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HONDURAS
SHELTER AND URBAN DEVELOPMENT
SECTOR ASSESSMENT

EXECUTIVE REPORT

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ABOUT THIS REPORT

This executive report summarizes the principal findings and sector strategy recommendations of the Honduras Shelter and Urban Development Sector Assessment performed by The Urban Institute.

The study as a whole consists of four volumes: (1) the Executive Report, (2) the full Final Report, presenting the analysis underlying the study's conclusions, (3) Appendix I, Shelter Sector Studies, providing detailed supporting information on the linkage of shelter sector finance to the rest of Honduras' financial sector, and (4) Appendix II, Urban Development and Decentralization, which examines institutional capabilities and constraints in the urban subsector.

The Executive Report first summarizes the principal findings of the study. It then recommends a sector strategy for USAID and the Government of Honduras to pursue. The strategy identifies policy priorities, key implementation steps, and needs for further analytical studies.

I. PRINCIPAL FINDINGS

SHELTER SECTOR

1. Formal sector institutions have not provided or financed housing on remotely the scale that Honduras requires.

1a. To meet the needs of population growth, and to replace inadequate housing units, Honduras would have to build about 46,000 new units per year. The formal sector in fact has been building or financing about 7,000 units per year.

1b. The share of GDP that Honduras devotes to formal-sector residential construction is significantly lower than that of other countries in the region or of other countries in Honduras' income class.

1c. The Honduran formal-sector housing system produces housing only for the relatively affluent. The average formal-sector house built in Honduras costs substantially more than the average formal-sector house built in Costa Rica, and has 40 percent more floor space, despite the latter country's much higher income levels.

1d. Formal-sector housing production in Honduras has displayed extreme cyclical volatility. This has driven up average construction costs. Production swings follow the election cycle rather than the economic cycle, and have been most pronounced among public sector institutions.

1e. Formal-sector mortgage finance reaches only a small fraction of the Honduran population. In its 20-year lifetime, the entire savings and loan industry has financed 17,771 homes (compared to annual housing needs of 46,000 units).

2. Formal-sector, owner-occupied housing that meets minimum adequacy standards is too expensive for much of the Honduran market to afford, without subsidy.

2a. A house built in an urban area of permanent materials, of minimum standards, with access to drinking water, electricity, and human waste removal, is estimated to cost Lps. 8,300 (in 1986 lempiras).

2b. On average, the below-median income population can afford to pay only about 43 percent of this amount for housing, if financed at market rates of interest. The gap in ability to pay is greatest in rural areas.

2c. In order to provide housing to the mass market, Honduras therefore must look beyond the provision of finished formal-sector homes.

One affordable alternative is progressively improved informal-sector housing. Another alternative is rental housing, which already accommodates more than a third of the poor population of Tegucigalpa and San Pedro Sula.

2d. There are important constraints which drive up the costs of these alternative housing solutions. Land development laws establish unrealistically high standards for infrastructure installation prior to land sales for land that will hold informal-sector housing. Lack of capital financing for informal-sector rental construction has restricted the rental housing supply, causing higher rental prices. Rent ntrol laws may also have limited supply.

3. Informal-sector housing production has compensated for much of the formal sector's production shortfall.

3a. Total housing production in Honduras is now running at about 33,000 units per year, 80 percent of it built by the informal sector.

3b. The volume of housing production has outpaced population growth and household formation, allowing reductions in average occupancy levels. According to preliminary data from the 1988 Census of Housing, between 1974 and 1988 the average number of persons per dwelling unit in Tegucigalpa fell from 5.9 to 5.0 and in San Pedro Sula from 5.6 to 4.8.

3c. This production record makes it necessary to rethink the nature of the shelter problem in Honduras. All previous studies, based on formal-sector data, have emphasized the inadequacy of construction rates. In fact, total housing production approximates the level that the country requires.

