Home Finance Subsidies in Hungary

By Anikó Dobricza, Assistant Professor,
Széchenyi István University in Györ (Hungary)

The case of Hungary concerning housing subsidy cannot be explained without having examined the housing structure and characteristics. As a transition economy, the history of the housing market went through several changes during the past 15–20 years. The inherited situation from the past regime predetermined the latitude of the newly born market economy and the role of the state. The political changes could not make the market economy's potential benefits put in place at a glance. The first step of the reforms in the housing market began by privatising the state-owned dwellings towards the renters. The flats and the blocks were in a bad condition, and in need of renovation. The state budget though was not able to finance reconstruction at that time, so the government chose to sell the flats to the renters at a fraction of the market price. This was a grant for the former renters, connected with very lucrative financing possibilities: long-term credit at a relatively low rate. Though many analyses discussed the costs and benefits of the dwellings' privatisation, one argument is common by all the authors: it was an urgent need when approaching the market economy.

The economic situation had gone through changes. The paternal state drew back, and left the people struggling with their housing problems alone. Some of these problems were connected with the overall fiscal and financial situation of the economy, others were inherited from the past regime, and again some arose due to the lack of appropriate institutional background.

One example for the first group of causes is the high inflation rate: From over 30% at the beginning of the 1990s, the inflation rate went down to 28% by 1995, and fell to about 10% by the end of the century.

At a high inflation background, long term credits for housing are very risky. The housing credit stock was consequently almost negligible at that time. The institution of mortgage lending was promulgated only in 1997, when the act on mortgage was approved. However, despite the legal circumstances, housing credit supply only ascended until subsidising appeared on the credit side. However, after the introduction of the home-finance subsidies, the housing credit stock went up dramatically.

The housing credit stock in Hungary is shown in Table 2.

The radical growth of the indebtedness of the population is reflected by the numbers in the table: this tendency was caused by the reforms of housing policy on one hand and by the planned future cuts of the system benefits on the other hand. The huge number of loans meant a high future burden on the state budget since the state has committed itself to compensate the banks for the difference between the market-rate and the offered subsidised rates.

Credits are very important in a market economy, because with their help financial

Table 2 – Growth of Mortgage Stock 2001-2004

	Housing Credit stock (Ft billion)	Growth (in % of previous year)
2001 January	191.5	152.8
2002 January	331.5	173.1
2003 January	816.3	246.3
2003 July	1,182.0	228.1
2003 December	1,576.0	192.2
2004 Estimated	1,650.0	

