HOUSING FINANCE IN HUNGARY: SUBSIDIES AND THE SZECHENYI PLAN

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Introduction

Over the past century, Hungary's housing market has gone through many significant changes. The country saw the rise and fall of communism, which left a legacy of low quality structures that continue to be a problem today. In the 1980s the housing market was opened up to private development, while the 1990s brought a tremendous decline in the values of bank loans for the purchase of housing. This decline in lending caused the country's housing prices to fall substantially. Then in 1998 the housing market turned around as investors fled the stock market after the Russian financial crisis and began to buy real estate instead.

In 2000 the Hungarian government instituted a generous housing subsidy package, the Szechenyi Plan, which created a large increase in lending. The government designed the program to fix many of the problems that had developed during the 1990s and the transition from communism. While the program proved very popular, it proved to be a strain on the government budget and was abandoned at the end of 2003.

In this article, I first present a brief history of the housing environment in Hungary. Then I examine the problems that the housing market faced in 2000 and the Szechenyi Plan, which was designed to address these problems. I conclude by offering several recommendations for improving Hungary's housing system.

A Brief History of Housing in Hungary

Housing in Hungary has faced many significant challenges and has undergone many changes during the transition from communism. During the communist era, the state had the responsibility for providing housing. While the vast majority of Hungarians lived in state-owned housing, only the wealthy few who lived in rural areas owned a home. Hungarians generally lived in three primary types of homes:

pre-World War II apartments, self-standing homes, and high-rise suburban housing projects. The government built many high-rise suburban housing projects due to their low cost and rapid construction time. Unfortunately, their poor construction led to inadequate insulation and quick degradation, problems which continue today. As with many of its other assets, Hungary chose to privatize the vast majority of state-owned housing in the early 1990s. In this respect, Hungary served as a notable exception to the other countries in the region by privatizing 92 percent of formerly state-owned housing. (Szilagyi, p. 68) Compared to a rate of 48 percent in Poland and 42 percent in the Czech Republic, Hungary had one of the highest home ownership rates in Europe. (Markharn, p. 4; Sykora) A tenant at the time of transition had the option to purchase his home for roughly one-quarter of its estimated market value. Those living in the nicest apartments received the best deals while those living in the run-down projects usually ended up saddled with high maintenance costs and poor living conditions.

While the new homeowners usually received a bargain, a new set of problems emerged shortly after transition as a result of the mass privatization. Anyone who did not occupy a home at the time of privatization faced a difficult housing market. Rental units comprised a very low proportion of the housing market, and loans to purchase a home offered expensive and undesirable terms. The high ownership rate created a market with relatively few housing transactions. Home building also fell sharply during the 1990s, with the number of homes built dropping 64 percent from 1985 to 1998. (Hegedus and Varhegyi, p. 1636) It was private citizens and their relatives who built the majority of these homes, because for-profit building companies were almost nonexistent. (Hegedus and Zsamboki, p. 8) The market for housing loans paralleled the decline of the construction business. Debtors repaid old loans and banks issued few new loans. The low level of demand in the housing market created an environment of decreasing prices. (Hegedus and Varhegyi, p. 1636) Furthermore, soaring inflation sent investors to other forms of investments; and they avoided the housing market, where prices dropped almost in half from the time of the transition to the late 1990s.

The above problems were compounded by the fact that the Hungarian banking system remained largely noncompetitive throughout the 1990s with the former state bank, OTP, dominating the banking industry. (Diamond, p. 9) While two other large banks had begun operations, they had failed to add a significant competitive element to the market. Partly as a result, Hungary has long suffered from high mortgage interest rates. High interest rates have often prevented those with average incomes from being able to afford mortgages. Then in 1998 the Russian financial crisis severely affected the Budapest Stock Exchange and drove many investors back into the housing market. While housing prices began to recover from the wave of new investors, the country entered the new millennium with an array of housing problems that had not been successfully addressed during the prior decade.

