to achieve them. Economic systems are inefficient and highly distorted due to this gap. The pure concept of equal "distribution" of housing has proven to be unworkable.

On the production side, large state industrial housing companies have no valid economic and technical rationale. They are bureaucratic and monopolistic organizations that receive no feedback from households on their preferences.

Of the three basic functions of production, regulation, and finance, government emphasizes regulations and indirect guidance of the housing markets.

III. CHARACTERISTICS OF HOUSING AS AN ECONOMIC GOOD  
IN A MARKET ECONOMY

A. Housing is an Unusually Complex Economic Good

3.1 The objective of reform in socialist economies is to move away from state-controlled decisions to an economy that responds to market forces. In housing, the result would be a system that is well integrated into the rest of the economy. At present, fragmented housing sub-systems are governed by a variety of administrative rules implemented by poorly coordinated or competing government units that are often too far removed from local conditions. The administrative housing systems of socialist economies amplify transaction costs and lower productivity by failing to treat housing as an economic good. As a result, it is much more difficult to achieve social policy objectives in the sector. Understanding the economic nature of housing is central to the success of reform.

3.2 Housing is not the most complex technical good produced in an industrial society. However, it is perhaps the most complex economic good to analyze and manage properly because of its durability (measured in decades), heterogeneity (in terms of design, age, and utilities), spatial specificity (with the influence of neighborhood, ecological, sociological, and infrastructure qualities), and extensive regulation by government. These features lead to the unique behavior of housing markets and affect economic analysis, policy design, and decision making. They explain why indirect policy instruments of decentralized market systems are superior to the direct, centralized bureaucratic interventions by the socialist state, in achieving efficiency and meeting social goals.

3.3 Managing the transition to markets implies a change in perspective. The technical-administrative emphasis of socialist systems needs to change to the more flexible economic and financial perspective of decentralized market decisions. To achieve this transition most favorably, four main characteristics of housing markets must be respected. To clarify this new perspective, these four characteristics are examined in greater detail below.

#### B. Durability

3.4 A housing unit is a capital good with an extremely long life compared to most other capital goods. In policy analysis it is, therefore, critical to distinguish between "housing stock" and "housing services."

Expanding the housing stock requires producing new housing through the use of:

- land
- labor
- building materials and
- financing.

Producing housing services consumed day-by-day requires the use of:

- a housing unit from the existing housing stock
- labor and
- other operating inputs (heat, light, water, furniture, appliances).

3.5 It is not the housing stock but the housing services flowing from it that generate utility and service demand by households. To say that "housing is consumption" can perpetuate the confusion between the housing stock, which is definitely an investment good, and the flow of housing services, which is generated by this housing stock and consumed daily. To make a comparison: when we finance a textile plant we finance a facility that will produce shirts, pants, or socks; we are not financing shirts, pants, or socks.

3.6 From a macroeconomic management viewpoint, the central efficiency issue is the relative rate of return on additional housing investment compared to other sectors of the economy. The rate of return to new housing is particularly high in socialist countries that have systematically underinvested in housing. But investment gaps in other sectors are also severe. The relative share of housing investment will vary from country to country.

3.7 Because of durability, the housing demand decision for a household in a market system is a two-step choice regarding:

1. The quantity of services to consume. This is the demand for housing services as a consumption good.
2. Whether to own or to rent. This is a totally different demand for housing stock (as an investment), which should be compared with other asset-market choices. This tenure decision has a major impact on household saving behavior in market economies.

### The Housing Stock-Adjustment Process

3.8 Investment in housing differs greatly between socialist economies and market economies.

1. In socialist economies, central government administrative decisions are based on demographic variables and physical norms linked to five-year and annual plans.
2. In market economies, the stock-adjustment process is based on decentralized decisions based on the effective demand that originates from individual households.

3.9 The stock-flow adjustment behavior of housing markets is dominated by prevailing (user cost) prices for the flow of housing services from the existing stock. Three factors dominate:

1. The inelastic supply of housing units and housing services in the short-run.
2. The price of these housing services, i.e., market rent levels determined by the demand for and supply of inelastic services.
3. The price of these housing services compared with:
  - (a) the operating costs of the existing housing stock, including depreciation (both economic depreciation and physical depreciation);
  - (b) the expected rate of appreciation of housing prices; and
  - (c) the rates of return on alternative assets, for instance, financial assets or small business investment with an implicit risk adjustment for housing compared to other assets.

The net result of these decentralized and continuous evaluations is to determine a capital value per unit of housing stock, i.e., housing unit prices. In an efficient economy, the flow of new housing investment will depend on the supply price of producing new units compared with the capital value of existing housing (linked to rental value).

3.10 A major dimension of private ownership not always well understood in market reforms is that ownership rights include risk that the value of a housing unit can rise or fall. Expectations of capital gains or fear of losses are an important dimension of the real cost of ownership and the tenure choice between tenancy and ownership in market systems.

### Consequences of Durability

3.11 Four major consequences result from the fact that housing is a long-lived good:

1. New residential construction is a volatile component of national gross investment. In advanced economies, this volatility is about 40% between peak and trough in the housing cycle. In developing countries, volatility tends to be greater due to the lack of a housing finance system. The reason is that in developing countries, effective housing demand is either cash-based or asset-based; it is not financed with a mortgage loan.
2. Because of durability there are two important flows of funds into producing services:
  - (a) one for the production of new units every year, and
  - (b) one for the maintenance and/or renovation to expand supply from the existing stock.<sup>5</sup>
3. In managing the transition to market-based housing, governments need to monitor interactions among the components of the housing market involving both existing or new housing units:
  - (a) the market for buying and selling stock that is owner-occupied (its share seldom goes higher than 65% of total stock);
  - (b) the market for buying and selling stock for rental (mostly apartments).
4. The existing housing stock is therefore quite important relative to the annual additions of new housing: new construction increases the stock of housing units by about 1 to 5% per year.

3.12 A fifth consequence of durability for households is that the value of the housing investment generating services is large compared to the annual income of its occupants. In well-functioning housing markets, the housing price-to-income ratio (PIR) ranges between two and less than six. Hence, the critical role of long-term financing for housing ownership.

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<sup>5</sup> In the United States, over 30% of investment funds go for improvements to the stock. In the developing world, progressive housing investment is very common.

### C. Heterogeneity

3.13 Housing units that command the same total price can differ widely in:

- size
- age
- design
- access to other urban locations
- neighborhood quality and land use pattern and
- tax levels and services provided by the local government.

3.14 Far from being a shortcoming, heterogeneity is a source of diversity that satisfies the varied needs of equally heterogenous households. The effort to "standardize housing demand" to facilitate the production of identical housing units has become a major source of public dissatisfaction in socialist countries.

3.15 Given heterogeneity, households usually relocate when needs change. The rate of housing turnover in market economies is significant. In many markets, the percentage of units changing hands every year usually ranges from 15 to 20% . In socialist economies, the turnover rate is inefficiently low; it fell as low as 1% or below in Poland and Romania in the late 1980s.

#### Consequences of Heterogeneity

1. Housing markets are information intensive and not as efficient as financial markets. An organized commodity market with a single quoted price for a homogeneous unit cannot exist.
2. A well-organized real estate brokerage industry is needed to produce accurate and timely information. Socialist housing bureaus do not exist for that purpose and have proven quite incapable of producing such services. Lacking exchange mechanisms and relevant information, the socialist housing stock is generally misallocated.
3. Households face significant transaction costs to change the quantity of housing they consume. These include:
  - costs of search
  - legal transaction costs
  - moving costs
  - cost of readjusting furnishings to new unit and
  - psychic cost of disruption.

4. These transaction costs usually range from 3 to 7% of the value of the unit being exchanged and can be even higher. In addition, indirect taxes, housing registration costs and borrowing costs can add from 3 to 20% in countries of the European Community depending on country, type of unit and nature of the transaction.
5. For extended periods of time the housing consumption level of a household can differ markedly from what would be observed in the absence of transaction costs or recontracting.
6. In financial analysis, real estate markets are described as not being "perfectly efficient."
7. A certain amount of vacancy ("natural vacancy rate") improves the use of the existing stock. Depending on local market conditions, vacancy rates may range from 3 to more than 6% of the existing supply of units.

#### D. Spatial Fixity

3.16 Location is an inherent characteristic of the housing stock. It is generally useful to distinguish this spatial fixity from the heterogeneity of housing. That is to say, analyses and policies must differentiate between the characteristics of the unit itself and the characteristics of the neighborhood in which it is located.

Several major dimensions to location exist:

1. Distance from important locations. The place of employment is usually the most important location but there are secondary centers of attraction such as:
  - the central business district
  - other employment concentrations
  - shopping areas and
  - transportation modes and commuting routes in general.
2. The type of local government jurisdiction, which affects the level of infrastructure and physical services in the neighborhood. Jurisdictions differentiate themselves according to:
  - tenure for the occupation of sites
  - paved roads
  - water supply and sanitation



- police protection
  - fire protection
  - commercial and social services and
  - local taxes.
3. Within jurisdictions, the nature of land-use in the neighborhood has important affects on:
- open space and
  - sources and levels of various forms of pollution.

### Consequences of Spatial Fixity

1. The spatial fixity of housing affects the price of land and the entire issue of the substitution between land and building structure. It also explains why the sound regulation of land systems is so critical to housing sector performance.
2. Spatial fixity has advantages for housing finance. Housing is good collateral for lending:
  - it is immovable
  - it is in widespread demand
  - it is not so volatile compared to other commercial collateral i.e., housing does not fall in value with the loss of reputation of its owner/manager and
  - it is a preferred collateral for bankers.
3. Spatial fixity also creates serious public policy problems:
  - a trade-off between transportation and housing costs in household budgets
  - an intensification of spatial fixity problems dues to a rigid system of urban planning in socialist countries and
  - problems with land use efficiency, negative density gradients, and the withdrawal or hoarding of land in socialist cities.

### E. Government Involvement

3.17 The level of government involvement in the housing market is generally very high. Both direct and indirect policy instruments are used. Five major types of public interventions exist in the sector:

1. Provision of physical and social infrastructure which takes the form of:
  - physical capital expenditures and
  - tenure security and property rights, which are most important.
2. Taxation.
3. Regulations. Because of the spatial fixity of housing, government interventions in land use have some of the greatest efficiency effects on prices and resource costs in the sector.
4. Interventions into the housing finance system.
5. Creation of public institutions directly involved in production (three major kinds):
  - public land development agencies
  - public housing agencies and
  - public banks such as housing banks and municipal banks.

This form of direct intervention--reliance on public institutions for the production of housing--is usually the least successful, according to two decades of World Bank experience.

3.18 The rationale for public intervention must be carefully scrutinized. The Bank has learned a lot in market economies about:

1. The desirable division of labor between the public and private sectors.
2. Conceptual and operational differences between public goods, private goods, and merit goods.

Despite the complexity of public interventions in housing, perfect information is not required. Because of the flexibility and decentralized nature of pricing, most reforms in market economies can be and have been reforms at the margin. The problem faced in socialist economies that are in transition is that the entire economics of the public sector must be reconsidered and decision-making structures completely reorganized.

## F. Consequences of Housing's Characteristics for the National Economy

3.19 By any measure, housing plays a major role in any market economy, whatever indicator an economist might choose. The impact of housing reforms, therefore, will be deeply felt socially, politically, and economically because of the importance of housing to the overall economic well being of a country. Housing's major role can be measured from many important perspectives.

For household wealth:

A housing purchase is the largest transaction ever made (usually worth three to six times annual household income in market economies).

Housing assets form the largest share of total household wealth (often 75 to 90% of the patrimony).

For monthly household expenditures:

Housing requires from 15 up to 50% of monthly expenditures depending on local conditions and household tenure choices between renting and owning.

For national wealth:

The share of net residential capital and of related consumer durables is very high in the total reproducible physical (as opposed to financial) wealth of a country. This share ranges between 20 to 50% of total reproducible wealth and rises with urbanization and per capita income.

For annual national economic output:

Housing ranges from 15 to 30% of annual investment; that is to say, 2.5 to 7% of annual output (GDP).

For employment:

Residential construction alone represents about 5% of the labor force and total construction often makes up 9 to 12% of employment.

Real estate industry employment to manage the system is from 3 to 4%.

For the banking sector:

Mortgage-related assets can form a very substantial part of total banking assets (as high as 25 to 30%)

For price stability:

Housing expenditures are a large component of the Consumer Price Index (39% in the United States).