3d. However, informal-sector housing requires continuous upgrading to reach adequacy standards, and it is here that the model has broken down. Informal housing is typically located on land claimed by invasion and lacks proper title. In the absence of title, owners cannot obtain financing for home improvements; are reluctant to invest in upgrading; and have difficulty securing access to public infrastructure services. Sites chosen for their ease of invasion frequently are very expensive to connect to public road, water, and sewer networks--thus exacerbating the costs of upgrading to local government or public agencies.

3e. Even when land titles are clear, financing for home improvements has been difficult to obtain. The only institutions financing loans for this market have been credit unions, PVOs, and housing cooperatives. The latter institutions are capitalized almost exclusively with foreign funds.

4. Honduras' housing finance system has contributed very little to domestic resource mobilization.

4a. In 1988, deposit growth in S&Ls accounted for less than 3 percent of all new deposits and contributions in financial-sector institutions. These are the only institutions that specialize in housing finance.

4b. Almost all capital invested in the housing sector (beyond the household's own savings) comes from one of four sources, ranked in order of importance:

- ✦ external savings, earmarked for housing finance institutions through international grants or loans.
- ✦ captive savings, generated by mandatory contributions to public pension plans or social security.
- ✦ government-guaranteed full faith and credit borrowing, channeled to housing through FOVI lines of credit.
- ✦ government tax resources, transferred to the sector as subsidies for INVA and other institutions.

In each case, the housing sector is tapping resources that could be invested elsewhere in the economy, rather than adding to the aggregate pool of investible funds.

4c. Three critical constraints have prevented the housing finance system from generating funds from new savings sources:

- ✦ There are no mechanisms for tapping informal-sector savings. In particular, Honduras makes virtually no use of mortgage-linked savings plans for small savers. These plans have been shown in other countries to raise total household savings, as well as the share of household wealth held in the form of financial assets.

- ✦ Savings and loan associations in Honduras do not effectively compete for funds with one another or with the commercial banking system, because of their market structure. There are only six privately owned associations. Five of these are owned by commercial banking interests, the sixth by a developer. S&Ls are more valuable to their owners as "niche" institutions with high spreads than as vigorous competitors for deposits and growth.

- ✦ Abundant foreign lines of credit have displaced domestic savings. Foreign savings have been provided through specialized lines of credit that typically offer much better terms than resources raised through deposits. FOVI lines of credit, for example, free the lending institutions from all interest-rate risk. Several of the foreign lines of credit established with INVA have provided financing through donations or at 2 percent interest rates. Credit has been so widely available that often the overriding preoccupation of foreign agencies has

been to find ways to generate program demand. The net effect of easy external credit has been to discourage competition for domestic deposits.

5. Honduras has been moving away from a market model of capital allocation in the mass housing sector.

5a. Public employee pension funds are by far the fastest growing source of domestic capital finance for the housing sector. However, 90 percent of their mortgage financing is now channeled to members at below-market rates, and used to buy housing in projects developed and built by the pension funds.

5b. The market model of capital allocation--in which institutions generate deposits at market rates of interest, then finance mortgages at market rates of return--has failed in the mass market. The reasons are:

- Repayment risk. Many of the institutions lending for mortgage and home improvement finance in the mass market have poor repayment histories. Although some institutions have much better records, the lack of uniform reporting with respect to delinquencies and the lack of external audits makes it impossible for potential suppliers of capital to assess true repayment risk. The government-imposed interest rate ceiling makes it impossible to compensate for risk by charging higher rates. Capital suppliers have reacted by avoiding mortgage finance.

- Term intermediation risk. Mortgages are the longest term debt instruments in Honduras. They are issued on a fixed-rate basis, and financed from short-term (maximum one-year) deposits. Therefore, except for government-provided lines of credit, all the risks of financial uncertainty fall on the lender, including risks of devaluation and inflation.