Motivation for the Szechenyi Plan

One of the biggest problems has been the inability of the average Hungarian to receive an adequate housing loan to finance a substantial portion of a home. While a person could borrow up to 15 percent of the value of a new home, this left an enormous remainder to finance. Typically someone selling his home and purchasing a new home would have a large amount of cash to pay the amount not covered by the loan. However, those purchasing their first home are in a very difficult position. Typically a young person in Hungary will graduate from secondary school or university and live at home until marriage. After the wedding, the two families can usually come up with enough money to purchase a dwelling. However, those without strong family support are forced to find other less desirable housing options, such as living with friends or occupying more cramped quarters. In contrast to Hungary, Western European countries normally had a loan-to-value (LTV) ratio around 80 percent as of the year 2000. By allowing the buyer to pay for the home over a longer period of time, housing has been more widely accessible in Western European countries that offered

larger loans. But with financing not generally available and relatively high housing prices in Hungary, an environment of low affordability exists. In 2000 a new home cost seven or eight times the average annual household income in Hungary while in the rest of the EU this figure was around three times the annual income. ("Szechenyi Plan," p. 49)

As for the construction industry, it experienced a marked slowdown during the 1990s as the demand for new homes fell. According to EU averages, Hungary should have replaced about one percent, or roughly 40,000, of all its homes each year. Instead the country built only a little more than 28,000 homes each year during the 1990s. (*Yearbook of Housing Statistics*, p. 23) By neglecting to build new homes, the number of residences in poor condition grew; in fact, 55 percent of all homes in the country required renovation. The hastily constructed housing projects built during the communist era were especially in need of renovations and continued to be a source of concern to their residents. With extremely high ownership rates dominating the housing market, the stock of rental housing was small, with rentals representing only 7 percent of the housing market (compared to the EU average of around 38 percent). ("Szechenyi Plan," p. 50) In Hungary, renters have a strong aversion to renting due to a fear of rent increases beyond the tenant's control. (Hegedus et al., June 2004, p. 13)

Description of the Szechenyi Plan

As its economy began to strengthen in the year 2000, Hungary saw the possibility of EU accession on the horizon. In order to capitalize on this possibility, Hungarian lawmakers introduced the Szechenyi Plan. The plan consisted of six separate programs to deal with specific issues. The six programs covered the growth of small and medium-sized businesses, housing, tourism promotion, encouragement of innovation, expressway development, and regional development. The housing program received almost a quarter of the Szechenyi Plan's budget, which demonstrated the government's resolve to strengthen the housing system, even at great expense. ("Szechenyi Plan," p. 29) However, the budget for the housing program only covered the expenses from 2001 to 2002. The cost would grow much higher in the coming years.

In order to implement the housing program of the Szechenyi Plan, the government formulated four goals: increasing the housing supply, modernizing existing homes, modernizing the housing loan system, and enlarging the apartment rental sector. While the Szechenyi Plan had a specific budget for the entire housing program, the budget was not divided among the four goals. Furthermore, in what turned out to be an extremely expensive part of the housing program, interest rate subsidies, the plan provided no explicit limits on income or other criteria that an individual needed to meet to become a recipient. The Conservative Party that initiated the Szechenyi Plan provided only two years of budgetary figures for the Plan, the amount of time until the next major election in 2002[1]. In addition to its desire to increase the quality of housing in the country, the party also wanted to use the subsidies to generate votes in the 2002 election. If the party lost power, then creating a plan for more than two years would be irrelevant. If the party retained power, it could plan the housing program for subsequent years at that time.

Implementing the Plan

One of the first things the government decided was to institute a series of housing finance subsidies to make housing more affordable and accessible. Housing, of course, plays an important role in most societies due to the fact it affects both the quality of life and also the country's economy. The Hungarian government hoped to build a significant number of new homes each year. A new home is a relatively expensive item since it requires construction workers, building supplies, furnishings, landscaping, etc., which in turn support a large cross section of the economy. Nevertheless, a "broken" housing system can also consume a large quantity of resources. (Hoek-Smit and Diamond, p. 7) Fixing the underlying problems

[1]According to conversations while visiting Hungary, the political party in power has changed every four years since 1990.

the housing system faces is a far more efficient use of time, resources, and energy than simply giving housing subsidies.

While there are many ways to subsidize housing finance, Hungary chose three specific methods. These methods are the demand-side interest subsidy (DSIS), the supply-side interest subsidy (SSIS), and the personal income tax deduction (PITD). The DSIS directly provided home buyers with incentives. By this method, the government pays a portion of the borrower's interest payment to the bank. This subsidy ensured that borrowers would pay a maximum interest rate of 8 percent (Table 1). Between January 2000 and December 2003, the maximum allowable loan was increased from €31,500 to €44,600. Furthermore, the length of the subsidy was increased from 10 to 20 years and the maximum interest rate paid on the loan decreased from 8 percent to 6 percent. All of these factors greatly benefited home buyers. (Hegedus and Somogyi)

The DSIS was intended to help those who could not afford high interest rates, especially the lower class and young families trying to buy their first home. Unfortunately, this subsidy was not very efficient. Only a subset of the group that qualified actually needed the subsidy to purchase their homes. There were other problems as well. The subsidy disproportionately benefited the wealthy — the greater the loan, the greater the subsidy. By making the subsidy available only for new housing, it tended to raise the price of new homes. (Hoek-Smit and Diamond, p. 11) Finally, it was very easy for the government to hide the subsidy's true cost since all future expenses would appear on future budgets. At the time of the introduction of the DSIS, it appeared cheap and promised many benefits to home buyers, all of which courted favor towards the Conservative Party.