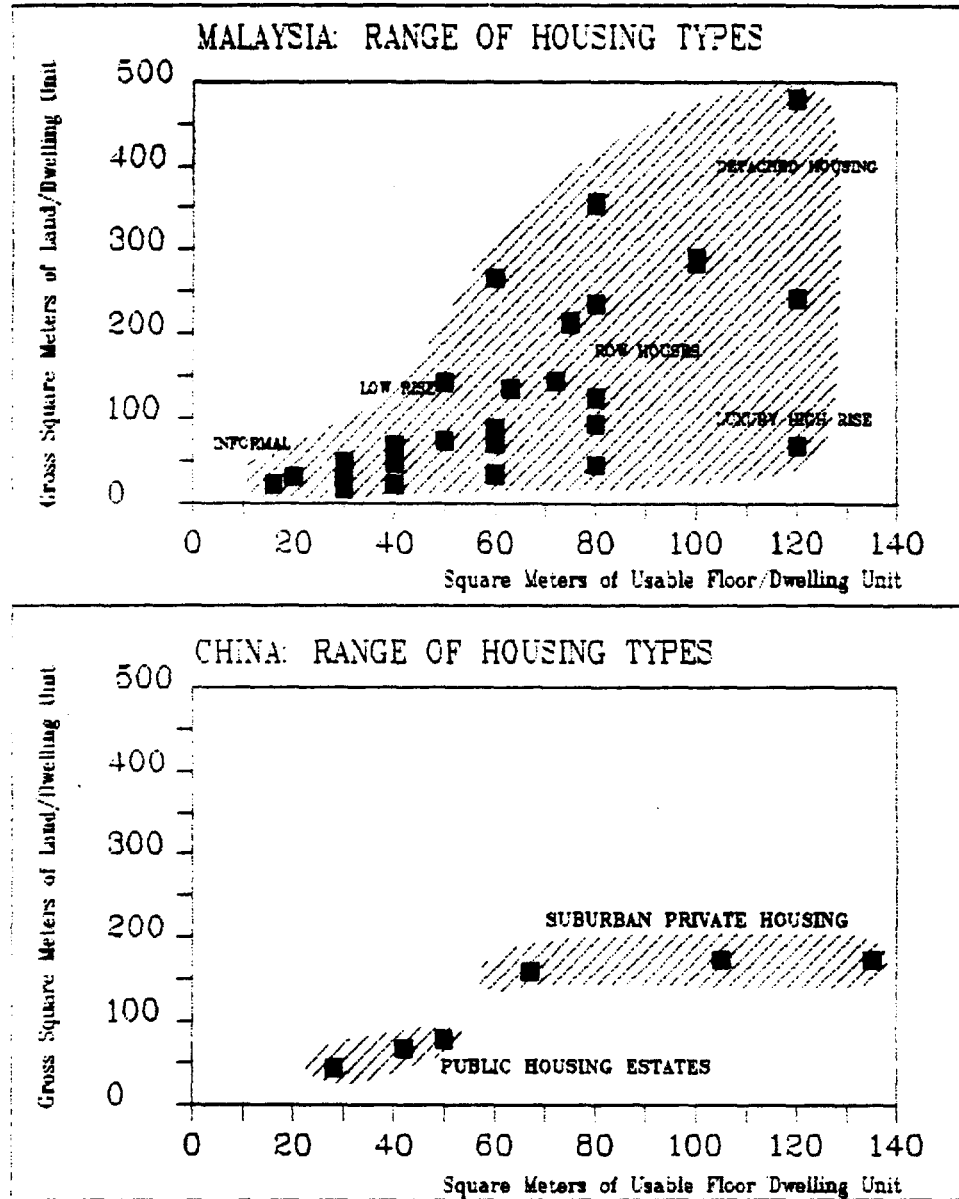
3.20 This overview of the characteristics of housing has immediate implications for the design of transition policies and the reassignment of responsibility for policy at various levels of government. New policies and institutions must reflect the fact that we are not dealing with a single homogeneous commodity market but with a series of overlapping and interacting sub-markets differentiated according to:

- location
- dwelling type
- tenure form
- age and quality
- vacancy rates
- financing and
- the socioeconomic characteristics of residents.

The great diversity of housing units must match a large and ever changing diversity of household and labor market conditions. Presently, indirect policy instruments and private contractual arrangements used in market economies to deal with this diversity are not yet in place in socialist economies undergoing transition. Public ownership of production, centralization of decisions, and the monolithic, gigantic scale of many housing organizations have dragged socialist governments into a quagmire of direct interventions. Using industrial housing systems, socialist countries have often been able to produce large volumes of housing units. However, they have not been able to meet the varied needs of households. This mismatch is evident in comparing urban housing in socialist China and housing markets in Malaysia. In Malaysia, for example, units respond to the housing demand of different households as presented in Figure 1.

3.21 To cope with the significant transaction costs inherent to housing, socialist governments have used oversimplified administrative rules that do not match the complex reality of the sector. Decentralized, indirect financial and fiscal market instruments in the housing sector are more effective and less management intensive. Reform governments now have to make rapid and correct decisions in managing the transition.

**FIGURE 1**  
**DIVERSITY OF CHOICES IN MALAYSIA and**  
**STANDARDIZATION OF URBAN HOUSING IN SOCIALIST CHINA (1989)**



**Source:** Bertrand Renaud and Alain Bertaud, "Urban Housing Reforms in China: The City Experiments and the 1988 Reform Plan". Paper presented to the Leading Group on Urban Housing Reforms, World Bank Seminar on Housing Reform, Beijing, October 1989 (unpublished).

#### IV. MAJOR CONSIDERATIONS IN THE TRANSITION TOWARD A MARKET HOUSING SYSTEM

4.1 In managing the transition to a market-based housing system six major problem areas should be considered.

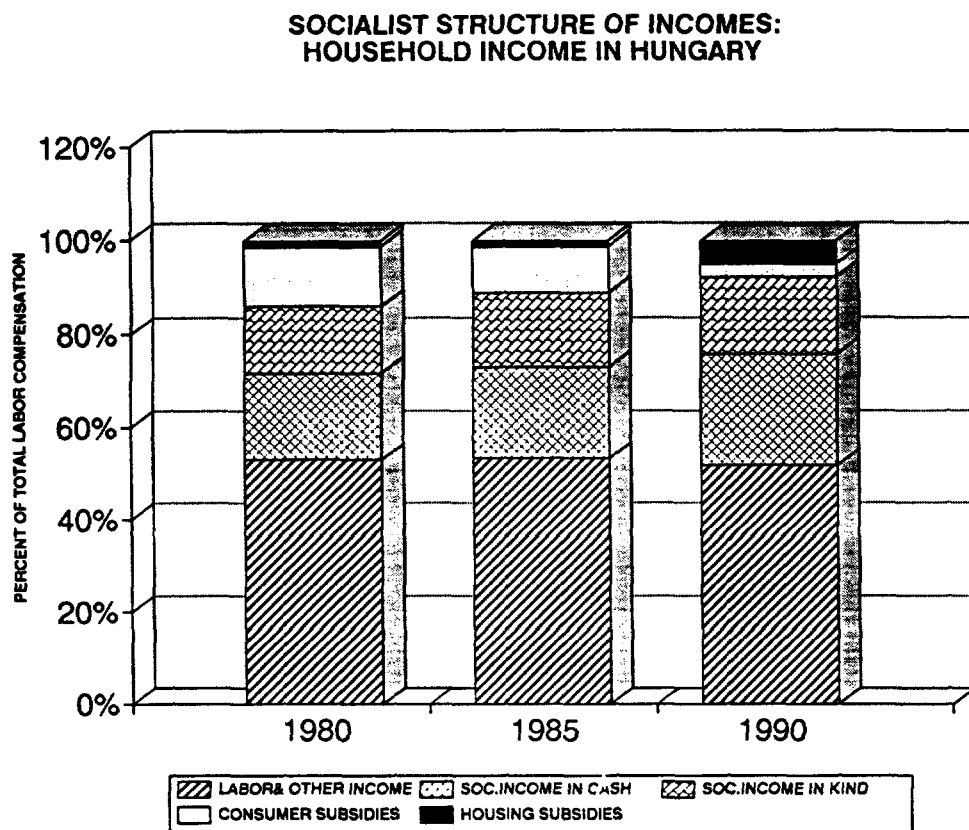
##### A. Structure of Household Incomes and Scope of the Reforms

4.2 Reforming the housing sector in socialist economies really means reforming the entire household economy due to the "distribution" link between low cash wages and extensive subsidies:

1. Income in kind and subsidies make housing a major source of inequality in the system, as well as a cause of large budget deficits and inflation.
2. Total household incomes are not used to formulate plans for housing production. They are not always well known and may have three parts:
  - (a) Wage payments in cash that tend to be low and rather uniform compared to market economies.
  - (b) Income in kind such as free or heavily subsidized housing, transportation, health services, education and retirement benefits, and access to scarce consumer goods, which varies widely according to the employer.
  - (c) Unreported incomes from the nonstate "secondary economy," which have become increasingly common among service sector workers.
3. Inequalities show up most strongly in the area of income in-kind. Not only is the housing subsidy system highly regressive because it is linked to the size of units, but access to such subsidies may also favor high incomes due to subsidized credit systems.

4.3 The extent to which cash incomes approach full market wages varies across countries. In China, real wages remain close to the traditional combination of low cash wages with public provision of services like housing. As a result, Chinese labor markets are limited. In Hungary, where "market socialism" was introduced in the 1960s, the share of cash wages remains low and the share of social amenities such as housing still makes up almost half of total income by 1990, as shown in Figure 2. Yet, this Hungarian ratio underestimates the noncash value of housing subsidies.

**FIGURE 2: STRUCTURE OF LABOR INCOME IN SOCIALIST ECONOMIES**



**STRUCTURE OF HOUSEHOLD INCOME IN HUNGARY**

	1980	1985	1990
HOUSING SUBSIDIES	1.3%	1.3%	4.9%
CONSUMER SUBSIDIES	12.7%	9.8%	2.9%
SOCIAL INCOME IN KIND	14.3%	15.8%	16.4%
SOCIAL INCOME IN CASH	18.8%	19.9%	24.1%
LABOR AND OTHER INCOME	52.9%	53.3%	51.7%

Source: Joint Hungary-World Bank Study of Social Policy and Distribution System Reform, 1991, Table II.3.a.

## B. Property Rights and Privatization

4.4 Most socialist economies are no longer trying to perfect the existing economic system but want to change it fundamentally. Crucial to this restructuring is the development of a legal "private" economy in which the state does not own and control the means of production and in which individuals have ownership incentives. In other words, individuals can earn income (or experience losses) according to a change in the value of the assets they own, not simply through a change in income commensurate with direct labor. Not only will there be managerial income, but entrepreneurial income as well.

4.5 These economies are moving from a poorly differentiated environment of state property rights to a highly differentiated set of rights attached to ownership in a modern economy: the right to receive income from productive assets; the right to negotiate the sale price of output in private voluntary transactions; the right to make decisions about their use; and the right to dispose of property through sale, transfer, or inheritance.

4.6 In the case of housing, property rights have to be extensively restructured, for both tenants and individual owners. At present, many types of housing tenure arrangements such as local government and enterprise rentals and housing cooperatives are subsidized by the state. In addition, new institutional arrangements have to be developed because of the absence of land markets and ambiguities about land use rights. Clear legal arrangements need to link building ownership rights with land use rights at a specific site. These new property rights will have a fundamental affect on the future development of urban land markets in which public landowners and private users are expected to operate.

## C. Price Distortions

4.7 Relative prices in socialist housing economies, both for the sale of housing and on rental markets, are highly distorted compared to underlying resource costs.

Prices are not the primary resource allocation mechanism in a centrally planned economy, and two significant price distortions exist:.

1. The first major price distortion is a low-rent policy, which is the direct cause of excess demand and undermaintenance of the large existing stock of housing. The rent received directly from households usually covers less than 25% of the maintenance funds required for full maintenance, and is far from full market rent.
2. For housing sales, the housing price-to-income ratio (PIR), which can be measured as the ratio of the average trading price of a housing unit to the average cash income of households in a given city, is usually extraordinarily high and ranges between 10 and 20% or more in socialist economies for which



data is available. This PIR is initially a major obstacle to privatization but can be expected to decline significantly with the increase of market transactions. This decline, however, will not reach the low PIR values of around three, commonly found in market-based housing markets. Moreover, high PIR values may be affected by several distorting factors:

- (a) The price of a housing unit may include infrastructure or neighborhood facility costs that would not be directly charged to a housing unit in a market-based system.
- (b) Housing standards may be much too high for the current purchasing power of the population. What is needed is a greater diversity of housing units. In Figure 1, two graphs show housing choices in terms of unit size and lot size in China and in Malaysia. The standardization of urban housing in China, through regulated building of 1-room, 2-room and 3-room units, stands in great contrast with the diversity of the housing stock in a market system like Malaysia. In Malaysia, households of different incomes, family size, and employment have a wide range of choices to meet their needs. They can also evaluate trade-offs between space and/or a more central city location.
- (c) The site value of land, the economic value of its location within a city, has no price under pure Marxist theory; only physical improvements produced by man's labor are priced. As a result, land can easily be misallocated. Socialist cities therefore have a tendency to have negative population density and price gradients.
- (d) Preferential access and pricing of goods and building materials for state enterprises can lead to dual pricing and an underestimation of the resource cost of state-built housing and an overestimation of privately built housing.

#### D. Lack of Financial Mechanisms

4.8 In most socialist economies, there is no efficient financial mechanism to mobilize household savings and to finance the purchase of housing:

1. Financing the purchase of housing units during the transition will be very difficult because of twin problems of housing price affordability, due to the initial PIR, and mortgage finance affordability, due to current high levels of inflation.