- Institutional preference to use savings on behalf of members. Mortgage subsidies to members have become an important element in pension fund politics. In the case of the teachers' pension fund, INPREMA, below-market mortgage lending (10 percent) has helped create a Lps. 300 million actuarial deficit in the pension fund. Pension fund directors appear to be gambling that the GOH will be financially able to make good on retirement benefits, despite the loss of income that results from subsidizing member mortgages.

In the case of the public employee pension fund, INJUPEMP, contributions appear to be high enough to fully fund retirement benefits, while subsidizing mortgage lending. The system then acts as a forced saving system, financing retirement and mortgage benefits for members.

In recent years the pension funds have lowered the average cost of the housing they have built. However, they have not proved to be very efficient builders. They continue to have large unsold housing projects, despite the availability of below-market mortgage financing.

URBAN DEVELOPMENT SECTOR

1. Honduras' public sector is highly centralized and represses local initiative.

1a. About 93% of public sector revenues are raised at the national level. Although local revenue raising is somewhat greater than in other Central American countries, local budgets are very small and prevent municipal governments from taking on broad service responsibilities. Outside of Tegucigalpa and San Pedro Sula, local governments raise an average of only Lps. 8.20 per year.

1b. Local governments do not have control of their own budgets. Only the first stage of budget preparation takes place at the local level. All budgets are then revised by the Ministerio de Gobernacion, typically without consultation with local officials, and must be approved both by the Ministerio de Gobernacion and the Department Council.

1c. Local tax rates, and most local fee schedules, are fixed by national law. Local governments do not have the ability to raise rates in order to provide better public services.

1d. Local elections are an automatic byproduct of national elections. This prevents local candidates from running for office on local platforms, and prevents the electorate from holding local officials responsible for their performance.

1e. Honduras has a very low level of intergovernmental assistance, relative to other countries in the region. In Honduras, central government transfers account for less than 20 percent of local government budgets; in Guatemala, as a result of decentralization financed by central government grants-in-aid, these now account for 85 percent of local budgets.

1f. Central government financial assistance is perversely designed to reward irresponsible financial management at the local level. Most national funding is provided on an Ad hoc basis to cover local salary shortfalls or to cover the most extreme local budget deficits, or is used to build local capital projects. This fiscal structure breeds dependence on local authorities , and discourages local revenue raising.

2. The key institutions involved in the local public sector face severe financial difficulties.

2a. Municipal government deficits, as a proportion of expenditures, are comparable to the central government deficit (about 12.5 percent of operating expenditures, and a much higher proportion of total spending).

2b. The municipal development bank, (BANMA), ended 1988 with Lps. 31.2 million in delinquent loan and guarantee accounts from municipalities. By normal accounting standards, it is probably insolvent.

2c. Overall, municipal governments collect less than 50 percent of the taxes and fees legally due them. Externally funded efforts to increase local revenue generation have been directed toward expensive cadastral programs, rather than at improving tax collection, which has a higher fiscal payoff.

3. With the exception of San Pedro Sula, local administrative capacity for service delivery, tax collection, and project implementation is extremely low. There are major systemic constraints to upgrading capacity through training.

3a. Municipal turnover rates are so high that most training now is wasted. Of the 172 municipal employees who received training in 1984 from BANMA, 85 percent no longer worked for local government in 1987. The most important factor in turnover is the indiscriminate replacement of workers when there is a change of local administration.

3b. Central government agencies now have virtually no training capacity. BANMA's training staff was slashed from 23 to 6 (two professionals) in the institution's 1988 staff reductions. The Ministerio de Gobernación has a very poor record of training.

3c. The central government has vetoed attempts to create local municipal associations to provide mutual self-help and training, on the grounds that these local efforts would conflict with centrally provided assistance.