Table 1 – Inflation Rates: Forecast and Actual 1995-2003

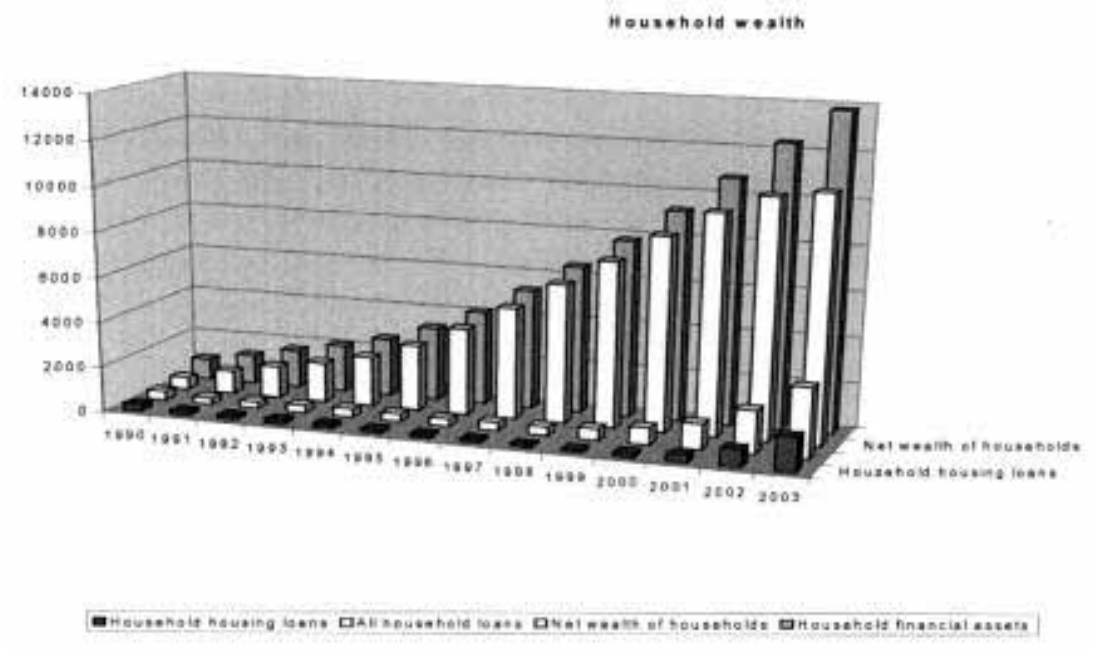
Inflation rate forecasts by	1995	1996	1997	1998	1999	2000	2001	2002	2003
Hungarian Central Bank	26.5-28%	20-25%	18-19%	13-14%	8-9%	8%	8.5%	7.5%	5.1%
Other Research institutions	28-33%	22-22.5%	19-21%	13.5-15%	8-10%	8-9%	8-9%	8%	4.6%
Fact	28.2%	23.6%	18.4%	10.3%	9.2%	10.1%	9.9%	7%	6%

Table 3 – Household Sector Financial Position 2001-2005

	2001	2002	2003	2004*	2005*
Household sector: financial position as a % of GDP	5,1	2,7	- 0,2	1,4	1,9

*estimated

Chart 1 – Household Financial Assets



means can be transferred in time. Buying a dwelling with credit results in instalments for long years – which is a financial burden on the households. The trade-off between having an own home earlier and the later financial costs is disregarded, if the housing credit seems to be lucrative. This causes high indebtedness of the population. Connected with constantly falling savings, the household sector almost reached a net debtor position by 2003 (see Table 3).

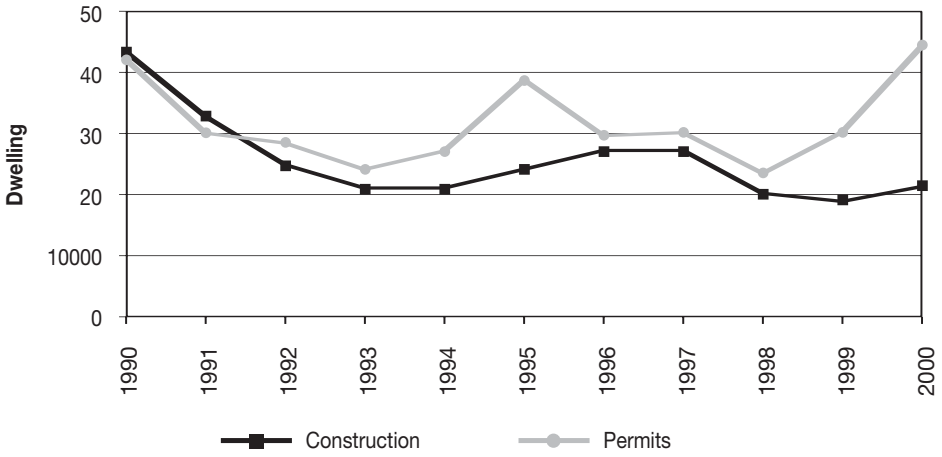
The financial assets of the households are represented in Chart 1.

The indebtedness of the households to the GDP is now about 20% in Hungary. The Western-European average is about 40%. These numbers would explain that the Hungarian credit expansion is favourable. Nevertheless, one should take into consideration, that the average Western-European GDP is 4-5 times the Hungarian, the 20% indebtedness seems to put a heavy financial burden on the population. The savings rate of the households in percent of GDP decreased from 7.7% (2002) to 1.5% (2003 December). This caused urgent need for foreign capital to finance the state debts.