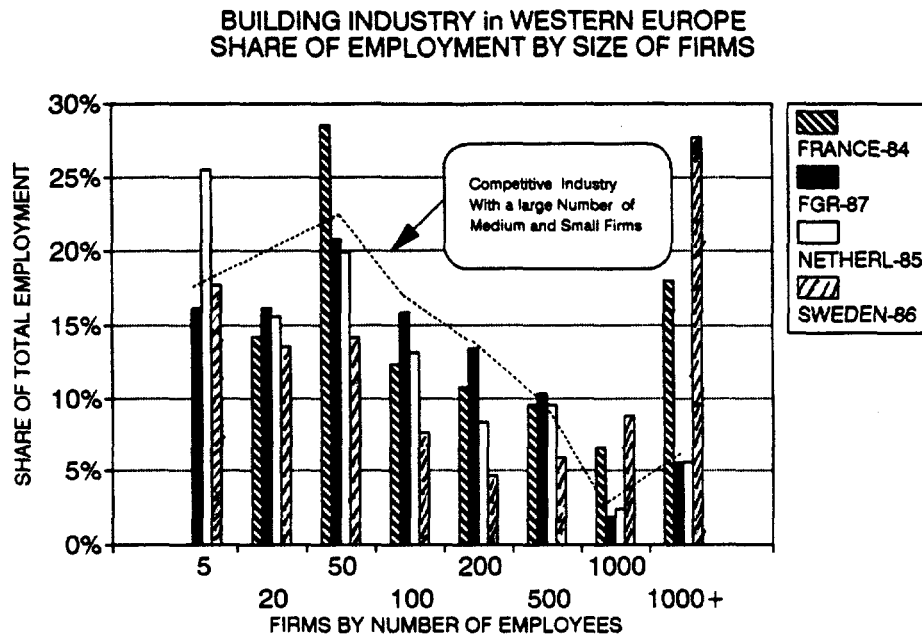
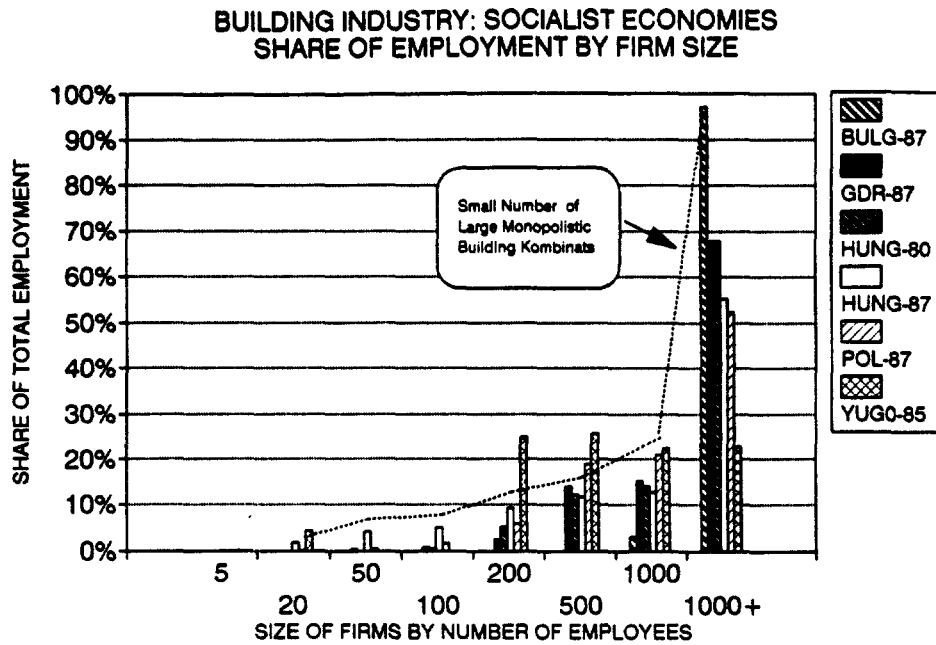
2. Financial intermediation is poorly understood. Traditionally, the monopolistic banking system has provided inter-enterprise payment mechanisms. It has had a limited interest in serving households.
3. Households have the least control over the flow of funds. Today, payment mechanisms for housing are mostly outside the direct control of households. Payments by the employer and subsidies from the state are channeled directly to the state builders as are "mortgage loans."
4. Interest rates do not play a major role in allocating credit, and this credit is heavily subsidized. The perspective on housing credit must be shifted from credit subsidies to positive real returns to deposits.
5. The difficult financial problem during the transition will be to optimize the three-part combination of household savings, transparent state subsidies, and sound mortgage finance.

#### E. Inefficient Building Industry Organization

4.9 The system of housing production in socialist countries is very rigid, monopolistic, and costly. It optimizes builder rather than household preferences. In any given country, the organization of the construction industry closely reflects the nature of decision making and the structure of financing: the organization of socialist and market-based construction industries contrasts sharply. In countries with central planning, the concentration of enterprise is extreme. There is a clear preference for vertically integrated organizations which is reinforced by choices of technologies.

1. The building sector in socialist economies was originally organized to operate as a centrally planned system but is now operating in a different and increasingly decentralized way.
2. Particularly conspicuous today is the problem of lack of feedback mechanisms and the wrong order of priority in designing housing: "standardization of demand" has been imposed on households by the building industry in order to industrialize it.
3. Large-scale public building enterprises are neither technically nor economically justified. Originally, the objective in socialist economies was to industrialize housing. The structure of the construction industry in Western Europe stands in complete contrast with that of socialist economies. Market economies have a diversified organization, with the greatest number of people employed in small and medium firms. As shown in Figure 3, European socialist economies have a strong preference for large monopolistic organizations: most of the

**FIGURE 3:  
THE BUILDING INDUSTRY IN EASTERN EUROPE AND WESTERN EUROPE**

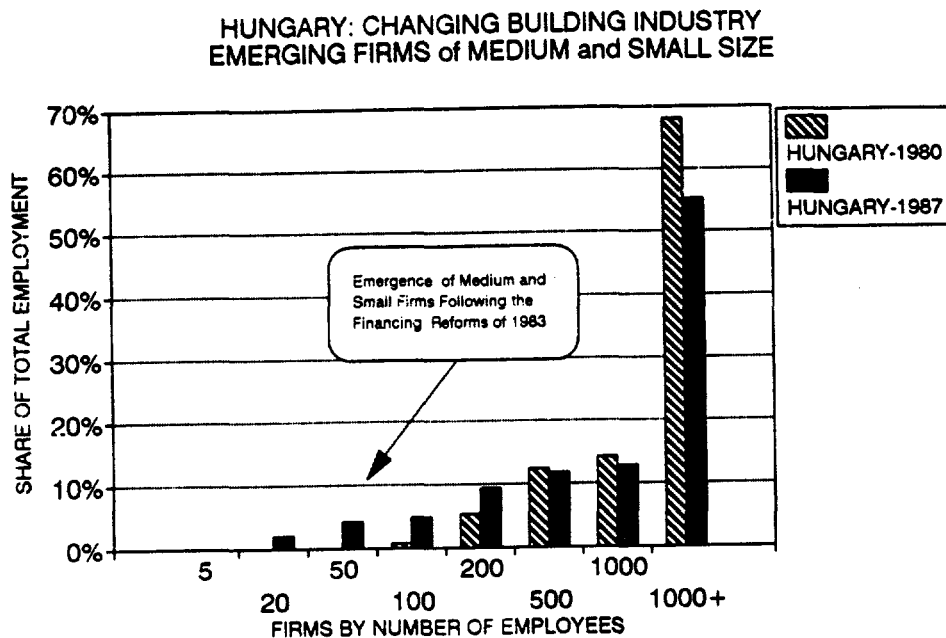


construction labor force is employed by firms of more than 1,000 workers. Within socialist countries, the likely impact of market reforms in changing the composition of firms in the building industry can be seen by comparing Bulgaria, which adhered to central planning until 1989, with Yugoslavia, one of the early leaders of "market socialism."

4.10 The slow development of the civilian mechanical engineering industry in socialist economies and the inadequate production of modern internal equipment and house finishings have seriously hampered the quality of the hoped-for industrialization of housing. As a result, a large percentage of the housing stock is now entering a phase in which maintenance costs are very high.

4.11 A shift to a market-based housing system will lead to major changes in the structure, conduct, and performance of the construction industry. In Hungary, as is shown in Figure 4, the 1980 size-distribution of construction firms began slowly to decrease in favor of more medium and small firms by 1987. This indicates a functional link between the changing flow of funds in the housing systems following the 1982 reforms when subsidies were shifted to the demand side and made available to individual households.

FIGURE 4



## F. Rigid Urban Planning System

4.12 The system of urban planning in socialist economies is rigid and has been making urban land increasingly inaccessible for housing production.

1. Urban planning is based on long-term land use plans that look ahead 30 to 40 years. These plans are derived from a priori principles assumed to have historical permanence. They therefore offer limited mechanisms for the modifications made necessary by evolving production technologies, rising incomes, changing social values of urban residents, or, simply, the lessons of experience.
2. The urban planning system has been shaped by large-scale industrial housing which requires construction on large parcels of land most easily available at suburban locations far from the city center.
  - (a) Such a spatial pattern of housing investment easily increases the demand for major trunk infrastructure and transportation services.
  - (b) A diversity of small and medium-scale housing projects would make use of land more rapidly, at a smaller cost, with a greater variety of housing units. It would imply a new type of urban planning.

## G. Shrinking, Stagnant, or Growing National Economy?

4.13 A critical exogenous factor for the transition of the housing sector to a market-based economy is whether the national economy is itself currently stagnant or even declining.

1. During earlier periods of central planning when heavy industry was a priority, socialist economies systematically under-invested in housing compared to market economies at similar income levels.
2. Due to the economic slowdown, the housing sector may once again become a residual sector in national planning. Even so, it will take considerable effort to realize the potential contribution that a well-structured housing sector can make to the growth of the economy.

3. Different socialist countries may face different priorities. In stagnant or contracting economies in which rapid action is needed, housing sector reforms may be closely linked to the need to maintain a minimum level of output during a difficult transition. In growing economies, the priority might be on removing inefficiencies and regressive subsidies to the system while improving social policies. In both cases, a new perspective on the housing sector is needed. Housing should be treated as an important productive sector and a major component of macroeconomic management. Scarce budget resources now presently used to subsidize rents and housing utility costs for most urban households should be redirected to weak social groups who might suffer the most during the transition to market-based economies.

## **PART II: FRAMEWORK FOR HOUSING REFORM IN SOCIALIST ECONOMIES**

### **I. HOUSING AS A MAJOR COMPONENT OF ECONOMIC REFORM**

1.1 Socialist economies are now moving away from the predominance of the state to market-based systems in most economic activities. In all socialist economies, housing reforms have become a high priority because of the large direct impact housing subsidies have on national budgets; the ineffective mobilization of household savings they cause; the significant constraints on labor mobility and industrial location they may generate; the economic burden they often place on enterprises, which is then shifted to the state; and the high transport, energy, and overall infrastructure intensity of the urban economy. In addition, the system of assigning housing and regressive subsidies is an important social issue. The economic and social costs caused by the current allocation of public housing are very serious: for a comparable level of resources, many people, given a free choice, would choose different types of housing units or select different locations for their housing.

1.2 Housing reforms are integral parts of macroeconomic stabilization and structural change. They cannot proceed autonomously and must be synchronized with reform in other parts of the economy. The proposed framework does not constitute a rigid blueprint: rather, it identifies the major components of housing reform, shows how they are functionally related, and the specific actions that must be taken with respect to each component. Autonomous actions that can be taken within the housing sector independently of other economic reforms deserve particular attention. This framework identifies strategic issues that need to be addressed in formulating action plans for the reform of the housing sector. Further refinements that take into account countries' specific macroeconomic and sectoral conditions would be needed to define frameworks for individual countries.

1.3 Part I has shown how in market-based economies, the housing stock forms a major share of national wealth. Similarly, the housing construction industry is linked to numerous production branches of the economy and the construction industry's annual output itself usually represents a large share of total annual investment in GNP. The housing sector is also a major source of employment. For these reasons, housing reform will be an important lever of economic and social policy during the transition to a market-based economy.

1.4 The relative size of the housing sector in socialist economies tends to be smaller because socialist economies have significantly underinvested in housing during periods of forced heavy industrialization. At present, the most visible dysfunctional features of socialist housing systems are a combination of severe shortages and ever-expanding public sector subsidies. The housing sector's low productivity and its large fiscal and financial effects on the macroeconomy

make housing a high priority in programs of economic adjustment and reform. Government budget subsidies to housing are very high, on the order of 3 to 5% of GDP or even higher. In addition, a substantial amount of off-budget subsidies come from enterprises and local governments. These subsidies go toward both the use of the existing stock and the production of new housing.