4. The capital financing system for local government has broken down completely.

4a. BANMA is the institution charged with financing local capital investment. However, it is unable to gain access to domestic savings, and has been reduced to a vehicle for channeling external funds to municipal governments. Between 1980 and 1988, 89 percent of all BANMA capital loans were financed by external sources; the remaining capital was channeled to BANMA from pension funds and other sources at government command. Over the past four years, BANMA has been a negative net lender to local governments, receiving more in debt payments than it has lent out in new loans.

4b. The repayment record of municipalities to BANMA has been so poor that commercial banks and other private sector financial institutions strongly resist municipal lending. Special guarantees will be necessary to support private-market lending to local governments.

4c. Central government and external financing of local capital projects has discouraged local government investment from own resources and has contributed to the poor record of loan repayment. Centrally financed projects typically have been built without cost to local government or private beneficiaries. Local capital projects constructed under the Employment Generation program funded by USAID, for example, exceeded in value all capital lending to local governments over the same period. The donated projects have created an expectation of local entitlement to free capital investment.

4d. Like household demand for shelter, municipal demand for infrastructure investment is sharply constrained by low municipal revenues and low underlying household incomes. Honduras badly needs a policy that spells out, clearly and for the long term, which types of community investments can be financed at below-market interest rates or can have access to government subsidies, and which investments are expected to be financed from local resources at full market rates of interest. Until this is done, local governments will continue to devote most of their energies to trying to obtain central government and external subsidies for all their capital spending.

II. SECTOR STRATEGY DESIGN AND IMPLEMENTATION PRIORITIES

The performance record of the Shelter and Urban Development Sector has been sufficiently poor to suggest that both USAID and GOH need to refocus their sectoral strategies.

GENERAL ORIENTATION

Most of the housing built for USAID's target population--households with below-median incomes--is constructed by the informal sector. AID's first priority in shelter sector operations should be to understand the informal-sector production process, and use its technical assistance and capital funds to overcome the bottlenecks in this process. As a second priority, it should continue its efforts to move savings and loan mortgage financing down the income scale, while providing new incentives to the mobilization of domestic resources throughout the housing finance system.

With respect to urban development, USAID should assign top priority to assisting in practical decentralization, by strengthening the capacity of local governments to deliver services and manage their own budgets, and by giving them access to a workable capital financing system. It is tempting to exaggerate how much can be achieved by decentralization in Honduras, and how quickly changes can be accomplished. The example of San Pedro Sula, while encouraging in its demonstration of what local government can do, also is unique; no other municipal government has demonstrated similar competence, or a comparable desire to expand local responsibilities. Practical decentralization will be the work of a decade. It will require large amounts of technical assistance, as well as an overhaul in national-local fiscal relations. The potential payoff, however, is worth the investment. Only at the local level can taxpayer-voters participate in fiscal decision-making, by making choices about local taxes and local public service packages, while holding local officials accountable for performance.

Public sector decentralization and informal sector housing production come together at two key points of intersection: land development and infrastructure investment. These are the substantive areas where AID should concentrate much of its technical assistance and financing. The land development and public investment process now works badly. It produces sites for which the occupants lack legal title. If private landowners comply with the laws regarding infrastructure installation, the land they provide to the market is too costly for informal sector development. If invasions channel land development to other, cheaper sites, the eventual costs to the public sector of infrastructure provision often are prohibitive. The proposed municipal law would greatly strengthen local governments' ability to shape land development, by turning over to them ownership of common ejido lands, by creating new flexibility in tax policy, and by authorizing a broader range of development agreements with private sector entities.

Which Institutions to Work With?

Central-government institutions in Honduras have proved to be inefficient suppliers of housing, urban land, and public services. A new sectoral strategy should reduce their role in direct production, while strengthening the role of local governments, PVOs, and for-profit firms. AID should take the lead in this reorientation by designing its sectoral strategy around these latter organizations.

In the shelter sector, this means working much more closely with private organizations that have established ties to the informal sector: housing cooperatives, credit unions, and PVOs. In the urban development sector, it means working directly with municipal governments and municipal associations, as well as with private land developers. AID strategy should move away from using central government organizations as intermediaries in reaching local institutions. Both INVA and BANMA have received multiple waves of technical and capital assistance in the past, without successfully reorienting their activities.

