Efficiency, Equity and Transparency of Housing Subsidies-- focus on LAC

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Outline

- Why subsidize housing
- Subsidy fundamentals
- Main categories of housing subsidies
- Predominance of implicit and hidden subsidies
  - Moving to transparency, explicit subsidies
- Effects on markets
  - Some Latin American data

Why subsidize housing?

Three broad reasons:

- Incomplete and imperfect housing markets which regulations alone cannot solve
- High externality cost of poor housing – poor health outcomes, unsafe informal housing, long commutes, high transport costs
- Redistribute income through housing rather then through income transfers in order to guarantee a minimum quality of house

Subsidy defined

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

➡ *A Subsidy is about changing behavior of households or housing producers, lenders…….*

Subsidies and opportunity cost

- *Opportunity Cost for Producers of Housing/Finance:*

  Current costs, net present value of future costs, uncertainty of future profits or costs related to lack of information

- *Opportunity Cost for Government to Provide a Housing Subsidy:*

  The costs of the subsidy compared to the allocation of funds to alternative uses or sectors

Criteria to evaluate housing subsidies

- Efficiency (with respect to a specific purpose)
  - Lowest cost per subsidy/cost of provision by government versus private sector
  - Does expenditures reflect true opportunity costs?
  - Is market value of assistance in line with recipient’s valuation?
  - “Buying out the base”/fungability of funds/ recipient’s reduction of own spending on housing because of assistance
  - % of recipients on the “margin”?
- Equity
  - horizontal
  - vertical / “cliff-effect”
- Transparency (fiscal costs and allocation)

Criteria to evaluate housing subsidies (2)

- Effects on Public Investment Portfolio (present and future)
- Effect on housing market as a whole
  - production (housing allowance vs. production subsidies)
  - prices
  - quality
- Effects on Labor Mobility
- Administrative simplicity
- Political Feasibility or Imperative

But most subsidies are hidden or implicit

Reasons:

- Political and fiscal reasons
  - keep budget expenditures low
  - no recurrent budget allocation battles
- Historical origins and difficult to change

Results:

- Difficult to compare subsidies on efficiency, equitability, etc.
- Creates unexpected, major costs for the state in crises
- Limits size of private housing finance sector

Current trend:

- Calculate cost of implicit subsidies. Move to transparency.

Types of housing subsidy: LAC focus

- Most subsidies in LAC are linked to housing finance
  - Demand subsidies: direct subsidy to down-pmt, interest rate, monthly payment, mortgage insurance pmt, tax deductions
  - Supply subsidies to the housing finance system: below-market funding thru provident funds, government lines of credit to housing banks; investor guarantees + tax exemptions; default relief
- But also production subsidies to land, infrastructure, labor, capital grants, cross subsidies
- Operating expenses such as employer/public housing, housing allowance (demand), utilities (demand)
- Real estate tax deductions: abatements and property tax caps (mostly local); income tax credits/ deductions for owners (demand) and investors; non/low tax on capital gains

Different levels of transparency: on-budget

- Explicit subsidies on government housing budget -- often small proportion of total housing subsidies. Examples:
  - **Vouchers** most transparent (Chile, Mexico, Costa Rica, etc.)
  - **Interest buy-down subsidies**, mostly provisioned for each year rather than for duration of the buy-down period

    Good practice: provision in year of issuance the NPV of cash-flow difference between expected market rate and subsidized rate for duration of buy-down period
  - **Program/production subsidies** - mostly explicit apart from government land / infrastructure costs

    Good practice: calculate current market value of land including uncertainty of future profits or costs related to lack of information

Different levels of transparency: tax system

- Tax subsidies administered through national or local tax office; outside jurisdiction of housing ministry
  - **State taxes employer/employee to create special fund for subsidizing mortgage lending** -MX5%, Brazil 8%, Columbia, etc. (cons: non-transparent costs, deeply inefficient with respect to purpose of fund and evolution of HF system; subsidize IR =>regressive/inequitable)

    Good practice: difficult to calculate explicit tax costs relative to savings. Reforms: scale IR progressively or bring to market rate with internal cross subsidy (FGTS, Infonavit); phase out Chile, Peru (difficulty to move to budget allocation), Argentina - move to demand-side on-budget subsidies
  - **State provides tax break on investments in mortgage bonds**, **MBS or housing related deposits** to expand funding market (Columbia, Brazil)

    Good practice: limit period, phase out; make cost explicit in NPV terms

Different levels of transparency: tax system (2)

- **Reducing effective interest rate by allowing deductions on taxable income of mortgage interest payments** (cons: hidden costs, causes higher tax rates, inefficient and regressive, difficult to phase out)

  Good practice: limit eligible property price, phase out; make costs public by income group and region/locality

- **Local government real estate tax breaks** (or zoning/density easing)

  Good practice: limit period, target to priority housing segment, calculate cost (upfront yearly allocation or end of fiscal year)

NB: US uses corporate tax credits for equity investors in low-income rental housing (LIHTC); use of intermediaries reduces $ of tax subsidy spent on beneficiaries. Linked to high corporate tax rate in US. Not used in emerging markets.