1.5 Because of the large role of the housing sector in the economy, the massive amount of subsidies it receives, their largely regressive nature, and the very distorted pricing of rental housing, reforms are of the highest priority. There is broad agreement that the inefficiencies, distortions, and inequities in current housing systems have created "a situation which is incompatible with a market economy, so that a housing reform is indispensable if the overall economic reform is to succeed."<sup>6</sup> This section discusses the common elements of a proposed housing framework in terms of property rights and fiscal, financial, and equity issues. It outlines major directions in reforming the building industry, in planning an urban system, and in defining the role of government.

#### A. Macroeconomic Stabilization and Housing Reform

1.6 Most, if not all, socialist countries face the transition to a market-based housing system when their economy is either stagnant or contracting. Stabilization will require rapid control over budget deficits, which include a large volume of direct and indirect subsidies to households for their housing. In contracting economies, reducing housing subsidies while real incomes are declining will bring structural economic reforms to the borderline of political feasibility. Moreover, there is no possibility of financing the overall economic transition by incurring additional debt in heavily indebted countries such as Bulgaria, Hungary, or Poland. For these reasons, socialist countries have made or will make different choices according to their need for stabilization. In these countries, the transition toward a market economy leads to important choices regarding the scope and sequencing as well as the speed of the reforms.

#### Scope and Speed of Reform

1.7 Macroeconomic stabilization and the ultimate structural goal of reform should be clearly distinguished. Stabilization is a top priority in every country, and it has been argued that reforms should be both more rapid and extensive in countries suffering from hyperinflation. Scope and speed are two more distinct issues. For design and implementation, the scope of the reform is the most important: how far do reformers intend to go with market mechanisms? Speed is closely related to stabilization; it may affect selected parts of the housing system, such as the privatization of part of the existing stock. In countries like Poland, scope and speed have been jointly emphasized.

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<sup>6</sup> Dr. Marko Simoneti, Under Secretary, Federal Executive Council, Housing Reform as an Integral Part of Economic Reform In Yugoslavia, presentation to the World Bank Seminar on Housing Reforms in Socialist Economies, Washington D.C. June 1990.



1.8 A fundamental issue is the continuing emphasis on the acceptance or rejection of "market socialism." Irrespective of their current macroeconomic situations, some of the European socialist countries have clearly rejected the search for a third way between a planned economy and a market-based economy. In Hungary, Poland, and Czechoslovakia authoritative voices have spoken in favor of radical and simultaneous changes toward a market economy.<sup>7</sup> Beyond the market rhetoric, it is not yet entirely clear whether other countries have fully abandoned the concepts of "market socialism" tried unsuccessfully in earlier decades.<sup>8</sup> This framework is based on the premise that the goal of reform is a housing system in which most households pay the full cost of their housing and have the means to do so. Housing is obtained in competitive markets, while public sector assistance is clearly targeted to those with special needs. In these market-oriented reforms, the goal is a housing system in which ideological, political and market monopolies have been removed and households preferences are effectively fed back into the housing system.

1.9 When it comes to speed, a distinction must be made between doing it fast and doing it right. Because a reform postponed usually later becomes a more painful reform, speedy decisions are certainly important. However, what really matters to the success of the transition is whether the policy framework is clear, coherent, and will remain stable once it has been adopted. The historical experience is that many institutional and financial innovations take between five and ten years to diffuse throughout society. Because housing is one of the longest-

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<sup>7</sup> Refer to the views of Professor Janos Kornai: "I wish to use strong words here, without any adornment: the basic idea of market socialism simply fizzled out. Yugoslavia, Hungary, China, The Soviet Union, and Poland bear witness to its fiasco," The Road to A Free Economy, 1990, p. 58. The Balcerowicz reform plan in Poland is based on a similar premise. These views were also advanced by Dr. Vaclav Klaus, Minister of Finance of Czechoslovakia, at the World Bank Annual Conference on Development Economics, April 1990: "We are not interested in a third road...There are still those who dream that it is possible to muddle through and to revise just some segments of the existing system". Professor Kornai's views on the functional and logical weakness of a third economic way are further developed in "The Affinity Between Ownership Forms and Coordination Mechanisms" Journal of Economic Perspectives, Vol. 4, No.3, Summer 1990, 131-147. He explores both the incompatibilities between state ownership and market mechanisms, and private ownership and bureaucratic-administrative decision making.

<sup>8</sup> In the Soviet Union, the debate about competing reform plans during 1990 led in September of that year to a major turning point regarding the scope of economic reforms that will carry into the housing sector. The Gorbachev compromise plan of October 15 now states: "The choice has been made. There is no alternative to the transition to the market. The whole world experience proved the vitality and efficiency of the market economy." (New York Times translation, October 17, 1990, page A8). Given the social, political, economic and institutional structure of the Soviet Union, the likely speed and scope of market-oriented reforms remains unknown.

lived investment goods, for a successful transition the stability of the new regulatory environment must be as important as the soundness of choices. An enabling political, institutional, and legal framework should be promptly developed. There will also be scope for experimentation and pilot operations in the more dynamic cities of some countries.<sup>9</sup>

### Sequencing: Should Reform Focus Primarily on the Existing Housing Stock?

1.10 The argument for introducing reforms simultaneously as opposed to sequencing them is that "sequential partial measures can be harmful and do not solve problems"; in other words, that "the sum total of ten different kinds of half results is not five full successes but five full fiascos."<sup>10</sup>

1.11 Regarding housing, reform faces two broad questions: What should be done with the large existing housing stock? How can the supply system and the production of new housing be reformed quickly? In terms of sequencing, should one begin with the existing stock or with new housing?

1.12 Given the multiplicity of decisions to be taken in all economic sectors, governments would like to identify the key bottlenecks on the critical path to successful housing reform. Where should scarce managerial resources go? In particular, which is more important: to reform the ownership structure of the existing stock or to reorganize the system of housing production? In terms of sector-wide impacts, the reform of ownership rights, rental payments, and regressive subsidy mechanisms in the existing housing stock is causally the most important. On the other hand, whether to reform the management of the existing stock or the housing production system first is not really a choice. Both types of reforms must be initiated right away and in parallel because the markets for existing housing and the markets for new housing interact. Distortions in one housing market quickly spill over into the other. Moreover, a major goal of reform is to significantly reduce the severe fragmentation of present housing systems caused by bureaucratic management and large price distortions.

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<sup>9</sup> Devolution of operational decisions at the local level will be important to effective housing reforms. The casual view that authoritarian governments are more efficient in managing stabilization and structural adjustment has not been supported by a comparative analysis of 44 authoritarian and 39 democratic systems. See Stephen Haggard and Robert R. Kaufman, The Political Economy of Inflation and Stabilization in Middle-Income Countries, World Bank, PRE Working Paper WPS 444, June 1990. The pervasive problems of socialist economies bear witness to this issue of effectiveness. Rather than the authoritarian or democratic nature of governments, the efficiency in implementing stabilization policies and carrying macroeconomic adjustment reforms is determined by the quality of government, which is best gauged by the length of its time horizon, the coherence of policies, internal government coordination, and a strong sense of personal accountability to the public.

<sup>10</sup> Janos Kornai, The Road to A Free Economy, Shifting From A Socialist System, The Example of Hungary, New York: W.W. Norton, 1990, p. 159.

## A Critical First Step: New Government Institutions For Housing Reforms

1.13 Housing reforms have major implications for central and local government institutions undergoing reorganization. In fact, a critical first step is government reorganization. Radical change cannot be successful if the proper institutional infrastructure is not in place. What must be avoided is creating a vacuum by abolishing the old mechanisms. Eliminating staff, skills, and regulations would be the shortest way to cause a collapse of the housing system, the effects of which would then spill over into national output, employment, and social stability. Abolishing central planning mechanisms is only half of the task of promoting healthy housing markets. As was stressed in Part I, governments will continue to play a major role in market-based economies by promoting the right incentives and regulating market operations.

1.14 While reforms in the existing stock and in new housing should proceed in tandem, reforms of the central and local government institutions related to housing and infrastructure must be well under way before radical changes in housing regulations are undertaken. Housing markets require an infrastructure of financial, professional, and social institutions. That infrastructure must be at least partially in place before radical reforms are initiated.

1.15 Under decentralized and indirect government regulation of housing markets, the central questions become who coordinates physical and financial flows, who regulates the housing finance system and new production and how, and what levels of government monitor the sector's performance.

1.16 Government reorganization should begin with branch-structured and physical planning-oriented ministries that affect housing. Such ministries are oriented toward new production and usually lack a mandate to deal with important fiscal and financial issues affecting the sector. Housing and urban infrastructure must be treated as a major economic sector, not exclusively as a social issue, as it is at present. Usually, existing structures are neither adequately staffed nor suitably organized to analyze and coordinate all regulatory, financial, and production facets of housing reforms as a single, integrated housing policy. Neither are they used to coordinate with ministries of finance and banking authorities. Separating reform of the management of the existing stock from housing production would make it only too easy for the old ministries to devote all their effort to new housing production while neglecting critical issues connected with the existing stock. The structure of decisionmaking between central ministries and local governments should be clarified. At the national level, the coordination of all housing-related policies, including finance, will benefit from being located in a high level decision center.

### B. Structural Aspects of Socialist Economies that Affect the Housing Transition

1.17 In addition to current macroeconomic conditions, several important structural characteristics differentiate socialist economies with regard to the structure of the housing sector and its reform: 1) the prevalence of a low-wage structure, 2) the function of subsidies to households and their sources, 3) the dominant constraints on the performance of the economy, and 4) the urban growth rate. These characteristics are described in detail below.

## Low-Wage System and Nature of Household Subsidies

1.18 Socialist housing reforms are difficult because of the confusing dual role that housing plays as a social "merit" good, of which a minimum amount should be guaranteed, and as a component of wage compensation, which should be differentiated according to labor performance. This is why Part I stressed that reforming the housing sector in a socialist economy really implies a total restructuring of the household sector. Housing reforms--particularly rent reforms and wage reforms--and income growth are highly correlated. The ability to move rapidly to a market-based housing system depends on the degree to which the wage structure has already been freed and the extent to which cash wages already reflect the ability to pay and/or save for housing.

1.19 To achieve control over savings in the economy, centrally planned economies have captured potential household savings through uniformly low cash wages, followed by the control of enterprise earnings. To solve their housing problem, socialist economies have then resorted to a comprehensive social approach that includes the assignment and use of housing. Citizen rights to housing are usually sanctioned in socialist constitutions. These rights are given effect not only by state development and maintenance of housing stock, but also by the generalized application of subsidized low rents and utility charges. As a result, households have little if no control over the flow of funds affecting their housing. Today's housing systems are differentiated by the degree to which housing payment mechanisms are outside the control of households. The combination of low cash wages and heavily subsidized housing, which began under pure central planning, has endured in most socialist economies. The economic problem created by this system is that the rapid expansion of the housing stock brings with it a constant growth in the volume of state subsidies. As a result, excessive levels of housing consumption can be seen in some parts of the economy at the same time as extensive shortages.<sup>11</sup>

1.20 Housing subsidies are perceived differently in socialist economies that have low wage structures than they are in market-based economies. Housing subsidies have two dimensions and play two roles: 1) they serve as a labor compensation and 2) they serve as a resource transfer (as we know it in market economies).

1.21 In all countries, the transition to a market-based housing system will be dependent on the nature and speed of wage reforms. Rapid rent reforms and privatization should be easier in countries where the second economy, operating on a market basis rather than under central controls, is large and wages are moving toward full market wages. For instance, very preliminary estimates for the late 1980s indicated that the second economy amounted to about 40% of GNP in Hungary and 20% in Poland, but only 10% in Bulgaria. A logical choice would be to first remove housing subsidies from the high-income social groups and other

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<sup>11</sup> Yukun Wang, The Size of Housing Subsidies in China, paper presented at the Seminar on Housing Reforms in Socialist Countries, June 1990, Washington, D.C.

households already enjoying full or close to full market wages. In economies where most wages have been freed, housing subsidies can be restructured and targeted toward low-income social groups. In this way, they can continue to play their traditional role as an important part of the social welfare net.

### Extent of Distortions in Other Sectors and Intermarket Spillovers

1.22 An important monitoring element during the transition to a market-based economy will be the behavior of household expenditure patterns. Cash wages may rise but the total household compensation (including cash wages, "social" or "distribution" goods, and income from the secondary economy) may be shrinking because goods and services that were subsidized or even free must now be paid for. If this is the case, rent reforms and housing sales may become more difficult. Given this scenario, intermarket spillover effects will be gradually eliminated. For example, in China an explicit goal of housing reform has been to moderate the exceedingly high demand for luxury durable goods. Freeing food prices and eliminating a large proportion of consumer subsidies needs to be planned so that this reform will not collide with housing rent reforms. Crowding effects could be very strong. For example, current food expenditures range between 35 and 55% of total expenditures in most countries, while housing expenditures range from less than 3 to 8% .