Central government does have a critical role to play in establishing the policy and regulatory framework for a new sectoral strategy. At present, there is no common policy with respect to mortgage lending terms or subsidy eligibility, either for shelter solutions or infrastructure investments. There is no sectoral policy as to how capital funds should be raised, or how the shelter sector should fit into national financial policy. There is no regular monitoring of basic sectoral information--such as housing output levels, urban land prices, or infrastructure investment costs and financing. There is no allocation of roles to public sector agencies, with the result that a wasteful duplication of activities has sprung up.

A central policy-setting institution for the shelter sector needs to be created. This could be a new Ministry of Human Settlements or a joint public-private committee, under the Office of the Presidency, specifically charged with setting sector-wide policy, and unifying regulations. The specific institutional format matters far less than the political mandate to coordinate policy in support of a practical decentralization of responsibilities to local government and the private sector. It would be logical for USAID to work with the two candidates for the Presidency, before the elections, to define a sectoral institution which can embody this sectoral policy approach.

Technical Assistance, Institution Building, and Capital Assistance

The sectoral program outlined here will require intensive use of technical assistance and grant support to strengthen institutional functions.

The strategy's need for external loan funds is less clear. There is strong, unmet demand for capital financing in the shelter sector. However, in the past external capital has been injected into the system so as to displace domestic savings. The effective constraints on program design are the ability of local institutions to raise domestic resources pari passu with the injections of foreign capital.

In the urban development sector, the "demand" for capital funds is obscured by the lack of seriousness with which municipal debt obligations are taken. An estimate of just how much additional capital borrowing municipalities would choose to incur, if required to repay their debts on time, will require a separate study. However, there are manifest limits to such borrowing. A $50 million capital loan program, if used to finance short-to-intermediate term development loans averaging five-year maturities at 17 percent interest rates, would create annual debt service obligations of approximately Lps. 37 million, or about one-half of total local government spending for both operations and capital investment in 1986.

The capital loan program for urban development may well need to be scaled back from current projections. At the same time, AID should look for ways to open lending directly to private sector land developers without passing through the limited budgets of municipal governments.

PROGRAM PRIORITIES: SHELTER

This section recommends specific policy initiatives for USAID/H to pursue as part of its sector strategy. The policy recommendations are listed by strategic objective, and are listed in descending order of importance.

A. Facilitate the Provision of Housing by the Informal Sector

1. Improve the land development process, by

   ✦ Establishing capital funds to allow households to purchase full title to their parcels of illegally invaded land. Such programs should be implemented through FEHCOVIL and other private-sector community organizations, as intermediaries who can hold the land in community ownership until households fully pay for their parcels. Title resolution should be coupled with community upgrading programs, which will also require capital financing.

   ✦ Helping municipalities plan and manage the land development process, by identifying the costs of infrastructure supply in different zones, managing the release of ejido land to the development market, and entering into planned development agreements with private developers.

   ✦ Reforming national legislation regarding infrastructure installation standards for privately developed land.

2. Increase the role of nonconventional financing institutions in lending for informal-sector housing investment and home improvement, by

   ✦ Qualifying additional PVOs for FOVI lines of credit for mortgage and home improvement financing.

✦ Helping qualified institutions gain access to FOVI lines of credit in practice; assisting in structuring of loan arrangements and cost recovery design.

✦ Increasing the total supply of lending for home improvement. This policy will require using FEHCOVIL, credit unions, and other nonconventional financing institutions as intermediaries. It will also require re-examination of titling and security requirements for loan eligibility.

3. Provide support for the low-income rental market, by

✦ Developing capital programs that provide financing for investment in rental housing, especially within the informal sector.