Different levels of transparency: implicit financial guarantees

- Implicit housing finance subsidies through Ministry of Finance or Central Bank liabilities
  - **State takes on some or all financial risks associated with operation of wholesale funding systems**, mostly through implicit guarantees –

    Caixa/ Brazil; SHF/Mexico; GSEs/US; most new liquidity facilities (cons: huge potential costs –skeletons in the closet; non-transparent)

    - Good practice: match with statutory or regulatory limits on exposure in terms of future costs; make guarantee explicit

Different levels of transparency: implicit financial guarantees (2)

- **State takes on part or all credit risk associated with individual loans at subsidized insurance rates or as implicit guarantee**

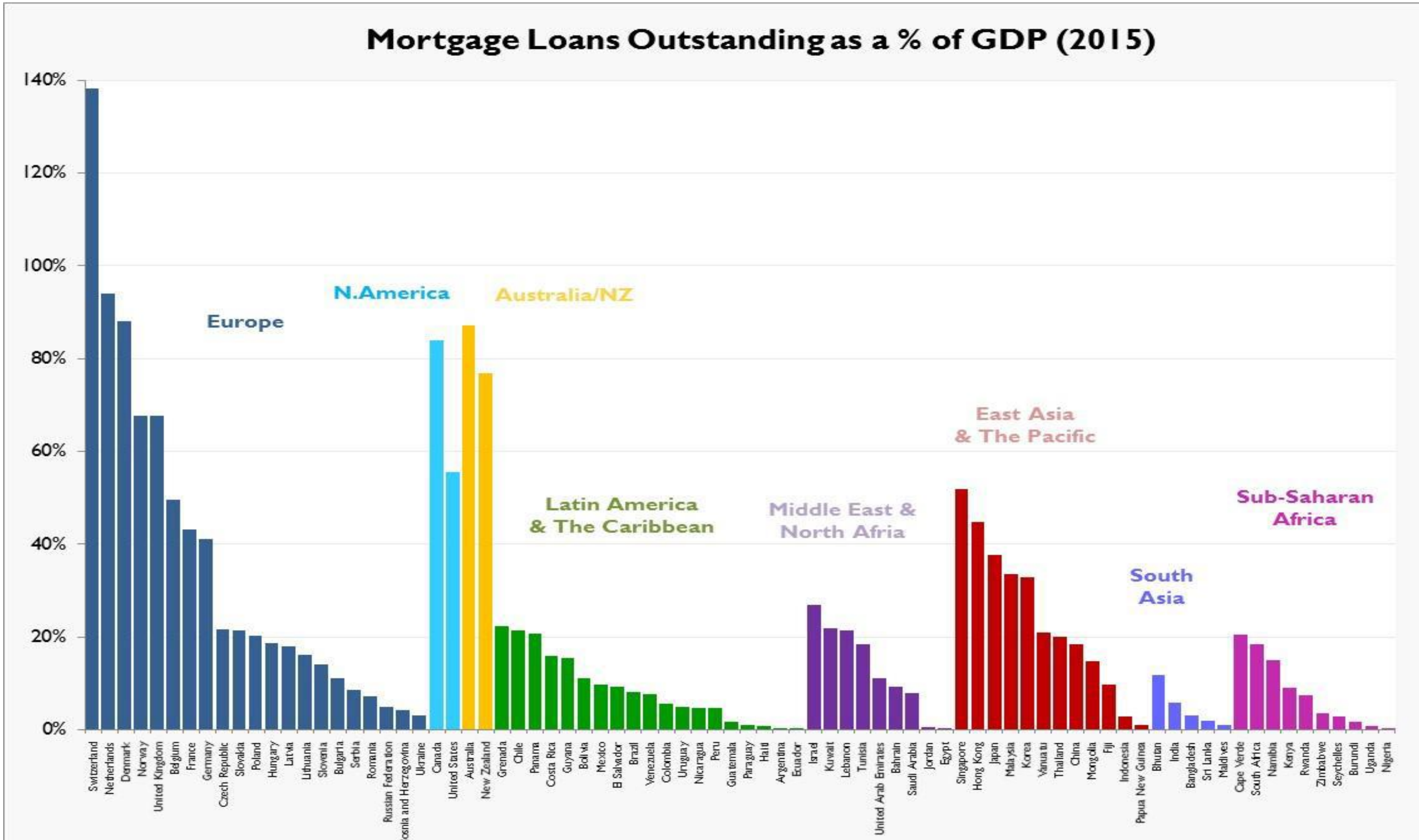
  Brazil insured accumulation of capitalized inflation 1990s/2000 and incurred huge costs; currently guarantees MCMV loans; FHA/US needed several bail-outs; Argentina; MI/India-new

  Good practice: calculate estimated costs of credit exposure and capitalization needs relative to subsidized premiums. Reforms: operate on commercial terms and charge commercial premiums or pay upfront premium to private MIs for deserving households

- **Reduce effective rate by drawing on special funds from central bank or budget; mostly operated through State Banks**

  Good practice: calculate NPV of future cost of differential between market rate and subsidized rate on subsidized mortgages.