### Supply Constrained or Demand Constrained Economy?

1.23 A fundamental difference between a market-based economy and a socialist economy is the dominant macroeconomic constraint on growth: market economies are demand constrained, while socialist economies are supply constrained. It is said that Poland has just crossed the threshold from being a supply-constrained economy to a demand-constrained economy. Implications of the disappearance of the socialist low-wage structure, as what seems to be occurring in Poland, deserve close examination. In a contracting economy like Poland, there has been concern about the role housing plays as a domestic engine of growth and therefore the need to move quickly on housing production reforms.<sup>12</sup> Maintaining a minimum output in the sector is certainly important. In more stable economies, like Czechoslovakia and Hungary, more emphasis is given to eliminating inefficiencies, economic distortions, and subsidies from the existing stock and dealing with new housing from that basis.<sup>13</sup>

### Urban Growth Rate and Subsidy Volume

1.24 Due to their dual role, housing subsidies cannot be eliminated instantaneously. A significant factor in housing reform is the rate of urban growth, which amplifies distortions in

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<sup>12</sup> Dr. Jan Sulmicki, Adviser to the President, Central Bank of Poland, presentation to the seminar.

<sup>13</sup> Dr. Gyula Partos, head, Strategic Planning Division, Ministry of Infrastructure and Telecommunications, Hungary, presentation to the seminar. Dr. Eva Pisova, Housing Reform Group, Czechoslovakia, presentation to the seminar.

the housing sector. A higher urban population growth rate will further constrain reforms because of the large need for new units and the burden of transitional subsidies. Some European socialist countries have a slow growth rate and are nearly fully urbanized. In those countries, restructuring the existing stock and improving its quality are more important than making rapid and large additions to the stock. In countries like Poland that have a significant housing deficit and that anticipate further rural-urban migration, the reform of new housing production will be more urgent. In centrally planned developing countries with a low level of urbanization, such as China, pressures for a rapid reform of the production of new units are even more significant.

### C. Diversity of Housing Conditions Among Socialist Economies

1.25 The common systemic features of housing systems in socialist economies should not obscure these economies' individual characteristics nor the major differences among them when facing market-oriented housing reforms. To indicate how these countries differ, Table 1 presents some basic data from a sample of ten socialist economies. Six are in Europe: Bulgaria, Czechoslovakia (now the Czech and Slovak Federal Republic or CSFR), Hungary, Poland, Romania, and Yugoslavia. Algeria is in North Africa. Two are in Asia: China and Vietnam. Finally, there is the Soviet Union.

1.26 These countries vary enormously in land area, population size and ethnic diversity. Their urban and housing systems also vary significantly. The largest and most diversified is the Soviet Union. The Soviet Union has the largest land mass in the world and over 120 different ethnic groups: it is 240 times larger than Hungary, the smallest country in the sample. The differences in population growth rates and age structures cover the entire spectrum, from countries experiencing high demographic pressures like Algeria, and to a lesser degree Vietnam, to aging and declining populations like Hungary. As a group, the European countries have considerably higher levels of urbanization than other countries. Their populations are older, their demographic growth rates are low, and their average urban household size is small and often below three persons. Therefore, investment pressures on their cities are comparatively moderate. At the other end of the demographic range are countries with high demographic and urban growth rates like Algeria or Vietnam, where there are heavy demands for urban infrastructure and housing investment. Algeria, in particular, now faces an average urban household size of about seven persons, which is one of the highest in the world due to its high demographic growth and housing under- and misinvestment during previous decades.

1.27 The weak economic performance of socialist economies that rely on central planning with government ownership of the means of production is reflected in the low per capita GNP of these countries, even if allowance is made for comparability problems when using GNP per capita figures.<sup>14</sup> Vietnam is the poorest country in the sample with a per capita income

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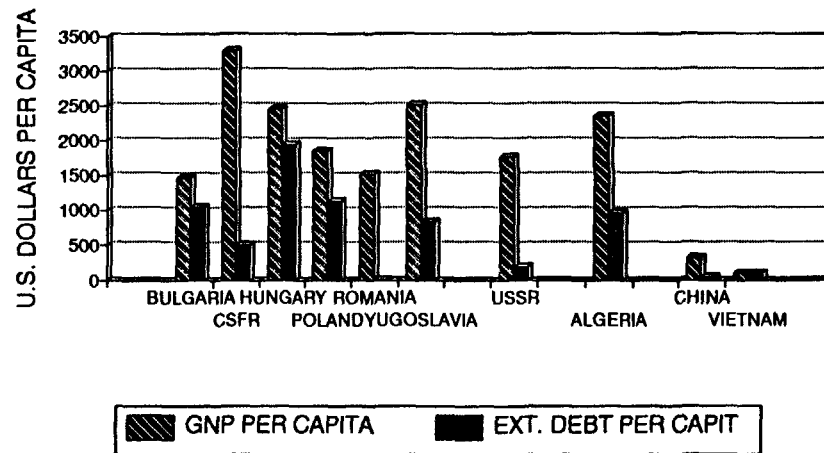
<sup>14</sup> As the recent study of the Soviet Union's economy stresses "there is no example of a successful modern centrally planned economy," see IMF-World Bank-OECD-EBRD The Economy of the USSR, World Bank, December 1990.

TABLE 1: DIVERSITY AMONG SOCIALIST ECONOMIES

LAND AREA (KM2)	POP. 1988 (Million)	POP. GROWTH (Annual)	POP. AGED 0-14	URBAN POP. (%)	URBAN GROWTH (Annual)	URBAN HOUSEHOLD SIZE	AGRIC. EMPL.	INFLATION 1980-88 (Annual)	GDP SIZE 1990/1985	GNP PER CAPITA (US \$)	EXT. DEBT PER CAP. (US \$)	EXT. DEBT IN 1989 (Billion \$)	
BULGARIA	111	8.9	0.1%	20.1%	67.0%	1.1%	2.9	18.1%	2.6%	0.1%	1470	1050	9.2
CSFR	128	15.6	0.2%	24.0%	69.0%	1.0%	2.5	11.5%	1.4%	-4.2%	3300	510	7.9
HUNGARY	93	10.6	-0.1%	19.9%	60.0%	0.7%	2.7	20.9%	6.4%	-0.9%	2460	1950	20.6
POLAND	313	37.9	0.8%	25.2%	61.0%	1.3%	3.1	28.5%	30.5%	-4.8%	1860	1140	43.3
ROMANIA	238	23.0	0.4%	23.8%	49.0%	1.3%	3.6	30.5%	12.1%	-9.8%	1525	2	0.5
YUGOSLAVIA	256	23.6	0.6%	23.5%	49.0%	2.0%	3.5	28.7%	66.9%	-8.3%	2520	835	19.7
USSR	22402	288.0	1.4%	25.5%	62.0%	1.5%	3.7	20.0%	2.1%	6.8%	1780	190	26.1
ALGERIA	2382	23.8	3.1%	44.4%	44.0%	4.2%	7.5	25.7%	4.4%	3.3%	2360	970	54.1
CHINA	9561	1008.3	1.4%	27.7%	23.0%	2.6%	3.8	73.4%	4.9%	41.6%	330	45	44.9
VIETNAM	330	64.2	2.1%	40.0%	22.0%	3.6%	4.2	67.5%	41.1%	21.0%	109	110	7.1

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SOCIALIST COUNTRIES: DEBT BURDEN COMPARED TO GNP PER CAPITA, 1989



comparable to Bangladesh and about one-fifth the income of its neighbor Thailand. Czechoslovakia is the richest with a per capita GDP of about one-fifth the average income of the Organisation for Economic Cooperation and Development (OECD) countries. Fiscal and financial conditions in these economies vary substantially. In many, the degradation of economic performance increases the urgency of reform but creates an unfavorable environment for housing. There are substantial regional differences. In all the European countries, the size of the economy shrank in 1990 compared to 1985, as in Romania and Yugoslavia. For all European countries, 1990 was a difficult year, and their economies continued to shrink due to rising energy costs and major disruptions in the regional Council for Mutual Economic Assistance (CMEA) trade patterns dominated by the Soviet Union. The Soviet Union's economy itself declined sharply in 1990 and faces further difficulties in the near future. On the other hand, Asia, China, and Vietnam experienced sustained positive growth, especially China.

1.28 The level of external indebtedness of socialist countries and their ability to draw on external financing during their economic restructuring varies sharply. Some governments borrowed heavily in the 1980s to compensate for a domestic slowdown. Today, Hungary's overall economic reform is constrained by one of the heaviest debt burdens in the world (see Table 1). On the other hand, Romania is essentially debt free, but it achieved that result at the cost of slow growth and a severely distorted and obsolescent economy.

1.29 The degree of price stability also varies considerably. During the 1980s, Poland, Yugoslavia, and Vietnam experienced some of the worst inflation rates in the world. In contrast, Czechoslovakia was able to maintain the price controls traditional in a centrally planned economy. At present, inflation is rising in most socialist countries due to the more rapid disappearance of central planning mechanisms compared to the speed of emergence of efficient markets. This rising inflation increases the urgency of sound housing finance reforms.

1.30 Property right reforms and privatization can support the stabilization of the economy through reducing the monetary overhang. They are important to improving housing productivity and to the efficient use of the housing stock. The scope for privatization varies among socialist countries according to the share of the housing stock that is publicly owned. Public ownership of the housing stock in cities ranges from highs of 72.3% in the Soviet Union and 67.5% in China to lows of 22.5% in Bulgaria and 24.8% in Hungary. The largest cities tend to have a disproportionate share of public housing. For instance, 42.4% of the housing stock in Budapest was publicly owned in 1987. Algeria and Romania have levels of public ownership rates of about 35% that are not markedly different from the rates in some market economies with long-standing public housing policies like the United Kingdom and Sweden.<sup>15</sup>

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<sup>15</sup> Housing systems in market-based economies differ considerably. The emphasis they place on direct public interventions is suggested by the share of public housing in their total housing stock in the mid-1980s. In Western Europe and the United States, we observe wide differences as follows:

Spain:	2%	Germany:	7%	Britain:	30%
USA:	2%	France:	17%	Netherlands:	31%
Italy:	5%	Denmark:	17%	Sweden:	38%



1.31 Housing investment conditions and housing sector performance vary considerably. The share of housing investment in total investment tended to decline in most countries during the late 1980s. However, it has ranged from very high values of 30% of total investment in China to minimal levels of about 5% in Vietnam.

1.32 Direct budget subsidies to the sector go not only for construction but also for financing, rents, heating, and other utilities. They depend on the extent of public ownership of the housing stock.<sup>16</sup> For instance, in the Czech and Slovak Federal Republic (CSFR), where public housing ownership is important, these direct subsidies amounted to 8% of the total budget until recently. In Bulgaria, where individual ownership is widespread, direct budget subsidies were less than 1% of the total budget in the late 1980s. Direct subsidies are not the entire story, however, and in most countries direct and indirect subsidies to housing amount to a very high share of GNP, as already stated.

1.33 An indicator of the difficulty of reforming the financing of housing is the share of total housing expenditures in household budgets. The level of budget subsidies for housing, and more generally the level of cost recovery, is related to the share of publicly owned housing. In market economies, housing expenditure ratios, including rent and utility costs, vary between 10% for the lowest income countries to 25% in middle to high-income countries. In socialist countries this ratio varies from very low levels of 2% for urban China and 2.5% for the Soviet Union to 12.1% in Bulgaria, which has never pushed public housing and has a high level of private ownership in cities and higher recovery policies for rents (7.65% of expenditures and 4.5% of utilities). Socialist countries like Hungary and Yugoslavia, which have experimented with market socialism for some time have intermediate housing expenditure ratios on the order of 9% averaged over all households. In the same manner that low rents stimulate excess demand for housing and misallocation of its stock, low utility prices encourage high energy consumption rates and high energy inefficiencies.

## II. CLARIFICATION OF PROPERTY RIGHTS AND PRIVATIZATION

The two issues of property rights and privatization are functionally related but are better discussed independently.

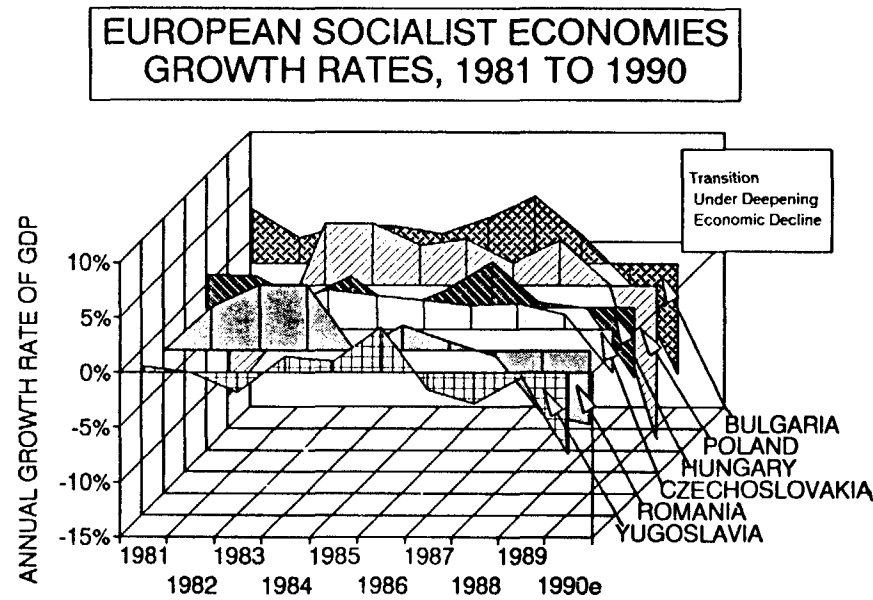
### A. Clarification of Private and Public Property Rights: Main Issues

2.1 A major cause of economic inefficiency in socialist economies is that property rights are often ill-defined or administratively and arbitrarily restricted. The universal criticism of the concept of "ownership by the whole people" is that property under such ownership is owned by no one and therefore misused and difficult to manage. The economic benefits of well-defined

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<sup>16</sup> Data collected by the IMF on central government expenditures suggest that budget subsidies to housing in market economies may be sustainable and are not destabilizing at levels of about 2 percent of total budget. In addition, the size of total public expenditures in GNP is considerably smaller than in socialist economies.