Initially only first time home buyers who purchased new homes were eligible to receive the DSIS. This gave the subsidy to those who needed it most. But in June 2000, anyone purchasing a new home also now qualified for the subsidy. And as Hungarian lawmakers continued to be swayed by political pressure, they finally granted the subsidy to anyone renovating their home and to private developers as well. (Hegedus and Somogyi, p. 4) In addition to helping the construction and banking industries, the widening eligibility criteria for the DSIS served as a "present" for the general public of Hungary. And its true purpose became not just to increase the standard of living, but to win votes from the people.

In addition to the DSIS subsidy for borrowers, the government also created the supply-side interest subsidy (SSIS) for banks that borrowed money. By allowing the banks to borrow money at a lower interest rate, banks could then lend money to home buyers at a lower interest rate. The SSIS was based on the

Table 1
Demand-Side Interest Rate Subsidies: 2000–2003

	January 2000	June 2000	June 2001	October 2001	June 2003	December 2003
Maximum loan (million HUF)	8	10	10	10	15	15
Term of Subsidy	10 years	10 years	20 years	20 years	20 years	20 years
Eligibility	First time buyers of new homes	All buyers of new homes	All new home buyers and renovation loans	All new home buyers and renovation loans	All new home buyers and renovation loans	All new home buyers and renovation loans
Maximum Interest Paid on Loan	8%	8%	8%	6%	6%	Variable

Source: Hegedus and Somogyi, "Failure or Success of the Mortgage Subsidy Program in 2000–2004 in Hungary?" p. 8.

assumption that the banks would pass on the cost savings generated by the subsidy to the borrower. During the initial implementation of the SSIS in 2000, the subsidy ensured that banks would make a return of 4.5 percent on their loans. As time progressed, however, lobbying groups pressured the government into increasing the level of the SSIS. (Hegedus and Somogyi, p. 3) As a result, in June 2001 the bank subsidy became more generous; and in October of that year the government allowed banks to borrow money at zero percent interest. Incredibly, in February 2002 yet another change to the SSIS meant that banks could borrow money at 9 percent and receive a 10 percent subsidy from the government. In other words, the banks could profit simply by borrowing!

The third method that Hungary chose to subsidize housing finance was by a generous personal income tax deduction (PITD) for mortgage payments. Using this subsidy, individuals could deduct the interest paid on a housing loan from their income tax obligations. Before 2000, individuals could deduct up to 20 percent of their interest payment with a maximum deduction of €135 per year. In 2001 lawmakers increased the deduction to 40 percent of the interest payment subject to a maximum of €800 for those who purchased a new home. (Hegedus and Somogyi, p. 4) All in all, the PITD encouraged the use of the mortgage finance system by making a mortgage more affordable, and it also helped the middle class purchase a home. However, the PITD wound up doing a very poor job; for all homeowners received the subsidy while relatively few new buyers eventually purchased homes. This tax deduction also provided very little benefit to the lower class, since most in this class rent and pay little income tax.

In 2002 the Socialist Party won the elections and displaced the Conservative Party, which had been in power for the previous four years. In their campaign, the socialists promised to maintain the current housing subsidies and even hinted at the possibility of increasing some of them. The government initially kept its promise, but then in June 2003 it reduced the benefits of the housing subsidy program. Although the first decrease proved to be far milder than expected, in December 2003 the government dramatically cut the housing subsidy program to keep the budget deficit down. The result was that at the end of 2003, borrowers took out a record number of new housing loans before the removal of the generous subsidies. ("Report from…," p. 7)

Effects of the Plan

The legacy of the Szechenyi Plan for Hungary was mixed. In some respects the plan met its goals and in other respects did little of what it set out to achieve. On the positive side, the number of home loans increased. The plan also met its goal for increasing the number of new homes constructed, while homes on average became more affordable. Finally, competition among lending institutions increased, and the number of bank branches and real estate offices grew. On the negative side, the plan produced large budget deficits. Also a disproportionate amount of the subsidies went to the wealthy, and the market share of rental housing remained flat. In the next few sections I discuss each of the above in more detail.