Housing credits are most beneficial for new construction, because it creates value. Regrettably though, two-thirds of housing credits was spent on the housing secondary market. The only positive effect of it is that it provides liquidity for housing mobility and so for new construction.

The number of new dwellings has shown a constant rise. Before the first reforms in home subsidies were introduced, the new buildings amounted to 19,287 in 1999. In 2001, the figure increased to 28,054 dwellings. In 2003 – when the subsidies' reduction was announced for the future – it reached 35,543. With these constructions, the Hungarian housing market changed from a relative under-supply to a relative oversupply.

Chart 2 - New dwelling construction and new building permits from 1990-2000



Year	Dwelling construction (Units)
2001	28,054
2002	31,511
2003	35,543
2004	25,000 (estimated)

The number of flats without inhabitants has been rising for years, reaching 8% of total dwellings. Today in Hungary the problem is not the lack of flats, but the lack of good quality flats. There were 673,000 substandard dwellings in 1999, and 528,000 in 2003. Though the diminution is pleasing, the detailed data are less optimistic. The ratio of the substandard flats in the lowest income quintile has risen from 36% in 1999 to 41% in 2003, but in the highest quintile, it fell from 6% to 4%. This is not sufficient to lead one to the conclusion that the introduced subsidising reforms aimed at the higher income population. The higher income families can more easily find means to improve their home quality.

BACKGROUND ANALYSIS

By analysing subsidy systems, the main questions are the following:

- Is the system capable of achieving its goal (to help those in need)?
- How much has the government to spend in order to finance this goal?

Before the introduction of reforms, experts should always carry out research about the present situation. However, it seemed that in Hungary this step had been neglected and amendments of the subsidy scheme were put into force.

The state of the housing market can be analysed through two other factors: home-ownership and home-mobility. Home ownership is not expressively the main aim of a well functioning subsidy system; the main aim is to give a shelter to everybody, either by ownership or by rental housing. The indicator of dwelling-affordability measures the ratio of average household disposable income to the income required to meet payments on a typical dwelling. This ratio grew in Hungary from 40% (1999) to 71% (2003). Taking into consideration that during this period the average dwellings prices doubled, housing affordability is prospering. In an average developed country the ratio should be around 110%. In Australia, for example, it is 137%. These data show that there is much to achieve in this area for Hungary.

On the one hand, dwellings in Hungary are not cheap. One needs about six years' income to buy the average flat. Owing to the introduced housing subsidies, much capital flew into the housing market. This capital was partly originated from past savings, but mostly from the expanded mortgage finance possibilities. This caused a deep upward change in the house prices. The average price of a flat changed from 3.7 million Forints (1999) to 9.3 million (2003). In the city of Budapest, the change was even higher: from 5 million to 13.4 million Forints in the relevant years. The dwelling prices and the yearly household income ratio moved from 3.7 in 1999 to 6.1 in 2003. Though the change in only four years has been appalling, it has not necessarily meant the decay of finance-ability, because the house prices have partly risen due to the new financial opportunities (subsidised loans).

On the other hand, rents are comparably low, yearly about 6% of the market value of a dwelling. This is just about half of the state bond yields. The housing market is now over-valued. This fact is shown in Table 4

Chart 3 - Average dwelling prices in HUF thousand per square metre (1999-2004)

which outlines the price tendency of an average flat through the last few years.

The over-supply tendency was even deepened by the easy availability of (still relatively) cheap mortgage loans. (See table below and appendix 1.)

Housing mobility is important for the market. If the mobility is low, the market remains stable and less developable. In Western European countries an average household moves to a new home about six times in its life, whereas in Hungary only twice. There is an urgent need to enhance mobility to help develop the appropriate dwelling structure. The subsidy reforms were able to improve this figure (to about 3.4), but only temporarily. Slashing subsidies have had a controversial effect. Without enhancing the rental market, the home mobility will again be limited.