TABLE 2:  
GROWTH RATES IN EUROPEAN SOCIALIST ECONOMIES, 1981-1990.



	BULGARIA	CZECHOSLOVAKIA	HUNGARY	POLAND	ROMANIA	YUGOSLAVIA	USSR	ALGERIA	CHINA	VIETNAM
1980		2.9%		-2.5%		2.0%	4.5%	0.9%	6.4%	
1981	4.9%	-0.1%	2.9%	-10.0%	0.1%	0.6%	3.8%	3.0%	4.9%	
1982	2.3%	0.2%	2.8%	-4.8%	3.9%	-0.1%	3.9%	6.4%	8.3%	
1983	3.4%	2.3%	0.7%	5.6%	6.0%	-1.9%	4.5%	5.4%	9.8%	
1984	3.4%	3.5%	2.7%	5.6%	6.0%	1.5%	4.0%	5.6%	13.5%	8.3%
1985	2.7%	3.0%	-0.3%	3.6%	-0.1%	1.0%	2.3%	5.4%	13.1%	5.7%
1986	4.2%	2.6%	1.5%	4.2%	2.3%	4.1%	2.3%	1.2%	8.0%	3.4%
1987	6.1%	2.1%	4.1%	2.0%	0.8%	-1.6%	1.6%	-7.0%	10.5%	2.5%
1988	2.6%	2.3%	0.4%	4.1%	-0.5%	-2.8%	4.4%	-2.1%	11.2%	5.9%
1989	-1.9%	1.3%	-0.1%	0.1%	-5.8%	-0.4%	2.5%	3.4%	3.9%	1.5%
1990e	-11.3%	-4.0%	-6.5%	-14.0%	-6.7%	-7.5%	-4.0%	2.5%	2.7%	6.2%
GDP SIZE 1990/85	98.7%	104.2%	99.1%	95.2%	90.2%	91.7%	106.8%	97.7%	141.6%	121.0%
POP SIZE 1990/85	100.5%	101.0%	99.5%	104.1%	102.0%	103.0%	107.2%	116.5%	107.2%	111.0%
GDP PER CAP GAIN	-1.8%	3.2%	-0.4%	-8.8%	-11.8%	-11.3%	-0.4%	-18.8%	34.4%	10.0%

property rights are to minimize transaction costs in the economy, to facilitate the governance of contractual relations over time, and to allow the emergence of organizations that are efficient and adaptable to a changing economic, technological, and social environment. Social justice also tends to be better served by clarity, access to information on policy decisions, and accountability.

2.2 To manage the complex urban environment of a modern economy, both public and private property rights must be well defined and well publicized. In addition, these property rights must be continuously verifiable and adjustable through the use of appropriate and efficient legal proceedings, preferably at the local level.

2.3 In the housing sector, three types of rights must be clarified: land use rights, the ownership of buildings or individual housing units, and the ownership of infrastructure and other public assets by central government, local governments, or suitable nonprofit corporate organizations. Given the range of services to be delivered in a modern urban economy, the division of labor between the public and private sectors can vary considerably with respect to both the ownership of production facilities and their maintenance and management. They also can be affected by the setting of prices and the collection of fees.

2.4 To clarify property rights will take time. The changeover to a market-based society is sharply asymmetrical: in these economies it was easy in the past to expropriate private owners by fiat, but reconstituting such a system of rights now is likely to be a protracted process. For example, the relative balance between the public interest and individual property rights varies significantly across market-based economies and has fluctuated over time. In some instances, more emphasis has been placed on the public interest, and in others more attention has been given to individual rights. What needs to be removed immediately is the web of laws and administrative regulations that are systematically biased against the free and effective use of private property.

#### B. Tenure Types, Property Rights, and Outcomes

2.5 The tenure categories, such as ownership or tenancy, used in market systems are not immediately applicable to a socialist system. In addition, the economic value of the set of rights attached to various forms of tenure varies considerably according to the type of tenure and the related level of subsidization. Private property, as it is understood in market systems, often does not exist since owners are not officially permitted to derive income from rental properties. This is indicated by the use of the term individual housing rather than private housing.

**TABLE 3:  
OWNERSHIP OF THE HOUSING STOCK IN SOCIALIST ECONOMIES  
AND COST RECOVERY FROM HOUSEHOLDS**

**HOUSING STOCK OWNERSHIP**

	<u>(local govt)</u>	<u>STATE</u> <u>(enterprises)</u>	<u>(total)</u>	<u>COOPERATIVE</u>	<u>INDIVIDUAL</u> <u>OWNERSHIP</u>
BULGARIA (urban, 1988)	10.2%	12.3%	22.5%	0.2%	77.3%
GDR (rural & urban, 1986)	----	----	22.7%	9.8%	62.5%
HUNGARY (rural & urban, 1987)	----	----	24.8%	----	75.2%
Budapest (1987, est.)	30.0%	10.0%	42.4%	0.9%	48.6%
Other Cities (1987)	----	----	28.9%	----	71.1%
POLAND (urban, 1989)	20.3%	12.1%	32.4%	21.8%	45.8%
ROMANIA (rural & urban, 1989)	----	----	33.0%	----	67.0%
YUGOSLAVIA	----	----	----	----	----
Apt. units in Slovenia (1987)	----	----	85.7%	----	14.3%
USSR (urban, 1990)	35.5%	36.9%	72.3%	6.3%	21.4%
ALGERIA (urban, 1989)	----	----	36.0%	----	64.0%
CHINA (urban, 1988)	----	----	67.5%	2.5%	30.0%

**SHARE OF HOUSING IN HOUSEHOLD EXPENDITURES**

	<u>TOTAL</u>	<u>RENT</u>	<u>UTILITIES</u>
BULGARIA (1988)	12.1%	7.6%	4.5%
CSFR	----	----	----
HUNGARY (1987)	8.7%	1.6%	7.1%
POLAND (1986)	4.4%	2.0%	2.4%
ROMANIA (1989)	4.4%	----	----
YUGOSLAVIA (1988)	9.3%	2.8%	6.5%
USSR (1989)	2.5%	1.0%	1.5%
ALGERIA	----	----	----
CHINA (1986)	2.0%	0.9%	1.1%
VIETNAM	----	----	----

housexpend.wq1

**2.6** The ownership of housing in socialist countries falls into two broad categories: socialized and private. However, for administrative purposes it is often classified into different subcategories such as: 1) municipal housing or local housing bureaus; 2) enterprises, organizations, state institutions; (3) state-controlled cooperatives of two kinds: house-building cooperatives and house-leasing cooperatives; (4) purely private cooperatives; and (5) individual housing considered as personal property.

### Important Features Attached to Various Tenure Arrangements

**2.7** The main problems with existing tenure systems and property rights are:

1. Property rights for tenants in state housing are often stronger and more valuable than for owners because the occupancy rights to heavily subsidized units are permanent and can be transferred to relatives.
2. There are unjustifiable differences between the cost of housing supplied under each tenure category; as a result, there is a great difference between the cost of housing for various strata of the population.
3. In some countries, access to heavily subsidized rental housing is given without consideration of household income.
4. The implicit economic value of various forms of tenure is defined by the state, which usually sets rent levels and regulations uniformly and in a centralized manner at the national level. In most cases, rent levels have remained fixed for extraordinary lengths of time: in the Soviet Union regulations that set rents were passed in 1928. In Czechoslovakia rents were fixed in 1964, and in Bulgaria in 1967. In East Germany they had not changed since the state was founded; in fact, they had not changed since the rent moratorium of 1936 in pre-war Germany. In China, rents were lowered between 1949 and 1960. Hungary announced rent changes in 1988, but their implementation was delayed. Hungarian rents have been adjusted only three times, the last time in 1983.
5. In socialist economies, there are usually important impediments to the subletting, transfer, and exchange of property. As already noted, private rental housing is in principle forbidden since property income in a market sense is usually illegal.
6. The transfer of a significant part of the housing stock must take place through municipal housing bureaus at controlled prices.
7. An additional layer of ambiguity and therefore inefficiency is created by the division between rights to the structure and rights to the land. In some

countries the private ownership of land, or even land-use rights remains unconstitutional. A major impediment to efficient urban investment may then be that there is no land market and no land-pricing mechanism.

8. In some countries, like Hungary, housing reforms have allowed construction and financing subsidies to be granted to private builders of housing.
9. Geographically, there has often been a correlation between the location of the national government and the amount of state rental housing provided. While in many countries the proportion of state rental housing is often around 25%, in the capital city this figure rises to above 50% of the local stock.

### Major Economic and Social Consequences

2.8 The above situation yields all the undesirable results encountered in some public housing projects in market-based economies plus quite a few additional ones:

1. Because housing is heavily subsidized, there is chronic excess demand and a permanent housing shortage.
2. The housing stock tends to be very poorly utilized: some households, especially at the end of the family life cycle, have too much housing. Others, especially young families, have too little.
3. Because subsidized rents and utilities are proportional to the size of units, housing subsidies are highly regressive.
4. Housing mobility rates are extremely low, which impedes labor mobility.
5. Household expenditures are distorted and there are important intermarket spillover effects between housing and other expenditures.<sup>17</sup> The incentive to own housing will remain weak as long as rental housing is more heavily subsidized.
6. Since rents do not cover maintenance costs, the housing stock is poorly maintained and housing production has to be subsidized.

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<sup>17</sup> For instance, Chinese policy makers have been greatly concerned by the rapid expansion of the demand for durable goods in urban China. With the rapid rise of urban incomes during the 1980s, expenditures on consumer durables like color televisions and music systems rose quickly to the level of Japan in 1965. This occurred in spite of the fact that China's per capita income is among the 20 lowest in the world. This expenditure spillover effect, caused by the fact that most Chinese urban households can buy housing, was explicitly mentioned as one justification for the 1988 housing reform announcement.

Over time, the housing system has become an extremely complex financial and fiscal daisy chain of distortions, large transfers, and inefficiencies. The grey economy covers a growing proportion of housing transactions that are tolerated but extralegal.

### C. Privatization

2.9 The primary purpose of privatizing socialized housing in socialist economies is not to hastily transfer housing stock to individuals at greatly undervalued prices in order to free the state from part of its housing subsidy burden. "The point is not to hand out the property, but rather to place it into the hands of a better owner."<sup>18</sup> The aim of privatization is the efficient and rational use of the existing stock. More specifically, in housing the two main objectives of privatization are:

1. The development of a functional rental housing market managed by private and social owners who will use the stock rationally. They will therefore meet the needs of a variety of households who for various reasons prefer or need to rent. Given the very high if distorted housing price-to-income ratio at the start of reform, the proportion of renters can be expected to remain large.<sup>19</sup> However, as reforms progress and the market expands it is expected that the high housing price-income ratio will decline significantly because market pricing depends on the marginal willingness to pay for buying. No analytical work has been done so far to determine within what range of values the equilibrium price is likely to settle. Free-market pricing will eliminate the current excess demand brought about by price distortions and lead to lower prices. However, since socialist economies have underinvested in housing, the relative price of housing may remain high compared to market economies.
2. The diffusion of private ownership will motivate households to accumulate savings for the purchase of a major asset. Multiple benefits will result from increasing individual ownership. Increasing ownership will reduce asset misallocation and intermarket spillovers. It will help reduce the monetary overhang. By increasing the direct influence of users, the diffusion of ownership will stimulate improvements in the quality and diversity of the new housing produced.

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<sup>18</sup> Janos Kornai, The Road to a Free Economy, New York: W.W. Norton, 1990, p. 82.

<sup>19</sup> As noted in Part I, West Germany, which has a high housing price-income ratio of about 6 and policies that favor renters, had only 42% of home owners by the end of the 1980s. The United States, which has a low price-income ratio below 3 and tax policies that favor ownership, had 62% of owners in 1988. More important, the rate of decline of the price-income ratio will be a major indicator of success in the reforms.