Prevalence of implicit subsidies limits overall HF market development in LAC



Source: www.hofinet.org

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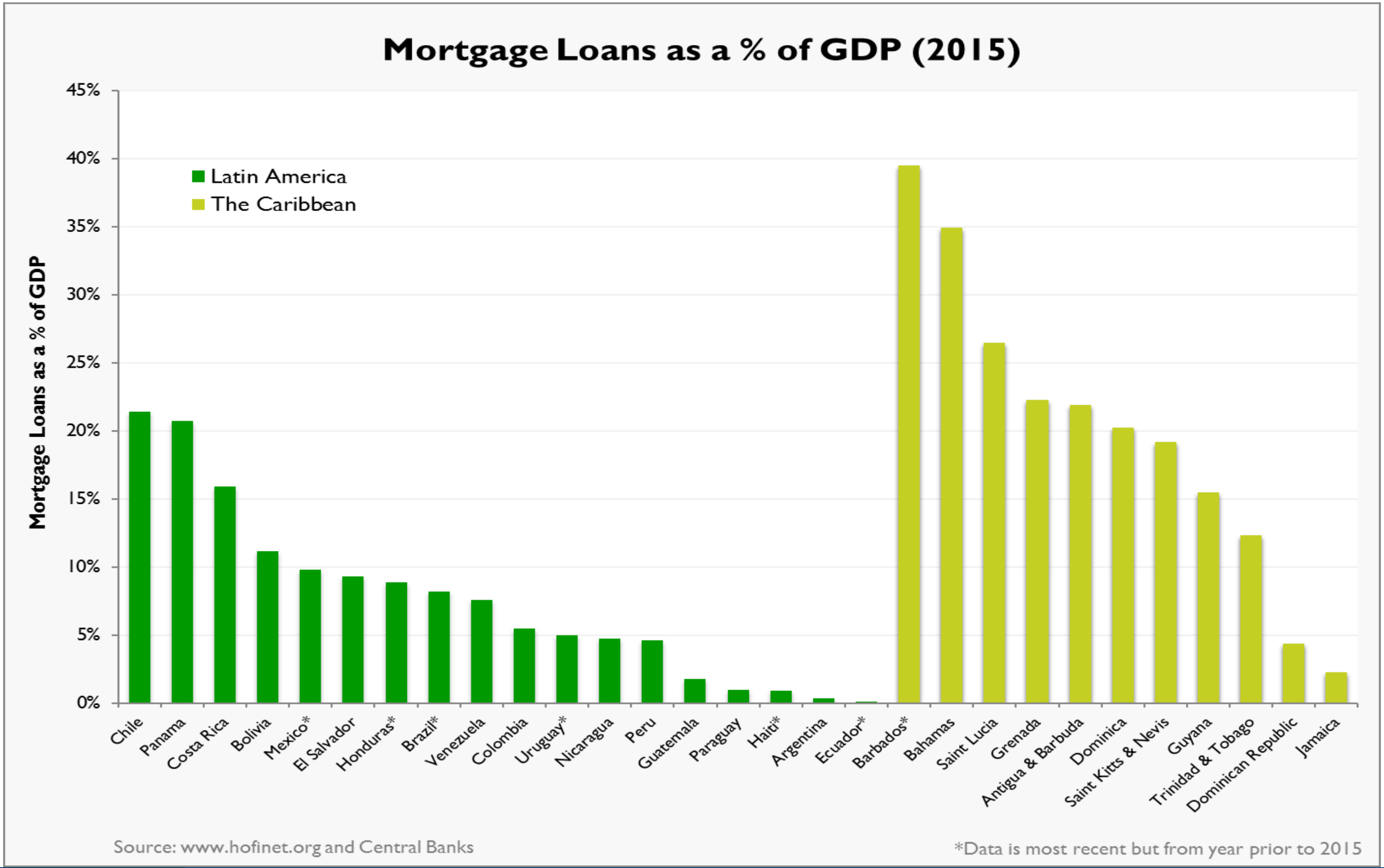

Summary

- The political system influences subsidy design
- Policy-makers often prefer off-budget subsidies to avoid cumbersome approval procedures
- Non-budgetary subsidies differ in levels of transparency and potential hidden costs:
  - tax credits/deductions related to interest payments or capital gains are semi-transparent subsidies
  - Government assumption of risk/guarantees of the housing finance system are mostly implicit
- Latin America's housing finance systems are characterized by high levels of implicit government subsidies
- Implicit subsidies are seldom evaluated on their actual and cumulative costs and equitability- nor on their impact on housing finance market development

Addendum

Amsterdam, June 15, 2017, **Federal Reserve** Vice Chairman **Stanley Fischer:** ……when it comes to past troubles, “memories fade.” …. government involvement “can promote the social benefits of homeownership, but those benefits come at a cost, both directly, for example through the beneficial tax treatment of homeownership, and indirectly through government assumption of risk. To that extent, government support, where present, should be explicit rather than implicit...”