✦ Examining the impact on rental housing supply and rental housing costs of rent control laws and other public restrictions.

4. Establish incentives for the S&Ls and commercial banks to finance lower income housing development, by

✦ Developing programs wherein formal-sector finance institutions lend to private developers for land development for the mass market.

✦ Encouraging S&Ls to create and fund programs for financing home improvement loans.

B. Make the Housing Finance System Contribute More Effectively to Domestic Resource Mobilization

1. Increase deposit mobilization by the S&Ls and commercial banks, by

✦ Requiring that they match FOVI lines of credit with resources raised from their own deposits, as a condition for participation in AID-financed programs.

✦ Introducing mortgage-linked savings plans, wherein savers become eligible for mortgages upon reaching threshold levels of savings. One variant of such a plan would be for individual savers; a second variant would involve payroll withholding for employees of large firms.

✦ Studying the industry structure of the banking sector, with recommendations as to how to increase deposit competition within the industry.

2. Increase savings mobilization by nonconventional financing institutions (NCFIs), by

✦ Setting up mortgage-linked savings plans in credit unions and other institutions that directly access informal-sector households.

✦ Setting targets for savings mobilization among NCFIs to qualify to participate in AID-sponsored credit programs for informal-sector mortgage and home improvement financing.

✦ Setting maximum repayment delinquency limits for NCFI participation in AID credit programs, in order to generate financial reflows from household savings.

C. Improve Institutional Intermediation in the Housing Finance Sector

1. Reverse the movement by public employee pension funds to internalize all housing investment, by

✦ Requiring pension funds to move toward market rates of mortgage lending, as long as they face actuarial deficits in the pension system.

✦ Encouraging pension funds to withdraw from the direct production of housing, by making a larger proportion of mortgage loans available to members who will buy, build, or improve homes on their own as part of independent development projects.

2. Address other constraints on sectoral capital flows, by

✦ Examining the feasibility of introducing adjustable rate mortgages into the Honduras financing system, in order to give lenders partial protection against inflation.

✦ Documenting through independent audits the repayment records of all institutional lenders in the housing sector. The range of repayment risk and the reasons for large differentials should be analyzed, including the differences in applicable mortgage foreclosure laws.

POLICY PRIORITIES: URBAN DEVELOPMENT

A. Secure Legal Authority for Local Governments to Exercise Greater Local Fiscal Choice

The critical elements for local choice, now denied to local governments, are:

1. Separate local elections
2. Local responsibility for preparing and approving local budgets
3. Local authority to adjust tax and fee levels

4. Municipal ownership of ejido lands
5. Local authority to form local municipal associations and enter into agreements with private entities for service delivery and land development.
6. Access to well-functioning and clear systems of intergovernmental finance and capital lending.

These six essential elements should be guaranteed to local government through a new municipal law.

B. Improve the Municipal Role in Land Development and Infrastructure Investment

1. Strengthen municipal capacity to plan and implement efficient land development, by

   ✦ Establishing in the larger municipalities the planning and analytical capacity to identify the net costs to the public sector of providing infrastructure support for development in different locations having development potential.

   ✦ Identifying and analyzing the tax, fee, and regulatory strategies that local governments can use to steer development to where it can take place most efficiently, including infill development in zones where infrastructure networks already exist.

   ✦ Assisting in planning the utilization of ejido lands, once they are transferred to municipal governments.

   ✦ Identifying and implementing joint land development ventures between municipal government and private developers.

2. Strengthen municipal and patronato capacity to plan and implement infrastructure projects, by

   ✦ Building on the experience of the RHUDO's secondary city infrastructure project to equip selected municipalities with project design and implementation teams.

   ✦ Assisting in investment planning and price setting for local governments that want to assume local control of their water systems.

   ✦ Monitoring cost recovery experience on investment projects, and suggesting reforms in community decision-making or betterment tax implementation where cost recovery is weak.