Positive Accomplishments

Turning first to the benefits of the housing program, the plan certainly increased the volume of housing loans. Before the plan was put in place, in 2000 there were €511 million in existing housing loans compared to a total of €3.36 billion at the end of 2003.[2] This increased the loan ratio from 2 percent of GDP in 2001 to 9 percent of GDP at the end of 2003. ("Hungary…," p. 14) The fact is that there were very few existing loans in 2000; most of the housing loans from the communist era had been repaid by that point.

Hungary also rapidly expanded its new home construction in line with the Szechenyi Plan's goal. According to the Hungarian Central Statistics Office (HCSO), the country had never produced more than 40,000 new homes in a year until 2004. While the country reached the home construction goal a year later than originally planned, the country continued to meet

[2]All figures given are in real euro terms (2000).

the 40,000 home goal in 2005. (GKI Economic Research Co.) Homebuilding provides the economy with a sustainable source of economic activity and will continue to increase the quality of life in Hungary as homeowners replace older homes.

During the period 2000–2003, interest rates dropped while incomes grew. This combination of factors moderately raised housing prices, but housing actually became more affordable. ("Remarks from…," p. 3) Housing affordability can be measured using the average-house-price-to-annual-income ratio, a ratio that measures the number of years it would take for the average person to buy the median priced home. (Hegedus and Somogyi, p. 11) In 2000 it cost the average person between seven and eight years of income for a new home, while this figure dropped to about six years of income in 2003.

While housing did become more affordable when compared to the average income, the situation did not improve in terms of how much a person could borrow. Before the Szechenyi Plan, the average borrower could take out a loan for only around 15–20 percent of the home's selling price. Also, foreclosure laws changed in 2001 to allow lenders to recover their money more quickly and therefore exposed them to less risk. About this time, the market also became more active, which enabled lenders who foreclosed on a property to realize a higher liquidation value.

With the revised foreclosure laws and increased market liquidity, along with greater competition among lending institutions, borrowers now had the ability to take out a loan of 50 percent of the home's value as of the end of 2003. (Rozsavolgyi and Kovacs, p. 4) While this represented a significant improvement over the prior more restrictive lending practices, it remained a long way from the original goal of reaching the European average of making loans available for up to 80 percent of the home's value. For a young couple looking to purchase their first home in Hungary, the large down payment required could create a significant problem. In November 2005, the average price of a home in Budapest was €77,300. (Ingatlan…) With average yearly income roughly €6,000, the €38,650 that a new home buyer had to give as a down payment presented an enormous obstacle for many. ("Thousands Celebrate…")

The plan did have the effect of making Hungary's housing infrastructure stronger. The increased level of development and competition among financial institutions for housing loans has benefited the consumer. Before 2000, the communist-era state bank, OTP, had 90 percent of the housing finance market; but after the start of the subsidy system OTP's share dropped to two-thirds. (Hegedus and Somogyi, p. 6) The growth of the housing industry has also led to more opportunities for real estate agents. Duna House, currently Hungary's largest real estate franchise network, grew from only three offices in spring 2003 to 45 offices in early 2006. (Duna House Co.) The growth of a national franchise network like this provides a level of uniformity to the real estate business around the country and eases the problems of moving. During the period 1991–1999, 87.9 percent of homes were built by individuals and their friends and family. By the end of 2004, only 60.3 percent of homes were built by the individual and their friends and family as housing developers had taken on a much greater role in home building. (*Yearbook of Housing Statistics*, p. 28) This marked progress towards a more efficient building system that utilizes economies of scale. Individuals could now obtain a higher quality home for a lower price.

Failures

The Hungarian housing sector experienced many positive changes from the Szechenyi Plan, but the changes were not costless. The housing subsidy plan severely strained the government budget. From the start of the program in 2000 the government spent more than it had expected. In 2001, the government spent more than twice the amount on subsidies than it had budgeted; and by 2003 it had spent five times the amount on subsidies that it had spent two years earlier. While the primary intent of the Szechenyi Plan was to encourage building and to help first-time home buyers, the government supplied 50 percent more subsidy funds for the purchase of used homes than it did for the construction or purchase of new homes. (*Yearbook of Housing Statistics*, p. 37)

Although Hungarians constructed and bought many new homes during this period, the average size of homes diminished with each year. One- and two-bedroom apartments also saw their average floor size decrease (by 16 percent), although the size of larger units remained roughly flat. (*Yearbook of Housing Statistics*, p. 31) These data suggest that perhaps those who could not afford a new home in the past could now afford to purchase a smaller unit. An overabundance of new small homes could pose a problem in the future; for when current occupants want to find a larger home, they may encounter a market saturated with small units.