ECONOMICS OF SUBSIDIES

State subsidy is a very important area in economics. The role of the state in an economy can not be regarded from only one aspect. It is a fact that any economy needs the intervention of the state as the provider of common duties. The question is to what extent should the state encroach into the economic process.

Table 4 – Changing Price of Flats 1999-2004

Year	Average price/square-metre for old construction (in thousand Forints)	Average price/square-metre for new construction (in thousand Forints)	Explanation
1999	65	80	The only subsidy in force is for pre-savings (bauspar system): a maximum of 36,000 Forints per year.
2000	100	145	Introduction of reforms with restrictions for age, number of children and only for new construction, also for used ones at an 8% subsidised rate, and tax reduction of 240,000Ft yearly.
2001	120	180	Restrictions abolished: investment-buying with subsidy allowed.
2002	160	230	Amount of state deduction after children risen. Subsidised rate fell to 4%.
2003	180	250	Reforms cancelled, effectuated step-by-step. Tax deduction cut by half; rate: function of state-bound yields (about 10.5%)
2004	180	290	Euro and SFR-based loans flourish, housing market stops booming, state subsidy for pre-savings doubled (bauspar system).

Source: own calculation based on advertised dwellings' prices

Any governmental aiding system is based on redistribution: transferring resources from one group to another preferred group of the society. Based on the professional literature, the criteria to a fair and efficient redistribution are the following:

- The first group of the motives are moral. Based on it, those households that have low income or many children should be supported. The decision covers the limit of the income and the relation between the number of children and state support. Ethically, the redistribution from every tax-payer (including lower income groups) towards those better off is unjustifiable. Finally, no ethical explanation can be found to the preference of hiring to owning flats.

- The second group of the motives are economic. There are debates on the fiscal influence of the home-financing process, whether grants or tax-reduction – or even extra taxes – are allowed to intervene in the allocation. It can be reasonable though to help the sector towards better conditions: new home buildings or renovation.

- The third group of the motives is the direction of the redistribution to selected groups of the society. Surveys should reveal, how the the selection of the group, which should be subsidised, can directly be measured.

From an economic point of view, the levels of welfare are represented by indifference curves, which can be reached in our case by combining expenditures on housing and other goods. The household reaches the highest welfare curve within its budgetary limits as soon as the indifference curve strikes the budget line (see graph on the left).

Regarding the subsidies, their effect results in higher welfare of the subsidised groups. The consequences of money-like subsidies are shown on in the graph on the right:

The household receiving financial support for housing achieves higher welfare (indicated by the turn of the budget line to the right). As a result the household will be capable of spending more on housing without cutting back its expenditures on other goods at the same time. The upper bold arrow shows the shift to a higher welfare curve, the small arrow below signs the turn of the budget line.

To estimate the need for support by the state, the different income groups should be treated differently. The average rate of housing expenditure from the household income can preferably differ by income levels. The higher is the household revenue, the higher can be the housing expenditures portion be without hardly reducing spending on the other needs. The average household expenditure in some countries are shown in Table 5.

Chart 4 – Welfare Effects of Housing Subsidies

Table 5 – Housing Costs as a % of Household Income

Country	D	B	DK	E	SF	F	I	IR	L	P	UK	SW
Housing costs as a % of household income	24.6	27.0	21.2	26.9	19.0	24.4	26.3	14.9	36.1	20.6	19	31.1

Source: EUROCONSTRUCT 2000 (National reports)

In Hungary, the average household spends 25% of its income on housing, one third of households spend over 30%. The lowest income groups need to spend 42% of their salary on housing costs. Therefore, the subsidy system should focus on low-income households. However, in their case the support should not necessarily be aimed at helping them to become homeowners, but long-term supported renters.

HOUSING REFORMS

After the political changes in 1989, the low rents have been gradually raised. Compared to the previous years, the portion of the discount to the income fell from 24% to only 8%.