**There are significant difficulties, however, facing privatization:**

1. Without rent increases, there will be no incentive to buy.
2. The valuation of existing units and the selection of sale prices will be difficult technical issues since the dynamic of housing prices following rent increases can be significant.
3. Who should be allowed to buy: the sitting tenant only? Any other interested buyer? Issues of fairness will be important in the treatment of the existing state housing stock, even though the goal is more efficient use of the stock. Sales must avoid unwarranted favoritism to the sitting tenant, but sitting tenants would need to be assisted if there is any displacement process.
4. How will the purchase be financed? Long-term mortgage lending will be difficult to find since the size of the housing finance system is typically very small compared to the assets to be transferred. Besides, socialist banks that have been financing housing usually never dealt with individual households before. On the other hand, lease-purchase contracts and seller financing may not meet the short-term cash-flow objectives of the seller since the current price-income ratio in most socialist countries is inordinately high (between 10 and 20). To solve this problem some transitional financing of purchases might be considered. As already noted, a significant and relatively rapid decline in price-income ratios can be expected with market reforms. Yet the valuation of specific housing units during the initial steps of the reform is a serious problem when one does not know in advance the price range at which housing will settle by the end of the reform.
5. There may be a process of adverse selection in the sales of social housing since only the better housing stock will be wanted. The process could result in a concentration of least desirable stock in the hands of the state, thereby leading to more social problems.

### **III. RENTS, PRICES, AND SUBSIDIES**

#### **A. Managing the Existing Stock: Rent Reform and New Tenure Rights**

3.1 Reforming the management of the existing stock has three dimensions: 1) the adjustment and clarification of property rights between renters and owners, 2) rent reforms, and 3) better subsidy systems. From an economic perspective, rent reforms in the form of major increases in rent should precede changes in property rights. This restores the balance between



rental and ownership and creates an incentive to buy. Maintenance and full capital cost recovery would finally be possible. Third, rent reforms would correct intermarket spillover effects and redirect attention to housing demand, which is presently channeled to other goods. This would make a balance in the consumer markets more achievable. However, from a political perspective, this may not be the shortest path to successful market reforms. Starting with property rights may be a better approach. The World Bank's experience over the past two decades demonstrates that tenure security is the core component of housing market systems, and that the clarification of property rights brings about better pricing and cost recovery within the population.

3.2 The reform of property rights regarding rental units should include:

1. The conversion of "permanent and guaranteed" tenancy rights to fixed-term renewable contracts.
2. The development of commercial rent contracts that balance the interests of owners and renters instead of the use of current one-sided contracts.
3. The selection of recipients of state rental units on the basis of demonstrated need and explicit rules for rent adjustments and changes of units when household income and/or family status changes. This would reduce frequent misallocation of the public stock.
4. The creation of decentralized, locally controlled, nonprofit rental housing corporations to manage the social housing stock, with maintenance functions open to competitive bidding.
5. The conversion of state-controlled cooperative housing stock to genuine private cooperatives or other forms of ownership.
6. The elimination of restrictions on the exchange of housing units and the sale of units at full market value.
7. The lifting of restrictions on the use of private housing, including reasonable mechanisms for strengthening eviction powers.

3.3 Reforming and clarifying ownership rights for a housing unit, typically an apartment, will not be enough. Socialist cities are confronted with the absence of land markets. In some countries like China, rather than return to full private ownership of urban land, they are experimenting with developing leasehold systems similar to those in effect in Hong Kong. An important problem regarding maintenance of housing is the mixing of tenure and ownership in a single apartment building. Usually there is also considerable confusion about which level of government or state enterprise owns which state asset: for example, who owns and must maintain public spaces and urban utilities?

## B. Rent Reforms and Utility Pricing Reforms

3.4 Rent reforms and utility pricing reforms are absolutely necessary to the successful reorganization of the housing stock:

1. The two central principles of rent reforms should be: a) to ensure that the rent will not only cover the maintenance of the unit but the full economic cost of housing (i.e. market clearing rent) and b) to provide social subsidies directly to the families and individual in need rather than through the allocation of a specific subsidized unit.
2. The intended results of rent reforms would be: a) to eliminate regressive subsidies to the higher income groups that do not need them; b) to use direct subsidies to allow disadvantaged households the possibility of choosing among alternative suppliers and locations of rental housing; c) to encourage a shift of household tenure to ownership, or, at least, treat renting and owning more equally; d) to create the possibility of more diversified suppliers of rental housing by allowing private housing rentals to become economically viable; and e) to help enterprises and other work units free themselves from the burden of rental housing and let them focus on their primary functions.
3. A first difficulty during the transition to a market-based system will be to select actual economic rent levels. The process may vary according to available local information.<sup>20</sup>
4. Rent adjustment should occur no less than annually to avoid abrupt increases, especially during periods of inflation.
5. Transitional subsidies will be necessary before shifting to a system of targeted housing allowances. Due to the practical problem of estimating household incomes until wages have been fully liberalized, targeting might be based on the socioeconomic characteristics of households. This is done in some market economies using direct, needs-based housing subsidies.
6. Given the past poor maintenance of the existing stock it may prove effective to combine rent increases with the provision of improvement loans for the unit to the owner of the unit, whether the owner is an individual, a nonprofit organization, or a commercial owner.

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<sup>20</sup> For an illustration of the range of rent calculations, see the Chinese discussions of the "rational" rent in Yukun Wang, The Size of Housing Subsidies in China, paper presented at the Seminar on Housing Reforms in Socialist Countries, June 1990, Washington, D.C.

7. Utility prices should be shifted to full-cost pricing, individual metering should become the norm, and peak-load pricing should be introduced.

### C. Reduction and Social Targeting of Subsidies

3.5 Macroeconomic stabilization requires that the volume of subsidies to the household sector be reduced and targeted considerably better. Efficiency also demands that subsidies be as transparent and easily measurable as possible. At present, subsidies are so pervasive through the housing system that their full and accurate accounting is difficult. Three subsidy issues arise during the transition to a market-based housing system:

1. Every effort must be made to abolish as rapidly as possible all the on-budget and off-budget subsidies given to the state production of housing. In addition to direct budget subsidies, housing production enjoys other subsidies that take various forms: underpriced or free land, preferential building material prices, and priority access to building materials, all of which should be eliminated. Monopoly power over the supply of housing in specific markets also should be abolished.
2. During the reform of the rental housing system, a new system of housing allowance will be needed to develop subsidies separate from the provision of a specific housing unit. These allowances should be granted directly to households. This new housing allowance system should be limited to the lowest income groups.
3. During the transition, up-front grants may be needed to resolve the twin affordability problems of households interested in buying a housing unit: the high price of units and the high cost of financing due to high nominal and real interest rates, especially at the beginning of the macroeconomic stabilization period. There is the price affordability problem caused by shortages and housing system distortions, which leads to the extremely high trading price of housing compared to household incomes. There is also the credit affordability problem caused by inflation and high nominal and real interest rates.

### D. Efficiency Goals, Stability, and Middle-Income Groups

3.6 Given the macroeconomic conditions of stagnation or contraction during the initial transition, reducing the total volume of subsidies and shifting their targeting onto low-income groups may affect the position of middle-income groups. To maintain political, social, and economic stability, it will be important to restructure subsidies so that the largest possible number of people can successfully move to the new market sector without subsidies.

3.7 Ideally, this should be achieved primarily through a resumption of economic growth and rising household incomes. In practice, the phasing out of subsidies will play a major role in countries where the low-wage character of worker's compensation is still significant. The adjustment of housing subsidies will have to proceed in step with the evolution of wage and privatization policies. (A question that was raised but not discussed is the role of the privatization of stock to middle-income households to achieve social, economic, and political stability during the transition).

#### IV. HOUSING FINANCE

4.1 Restructuring the flow of financing available to the housing system will have the greatest impact on the development of a market-based housing system because new financial mechanisms will affect resource allocation and decision making. At present, socialist economies do not have housing finance institutions capable of mobilizing resources and providing loans in a competitive and efficient manner. Diversified financial services for housing are needed to facilitate the restructuring of the housing stock, support its privatization, and, more generally, to help reduce the current fragmentation of the housing system. This fragmentation in various types of public and private housing subsectors has been caused by administrative decisions rather than household choices.

##### A. The Main Problems

The main problems of housing finance are:

1. A lack of genuine financial intermediaries in the sector and a severe shortage of banking skills. Financial innovations are required both in terms of new long-term lending instruments and new institutions.
2. The wrong perspective on housing credit, in which long-term finance and subsidy transfers are mixed and contingent liabilities for the financial system are significant.
3. Interest rates that do not play a major role in allocating credit.
4. Problems, already mentioned, of a) housing price affordability (high and distorted house pricing which ranges between 10 and 20 times the average income) and b) mortgage affordability in periods of significant inflation and interest rate volatility.

5. In some countries like Hungary the extensive use of subsidized credit and the imprudent use of mortgage loans at extremely low fixed rates is currently leading to a very heavy fiscal burden for the economy. This problem developed rapidly and illustrates the risks of adopting a subsidized credit approach to housing finance.<sup>21</sup>

#### B. A Proper Approach to Housing Finance

4.2 The problem of housing finance should be solved within the broader framework of the financial system, and not in a segregated or isolated way. The credit perspective should be shifted away from the extensive use of low-interest loans and subsidized credit to the recognition of the critical affect the ability to offer positive real interest rates to depositors will have on the development of the banking system. The priority issues are:

1. To initiate housing finance reform by selecting a viable adjustable long-term loan instrument, with particular attention being given to the dual rate adjustment mortgage loan (DRAM) in environments in which inflation is high and real wages are stagnant or falling;<sup>22</sup>
2. To clearly separate subsidy elements from financial credit during the transition and beyond, and to make funding of the subsidy transparent. However, the design of the subsidy should be integrated with that of the loan. As a result, during the transition there would a three-part funding structure:
  - household savings
  - mechanisms to solve the price affordability problem (noncredit subsidies or shared property mechanisms) and
  - a flexible unsubsidized mortgage instrument.
3. To lower the lending barrier created by the high price-income ratio by developing additional mechanisms such as shared appreciation mortgages and shared property systems.
4. To rapidly implement foreclosure laws and/or other forms of loan guarantees.

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<sup>21</sup> Presentation by Dr. Silvia Sagari, World Bank, made during the Panel on Fiscal and Financial Issues, Seminar on Housing Reforms in Socialist Countries, June 1990, Washington, D.C.

<sup>22</sup> In earlier work on this mortgage instrument, the Bank used the name of dual-index mortgage or DIM. The name DRAM, for Dual-Rate Adjustable Mortgage is more appropriate. It conveys the key notion of duality of periodic adjustments both of the mortgage repayments and of the outstanding debt while avoiding the emphasis on indexation in economies where price indexation has been a major cause of inflation, and indexation is an unwelcome word.

5. To encourage new lenders. These may be either specialized lenders, such as credit unions and mutual housing banks, or universal commercial banks. There should be open entry into mortgage lending, but the entire housing finance system should be closely supervised.
6. Given the scarcity of funds, to take local market conditions into consideration when selecting the financial services to be provided and the specific housing activities to be financed. For instance, to stimulate the economy and expand employment, there are questions as to whether the most beneficial multiplier effects are in middle-income units versus low-income units, improvement loans to upgrade the stock, or the financing of existing units for privatization.

## V. REFORM OF HOUSING PRODUCTION

### A. Diversification of the Housing Industry and Competition

5.1 The shift to a market-based housing system and in particular the reorganization of finance and subsidy mechanisms in socialist economies will facilitate the major changes necessary in the structure, conduct, and performance of the building industry. The problems of the building industry could be summarized as follows:<sup>23</sup>

1. The present supply system is able to produce large amount of floor space but the units produced do not match housing demand by households.
2. Builders' skills are adequate, but developers skills are almost entirely missing.
3. Supply is driven by production targets not by demand; as a result, the composition and location of production is distorted.
4. In most cities, housing production is dominated by one or very few large suppliers who set standards and prices.
5. Local monopoly situations limit the quality and quantity of the housing supply.
6. Innovation in design is stifled.

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<sup>23</sup> For more details, refer to B. Renaud and A. Bertaud, Urban Housing Reforms in China. An Evaluation of The City Experiments, 1989.

7. Land-use planning is arbitrary. Land values do not reflect location preferences and site value. Land-use standards are wasteful due to the rigidities associated with the traditional industrial housing process.
8. The analysis of production costs for managerial purposes is weak or sometimes completely lacking. As a result, a significant proportion of current housing subsidies go to finance production inefficiencies.

5.2 The main factors that will stimulate the development of a diversified and competitive building industry are:

1. The enforcement of open competition among housing developers. This may require not only the elimination of the pervasive and systematic biases against small and medium private developers but their active encouragement.
2. The restructure of the flow of funds to allow individual households to exercise their choices and reveal their preferences.
3. The elimination of preferential access to finance and building materials given to large state builders.
4. The comprehensive review of the rules and regulations affecting planning and building, with the general objective of removing unnecessary regulations and moving from specific norms to performance standards.
5. The total revision of the urban planning system, which was designed to fit the needs of large-scale industrial housing production and that magnifies land, transportation, and infrastructure requirements.
6. The reorganization of large industrial housing firms from "closed" systems that build large panels or entire housing units into "open" systems that build multipurpose components, and the coordination of building processes through industrial standards rather than contractual means and through rigid engineering.<sup>24</sup>

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<sup>24</sup> Haphazard restructuring decisions may hasten the dismantling of some of these large housing industrial building organizations. This seems to be the case in Poland where some housing kombinats are engaging short-sighted sales of critical assets at very low prices to increase liquidity. Presentation by Professor Hajduk, Director of the Construction Research Institute of Poland (ORGBUD) at the seminar.