If the government had hoped to make housing more affordable for the middle and lower classes, then it should have allocated more funds to these buyers. Unfortunately, the demand side interest rate subsidy (DSIS) and the personal income tax deduction (PITD) were not up to the task. Those buyers with higher incomes and who spent more on a home received more of the subsidies. The personal income tax deduction provides a rough indication as to which segments of society received the greatest portion of housing subsidies. In 2003, those in the upper 20 percent of the income bracket received 60 percent of the personal income tax deduction. (Hegedus and Somogyi, p. 5)

In addition to trying to increase the availability and affordability of new homes, the government also attempted to move the proportion of housing units that are rentals closer to the EU level of 38 percent. Unfortunately, the plan achieved very little progress in meeting this goal. The share of rental housing held flat at 7 percent throughout the period 2000–2003 despite the government's efforts. ("Housing Statistics…," p. 50) At the end of 2003, Hungary was on the verge of joining the EU. As this would open Hungary's economy to the other EU members, a shortage of rental housing units impedes the geographic mobility of workers throughout the country.

Recommendations

With Hungary's integration into the EU, it now has access to Europe's capital markets. The possible entrance into the Eurozone in 2012[3] will bring significant changes to the structure of the country's housing finance system by bringing about sustainably low interest rates. This will probably then make housing subsidies a thing of the past. In the meantime, though, Hungary will need to deal with its current housing finance issues. In order to continue the growth of the housing market, one of two things must happen: either the government should provide an upfront subsidy to home buyers or it should find a way to increase the loan-to-value (LTV) ratio.

With the current LTV ratio hovering around 50 percent, a tremendous burden is placed on first-time home buyers who are required to come up with large down payments. Even with the government subsidizing interest rates on mortgages, many buyers will still have to struggle to make the down payment. The government should provide qualified home buyers with the present-value lump sum equivalent to any future interest rate subsidies. For example, instead of giving subsidies on each interest payment in the future, the government can estimate the value of those subsidies and give them to the home buyer at the time of purchase. This would greatly ease the problem of coming up with the down payment. Chile successfully developed such a program that provided grants to low-income households looking to purchase a new home. (Hoek-Smit and Diamond, p. 34) The up-front subsidy would greatly ease the initial burden and if done correctly would not cost the state any more than if it were to offer a DSIS or a personal income tax deduction.

Similarly, the government needs to continue making structural reforms in order to increase the LTV ratio of a newly purchased home. One reform might be the creation of a centralized third party credit information system that extends beyond the proprietary information that each lending institution has about a customer. The more information a creditor

[3]In order to join the European Monetary Union (EMU) and adopt the euro, the country needs to meet the Maastricht criteria. This includes meeting conditions on the country's inflation rate, current account deficit, long term debt, exchange rate, and long term interest rates.

has about a loan applicant's history, the more confident the creditor will be when making a loan. Additionally, the state might consider guaranteeing loans. This would encourage banks to lend more. With the government guaranteeing loans, the market would become more liquid and make it easier for a bank to sell a foreclosed property in the event of default. This in turn means that the bank is taking on less risk and can lend more. This cycle benefits both the bank and borrower.

Regardless of which course Hungary chooses for the next several years, it needs to avoid regressive subsidy programs of the types it has put in place. By offering the upper-income class subsidized rates on their homes and large income tax deductions, the country is allocating a disproportionate amount of its revenues to relatively few home buyers.

Conclusion

Overall, the subsidy system in Hungary from 2000–2003 achieved a very modest degree of success. The number of new homes built each year increased beyond the Szechenyi Plan's target goal. However, the unchanged supply of rental units and a consistently low loan-to-value ratio has continued to make a home unaffordable for many. As the subsidy system expanded from late 2000 to the end of 2003, it included more members of society and became less targeted at new home buyers and the lower class. The government should institute more effective policies, such as a third party credit information system, and should provide up-front lump-sum subsidies. In any case, as Hungary moves closer to meeting the Maastricht criteria and adopting the euro, interest rates should fall and make many of the subsidies discussed in this article much less important to the housing market.

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