The introduction of the market economy has lead to a liberalisation of the construction industry, which solved the problem of lack of building materials, but also directed the attention to the insufficiency of financial facilities. One of the main problem areas in the housing sector was the diminution of credits. On average, credit financing reaches 60–80% of the value of the house, while in Hungary this rate was only about 10%. The low figure has the following reasons: firstly, investments in the housing sector fell dramatically: in 1991 only half as many flats were built as in 1980, and in 1997 only one third. The financial structure of the housing investments has also changed. Credit financing almost disappeared, and cash financing became more relevant.

Banks granted loans at high real interest rates, which were difficult to pay back. Moreover, the transition changed the way people think. The old habits of relying on the paternal state has to disappear and a more 'adult' society has to be developed, ie a society that is aware of its rights and its opportunities, but is willing to try to achieve it by its own means and efforts. Besides these, the financial situation of the people has only slowly improved. There has been a period of adjustment, when efficiency and market share have been the most required features. Under such circumstances, people did not dare to risk bankruptcy. Reforms became inevitable. The government introduced housing subsidies in several pillars and steps.

The housing subsidies introduced in 1999 were aimed at the young couples (below 35 years of age) and families with children. Under severe restrictions, these groups could be granted loans at a rate of 6% (young couples) and at 12% (families). The maximum loan was 8 million Forints, the home had to be newly constructed, and the duration of the loan had to be 10 years. All other home-buyers had to pay the 18% rate. These measures did not enhance the real estate market at the expected pace, so new changes had to be made. From February 2000, the home mortgage rate was lowered to 8% for families with three children. However, the requirement to invest the funds into new construction remained. The number of new homes doubled due to the reforms, but the home mobility and the housing market fluctuations remained very low, because the introduced system did not reach the segments of used houses and flats. The tax reduction possibility after the yearly instalments of the housing loan was 35,000 Forints yearly.

After being practised for two months, the system was hampered by new obstacles. From ten interested families, only two or three were eligible for the loan. The problem was that there were only a few couples, who were younger than 35 and had enough income to pay the instalments (instalments are not allowed to be greater than one third of the income). For example, to buy the cheapest 40 square metres flat in Budapest, the income of the family had to be ten times the Hungarian minimal income level. As a result, the system subsidised the new homes of the higher income groups.

The 110 billion Forint budget for the housing subsidy seemed to remain under-utilised. New rules were made: the age limit of 35 and the first home rule were cancelled, and the loan amount was increased to 10 million Forints. The new rules still did not reach those in need because the average wage was not enough to finance the monthly instalments.

In July 2001, the reforms reached the secondary market of housing with about 9% of loans. Tax deduction were increased from 35,000 to 240,000 Forints. The duration of the mortgage loans rose to 20 years.

The market reaction was of course a price-boom: house prices went up by 50% in one year. In December 2001 the maximum mortgage loan became 30 million Forints and loans were given at lower rates (4% for new and 6% for used dwellings).

After the elections in 2002, new reforms were undertaken. The loan limit was reduced to 15 million Forints, but the rates remained the same. Since the volume of subsidised loans reached 1,500 billion Forints by the end of 2003, the system was hard to finance any more. Hence, the loan rate support and the tax deduction put a high burden on the state budget. The house prices tripled in four years as the subsidised loans fuelled investments in housing. The funds available in the banking system did not suffice to finance the huge loan amounts. By now, the subsidised mortgage rates are about 10% (connected to the state bond yields), thus being less lucrative.

A new trend has recently emerged in housing finance: people ask for loans denominated in foreign currency (EUR or CHF). Interest rates for these loans vary between 2 and 4% pa. However, they include exchange rate risk for the borrower.[1]

The reduction of subsidies made the real estate market stagnate: people had to wait for long months periods until they were able to sell their dwellings. Hence, home mobility became limited. The housing problem has still not been solved. The frequent changes in subsidies caused only a transitory improvement, and made the actors of the real estate market insecure.

[1] Taking exchange risk into account, interest rates in HUF may amount to 10%.

