3 The Fiscal Policy Dimension

This chapter emphasizes the implicit fiscal dimension of housing polices. This perspective shows how a traditional public finance perspective on the rather modest levels of government spending in the sector is misleading. For understanding the government's role in the housing sector, it is less government's spending than implicit taxes and subsidies which are the major policy instruments. The chapter also presents evidence on how the sector has been affected by the way the world's more volatile financial environment has interacted with these implicit policies. Simple applications of a framework, which is developed more formally in Chapter 5, provide some insights into why policy-makers might undertake such approaches.

3.1 INTRODUCTION

In contrast to its importance as a source of capital formation and wealth, housing does not often figure heavily in the fiscal affairs of governments. As related in Chapter 1, the housing sector typically accounts for only about 2 percent of government expenditures. These expenditures also appear to be highly idiosyncratic. They are only weakly related to the rate or the level of economic development or urbanization. Against this background, it is easy to conclude that government policy in the sector is of low priority, and is as likely to be dictated by cultural proclivities or politics as it is by economic factors. This view is incorrect. It stems from too narrow a measurement of the role of the government in the sector.

To understand how the housing sector functions, and to evaluate policies in this sector, the 'off-budget' operations of governments are far more important than traditional 'on-budget' expenditures. In fact, as the case studies of subsequent chapters show, these unmeasured transfers sometimes augment and sometimes offset the explicit transfers.
in budget documents. The result is that budget documents provide little information on a government's policy stance.

Because the implicit subsidies and taxes imposed on this sector are often the by-products of the pursuit of other policies it is difficult to generalize about the details of the role of the sector in the economy in a cross-country comparison. As a result, our discussion of the causes of our empirical results is stylized. We want to emphasize the types and rationales for policy-induced distortions rather than argue that such policies were uniformly pursued.

3.2 THE HOUSING SECTOR AND THE ECONOMY SINCE THE MID-1970s

During the 1970s a series of economic shocks jolted the world economic system, leading by the latter half of the decade to an environment characterized by high inflation and high and volatile, nominal and real interest rates. These conditions added a significant new element of risk to saving and investment decisions. Perhaps as important, the new environment carried with it a new and largely unmeasured shift in the incentives generated by government policies. In the new environment, government financial and fiscal mechanisms, which in the past had permitted developing countries to accelerate the capital formation patterns, no longer produced the same results.

Financial institutions, in particular, have been dramatically affected by the changed environment. In many developing countries long-standing trends of increased financial deepening were first slowed and then reversed. For example, consider how the behavior of one frequently used measure of financial deepening, the ratio of $M2$ (broadly defined monetary holdings) to GDP, has changed in recent years. Comparing this ratio for a sample of developing countries over the 1965–73 period to the 1973–85 period, we find that in the first period, growth in this trend was common. Financial deepening progressed broadly; less than 6 percent of the countries experienced a reduction in the ratio. In contrast, over the 1973–85 period more than 50 percent of the countries experienced a reduction in this ratio. In many developing economies financial intermediation contracted, sometimes very sharply.