## **B. Reform of the Urban Planning System**

**5.3** A major cause of the high relative price of housing in socialist economies is the costly and time consuming urban planning system that was used for large-scale industrial housing. This system usually works against efficient small and medium-size housing producers. To remedy this situation the following steps should be taken:

- 1.** Urban laws should be reviewed to eliminate unnecessary or repetitive approval steps required by various levels of government that do not make a contribution to the quality of urban investment.
- 2.** The role of the master plan in socialist cities should be reconsidered. The master plan should only be the instrument used to decide on the location of primary infrastructure and public investment. It should not be the prime regulatory instrument determining individual development projects and builders. There should therefore be a rapid abolition or drastic cutback of the master plan regulations applied to private builders.
- 3.** The regulation of private-sector activities should be based on property and development rights and on an open review process.
- 4.** The review process for private development projects should be decentralized at the local level with no imposition of choices from higher levels of government. It should be based on ownership rights and should be a consensus identification mechanism to solve frequent but legitimate conflicts of interest among various members of the local community.
- 5.** To encourage more efficient patterns of urban investment and the rapid emergence of small and medium-size builders, optimum use should be made of existing urban land. This can be achieved through an in-fill strategy and changes in land-use density. This usually implies adjusting the contents of the entire sequence of laws and regulations affecting rural-urban land-use conversion, zoning, site planning, floor-area ratios, and building designs.

## **C. Role of Local Governments**

**5.4** The trend in favor of local governments and toward a strong decentralization of intergovernmental relations, as is the case in Poland, has the dual objective of returning public life to the norms of a civil society based on legal processes rather than administrative decisions and improving local investment and management. There is a risk, however, that decentralization may go faster than local governments' ability to rebuild their financial and decision-making capacity. It should be expected that government decentralization of financial responsibilities will be more rapid on the expenditures side than on the revenue side.



5.5 Local governments have three major roles in housing reforms with: 1) the regulation of land use and urban planning already discussed; 2) the provision of infrastructure in cooperation with other levels of government; and 3) the difficult but critical management of local public assets including the sale, transfer, and/or continuing management of rental housing.

#### Provision of Infrastructure

5.6 The system of infrastructure and utility provision and its pricing should be adjusted. Mostly, primary infrastructure provision should become the responsibility of the state. Lower levels of infrastructure should be incorporated in development projects. Fiscal transfers from the national government are likely to be quite important in financing various types of infrastructure facilities.

#### Management of Local Government Assets

5.7 A critical issue will be the management of local government assets. National-level institutions such as the National Property Disposition Board of Poland will not be enough. To avoid the squandering of real estate assets at a time when local governments are facing severe liquidity problems, there will be a need for local accountability and supervision. This will have three essential parts: a local review process, periodic central government audits, and the timely release of the results by both.

## **PART III:**

### **INITIAL STEPS FOR HOUSING REFORM**

#### **I. WHAT IS TO BE DONE?**

1.1 Housing reform is indispensable to the success of overall economic reform. The question is where to begin given the broad range of issues facing socialist housing systems. Economic and social conditions vary widely among these economies. As we have seen, some countries, such as Hungary or Yugoslavia, are further ahead than others in the introduction of market mechanisms in housing. Others, particularly the Soviet Union, remain close to the traditional centrally planned system. Economic conditions are often deteriorating, notably in Eastern Europe, where most socialist economies are confronting a deepening slowdown and inflation. In these economies, the burden of the past will be felt for some time to come. Even radical reform cannot be expected to quickly move these economies from the path of state-controlled, nonmarket socialist development to that of a modern, competitive mixed economy.

1.2 In each country the immediate task is to identify: (1) the largest and most costly economic distortions, (2) the greatest gaps in the supply of housing services under the present system, and (3) work needed to address these issues. Reform faces three broad constraints. At the macroeconomic level, economic stabilization will require strict control over the large and usually growing explicit and implicit housing subsidies for rents, utilities, and housing production. This will include control over credit subsidies as well. Privatization of public housing to reduce the monetary overhang might compete with enterprise privatization for the limited resources of the banking system and implies development of suitable financing mechanisms.<sup>25</sup> At the microeconomic level, changes in cost recovery from households must take into account the multiple impacts on household budgets of the temporary decline of real wages, as well as the effect of reducing food subsidies and increasing user charges on urban services. Third, protection of the weakest groups is a requirement for continuing support to reform, especially where there is a temporary decline in incomes. Given the differentiated needs of households and the organization of these housing systems, housing reform can be expected to proceed at different speeds across the various segments of the housing system.

1.3 Current analyses of socialist housing, as well as the lessons of past housing reforms in market economies, suggest leading directions for reform and give a clearer sense of sequencing. The critical first step is to restore a sound system of private property rights and the balance between public- and private-sector legal rights. Then, the two major directions for

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<sup>25</sup> It must also be considered that in the United Kingdom, housing privatization policies pursued by the Thatcher government have only reduced the share of public housing from over 32% to about 25% in one decade, with significant differences in the pace of privatization across cities.

change are to restructure the financing of the sector and to reorganize production. To guide and coordinate the transition, the government body responsible for housing reform must have a mandate broad enough to cover all aspects of that reform.

## **II. PROPERTY RIGHTS REFORM**

1.4 The clarification and adjustment of property rights are critical to improving the efficiency of housing and the entire urban sector. Considerable work is immediately needed on: (1) the choice of laws defining the fundamental approach to reform, which may imply reviving pre-socialist codes or adopting well-tested legal frameworks from other countries; (2) the removal of current constraints on the full private use, transfer, and free pricing of housing; (3) the development of mortgage laws, titling, and/or systems of guarantees to enhance the collateral value of housing and enforceable financial contracts; (4) the creation of enterprise laws for the conversion of organizations located within branch ministries into legally well-defined and financially autonomous organizations capable of making independent, economically sound decisions; (5) the development of contracting and guarantee systems to improve the operations of the building industry; (6) the clarification by various levels of government of the ownership of public urban assets, such as land and services facilities; and (7) the development of a suitable, independent judicial system responsible for the enforcement of contracts with the training of urban lawyers in market-oriented approaches.

## **III. FISCAL AND FINANCIAL REFORMS**

1.5 Restructuring the sources and flow of funds for housing is the most potent way to move the sector in the direction of a decentralized, more efficient, and fairer housing system. As emphasized in Part I, housing is not extremely complex as a technical good, but as an economic good its quality is very sensitive to the institutional environment. Housing reform is not primarily a matter of better physical designs or building materials—even though they are often needed—it is a matter of developing sound incentives and organizations. Changing the structure of financing will improve the all-important structure of incentives in the sector, both in terms of use and of production. From a broader perspective, reforming the financial mechanisms is a high priority for the stabilization of the economy because of the fiscal origin of a substantial share of the funds going to the sector. There are therefore both fiscal and financial components to a minimum package of housing reforms.

1.6 Reform should change the nature, volume, and channeling of subsidies, and make them directly controllable by households as much as possible in order to stimulate competition and innovation. Regressive subsidies for those who can afford to pay should be phased out in order to concentrate scarce public resources on the low income groups most seriously affected during the economic transition. This implies rent reforms in close coordination with reforms in

social housing allowances. The scope of privatization will depend directly on the comprehensiveness of rent reform, and on the share of the housing stock in public ownership which will vary from city to city. To control housing subsidies in budgets, it is very important for them to be transparent. This implies, among other requirements, the development of legally and financially autonomous public housing institutions.

1.7 The simultaneous development of sound deposit and credit instruments capable of adjusting to inflation is critical to reform. New deposit and lending instruments and financial institutions are needed to finance the sector. To ensure efficient financial resource mobilization and a competitive and financially neutral allocation of funds, housing finance reform will need to be closely coordinated with overall financial sector reform.

#### **IV. PRODUCTION REFORMS**

1.8 Reform of the supply system should have at least four initial components: (1) the introduction of competition among producers and active support to public and private developers; these components are missing in present socialist housing systems; (2) a more flexible system of urban planning to eliminate gaps and distortions in supply and to encourage an improved and more efficient use of land; and (3) better urban planning and regulations that provide access to land sites of various sizes. Some of this land may already be serviced, but the ability to finance the infrastructure for new urban land will be directly linked to pricing reforms. And, (4) reform of land use and ownership to encourage efficient land markets to reduce problems in land conversion and misallocation.

1.9 The learning process on socialist housing reform has begun, and the institutions and skills needed to operate sound housing systems are being developed. At this stage a broad consensus on the critical issues exists, but considerable work remains to be done.

The following two annex tables summarize strategic areas for reform that will affect the use of the existing stock, which dominates the reform transition in the short term, and the production of new units.

**ANNEX 1  
REFORM FRAMEWORK FOR THE EXISTING HOUSING STOCK:  
STRATEGIC AREAS FOR BETTER MANAGEMENT**

<b>STRATEGIC AREAS</b>	<b>PROPOSED ACTIONS</b>
<b>1. PROPERTY RIGHTS REFORM</b>	<ul style="list-style-type: none"><li>-Convert "permanent and guaranteed" tenancy rights to fixed term renewable rights.</li><li>-Develop commercial contracts balancing the interests of owners and renters.</li><li>-Eliminate restrictions on the exchange and sale price of housing units.</li><li>-Lift restrictions on private property.</li></ul>
<b>2. RENT REFORM</b>	<ul style="list-style-type: none"><li>-Charge full economic rent.</li><li>-Shift utility charges to full-cost pricing, peak-load pricing, and universal individual metering.</li><li>-Adjust rents periodically according to current economic level.</li><li>-Combine rent increases with provision of improvement loans for poorly maintained units.</li></ul>
<b>3. SUBSIDY TARGETING</b>	<ul style="list-style-type: none"><li>- As a transition subsidy, use a phased housing allowance system.</li><li>- Provide the new social subsidy directly to the family and detach it from the use of a specific housing unit.</li><li>- Target subsidies based on a mix of socioeconomic characteristics and the choice of unit.</li></ul>
<b>4. EXCHANGE OF UNITS</b>	<ul style="list-style-type: none"><li>-Develop listing and information systems.</li><li>-Write laws for efficient brokerage services.</li></ul>
<b>5. PRIVATIZATION</b>	<ul style="list-style-type: none"><li>-The valuation of unit and selection of sale price should be based on the macroeconomic situation and local market conditions.</li><li>-Sitting tenants should be given priority but sales should be possible to any interested buyer.</li></ul>
<b>6. NEW OWNERS OF THE RENTAL STOCK</b>	<ul style="list-style-type: none"><li>-Develop new decentralized, local non-profit institutions to manage the social housing stock on a financial autonomous basis. (Compare various European models)</li><li>-Deregulate and convert state cooperatives into private cooperatives.</li></ul>
<b>7. FINANCING</b>	<ul style="list-style-type: none"><li>-Due to the high price/income ratio some combination of seller financing and mortgage loan will be necessary.</li><li>-Shared appreciation mechanisms should be put into place to avoid large windfall gains.</li><li>-Use viable mortgage loans (DRAM).</li></ul>

## ANNEX 2

### REFORM FRAMEWORK FOR THE PRODUCTION OF NEW HOUSING: STRATEGIC AREAS FOR FLEXIBILITY AND DIVERSITY

1. FISCAL POLICY
  - Remove budget and in-kind subsidies to production: subsidized loans to builders, operating subsidies to builders, prices on building materials, underpriced or free land, etc.
  - Make sure that transition subsidies caused by currently distorted PIR values are up-front, transparent, and in the budget.
2. FINANCIAL POLICY
  - Eliminate subsidies through credits.
  - Select a viable flexible mortgage instrument that permits banks to give positive real interest to depositors.
  - Improve price affordability with some element of seller financing and shared appreciation mechanisms to make purchase price more accessible.
  - The mortgage loan must be adjustable and financially sound.
  - Design the combination of pure credit and government subsidies to minimize the total real subsidy over the life of the loan.
3. BUILDING INDUSTRY REFORM
  - Encourage competition among builders.
  - Encourage small and medium housing producers.
  - Convert industrial housing systems from closed to open systems.
  - Encourage the function of developer and the development of specialized professions.
  - Eliminate the preferential treatment given large housing firms with regard to access to land, building materials, and financing.
4. LAND MARKET AND URBAN PLANNING REFORM
  - Streamline land use regulation and eliminate rules that suppress small and medium developers.
  - Shift land use controls to local governments.
  - Shift to development rights to guide private housing developers and builders.
  - Encourage design and planning innovations to support a more diversified supply of housing.
5. INFRASTRUCTURE PROVISION
  - Modify the role of the master plan and limit its use to the location of primary infrastructure provided by the public sector.
6. ASSET MANAGEMENT AND LOCAL GOVERNMENTS
  - Provide support as well as auditing procedures to avoid excessive disposition of local government property during the transition.

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