SOLUTION PROPOSAL

The subsidisation model is regarded as efficient if it can achieve its aims by the often restricted financial assets. Efficiency can be measured only by an added-value/cost ratio, which is sometimes difficult in practice. The discounted values of all future financial engagements of the state should be taken into account. An efficient subsidy system should not focus on every income level. The state should choose priorities – requirably the low- and middle-income groups, and support them with fiscal funds. The support of the high-income families and the support of investment housing is not sustainable for any state in the long run.

A fair system should enhance pre-savings (like the German 'Bauspar' model) for housing, which was also introduced in Hungary in 1996. Confidence of the people in this system was destroyed by some contradictory news about the possible reduction of subsidies. With other lucrative loans available on one side and with high deposit rates on the other side, the pre-saving construction was not preferred any more. The radical changes in house prices produced the same results: the saved money represented only a little portion of the real price of the dwelling to be constructed or purchased. Since house prices rises have recently slowed down, the importance of pre-savings may rise for home-buyers. Such a system would help to increase people's awareness of their own responsibility in housing.

APPENDIX 1: HOUSING SUBSIDIES

The most important housing subsidies applied in Hungary are listed below:

- *Interest rate subsidies.*

  Couples and parents raising children are eligible for housing loans with an 8% interest rate. The subsidy can be claimed only once, and only to build or purchase a new home. The 8% interest rate also includes the bank's handling fee. The Government has undertaken to keep the interest and loan charges at or below 8% (together with the subsidy); the interest rate may be lower than 8%. The loans are available for projects with no more than HUF 30 million construction costs or purchase price (without land price) up to a maximum of 70 % of the total costs, but the actual loan amount may not exceed HUF 10 million.

  Everyone under the scope of the new system is eligible for mortgage loans with a 4.5% interest subsidy. The Government extends the interest subsidy through the lending bank; the subsidy is available for a maximum of HUF 30 million loan per home. The subsidy is integrated in the interest, i.e. the subsidy is deducted from the monthly payments to be made by borrowers.

  Interest rate subsidies are available for a period of 10 years for both the so-called 8% interest housing loans and preferential mortgage loans. The Government expects that by the end of that period declining inflation will have brought interest rates down to a level that is affordable for a wide range of the population without the need for a subsidy.

- *Mortgage Loans.*

  Mortgage loans represent one category of loans. Under a mortgage arrangement, the owner of the property undertakes an obligation whereby, in case of default, the property can be sold in accordance with pre-defined rules and the proceeds may be used to repay the debt. The funds for preferential mortgage loans are provided by the mortgage bank by the issue of mortgage bonds (special long-term securities). The bank raises the funds required for lending on the capital market, and channels them to the borrower through its own branch network or its partners (commercial banks, savings co-operatives, insurance companies).

  Mortgage loans which are refinanced by covered mortgage bonds are eligible for tax exemptions. Bondholders are not subject to taxes on income from capital.

- *"Social Policy" Subsidy for Families with Children.*

  The "social policy" subsidy is still available for those building or purchasing new homes, building flats or converting attics. In the case of couples acquiring a new home, the amount of this benefit is HUF 200,000 for the first child, HUF 1 million for the second child, HUF 1 million for the third child, and HUF 200,000 for each further child. Those refurbishing their existing homes are eligible for 50% of the amounts specified above. The subsidy amount for every other family member is HUF 30,000. The social policy subsidy is also available in case children are born later (after the start of repayment, but only during the repayment period) to reduce the outstanding debt. However, the subsidy cannot be paid out in advance

- *Tax deductions.*

  Tax deductions are allowed up to a 3.4 million Forints of yearly income. They should cover 40% of instalments, up to a maximum of 120,000 Forints.

APPENDIX 2: EXCHANGE RATES

The exchange rates for Euro and for USD in Forints (Ft) are:

Year	Ft/Euro	Ft/USD
1999	256	243
2000	263	313
2001	256	283
2002	241	245
2003	256	219
2004	246	193

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