C. Improve the System of Capital Finance for Municipal Governments

1. Redefine the role of BANMA, by

✦ Performing a financial audit and writing off BANMA's uncollectible loans. The audit should establish BANMA's true financial position.

✦ Conveying voting control of the Bank to local governments, as BANMA's shareholders.

✦ Tightly restricting BANMA's future role to that of a development bank. BANMA should finance only capital projects that contain an explicit subsidy component, provided either by international donors or the GOH, consistent with clearly defined development objectives. Its technical assistance should be limited exclusively to that needed for project implementation and cost recovery on the projects it finances. BANMA's commercial lending operations should be terminated. A much smaller staff can serve these purposes.

2. Establish a system of commercial lending to municipal governments by the private sector, by

✦ Using HG funds to establish lines of credit for municipal lending.

✦ Setting up a guarantee fund to help defray the repayment risks of municipal lending by commercial banks and S&Ls.

✦ Allowing local governments to pledge part of future, central government revenue sharing payments as security for commercial loans, with payments made directly to the lenders in case of local repayment delay.

D. Define the Role of Intergovernmental Assistance in Decentralization

In the short run, it is impossible to achieve significant decentralization without cost to the national government. Unless the decentralization program gives local governments at least moderately greater revenues, as well as greater latitude in spending, it will fail to persuade local authorities to take on greater service and investment responsibilities.

Over the intermediate term, the goal of fiscally neutral decentralization is more feasible. It depends upon the ability to identify service functions that realistically can be transferred to local government, as well as central government's ability to make staff reductions in central agencies once a transfer has taken place.

USAID and GOH must choose between a zero-cost decentralization program with extremely modest goals, and a program that assigns higher priority to decentralization but acknowledges its costs. An additional Lps. 20 million per year (roughly 2 percent of national

revenues), if used for intergovernmental assistance according to a formula which stimulated local revenue generation, could contribute importantly to strengthening the role of local government. This contrasts with the policy now in effect in Guatemala, which allocates an additional 8 percent of national revenues for local capital projects. Consideration should be given by USAID to the approach used in Guatemala, where external funds from AID, the World Bank, and other international donors have been earmarked directly for the Municipal Development Fund, contingent upon the realization of decentralization objectives.

IMPLEMENTATION STRATEGY

The previous section has outlined an ambitious set of policy changes. Not all of these can be implemented at once, and it would be self-defeating to attempt change on every front simultaneously.

In designing an implementation strategy, USAID should focus on priority steps. These fall into two categories: actions that need to be taken at once, either because their programmatic content is a logical prerequisite for further work or because they present opportunities unlikely to be repeated in the future; and analytical studies that need to be launched now, so that their findings can shape later program design.

Priority Actions

Passage of the Municipal Law. The proposed municipal law enlarges the authority and fiscal base of local government. Its passage is a prerequisite for the sector strategy outlined here. The critical elements of a new law were identified earlier; all other aspects of the legislation should be considered negotiable.

If the municipal law is not approved, an alternative sector program can be defined around urban land development, using existing local authority. However, a broader decentralization program would not be practicable.

Housing Finance Steps that Continue Present Policy Directions. USAID already has scope for implementing some of the policy changes recommended here under the capital programs it now has in place. Such measures include:

- Expanding FOVI operations to include more nonconventional finance institutions as on-lenders to the informal sector.

- Requiring savings and loan associations and commercial banks that use FOVI lines of credit to match external resources with their own resources.

- Introducing mortgage-linked small saver plans and mortgage-linked payroll deduction plans at S&Ls, commercial banks, and NCFIs.

Establishment of National Policy Agency. The Shelter and Urban Development sector badly needs policy direction from an organization authorized to shape the roles of other sectoral institutions. Negotiations on institutional reorganization should begin at once with the two candidates for the Presidency.

Land Acquisition and Titling Program for the Informal Sector. This program should move quickly to the design stage. FEHCOVIL and other PVOs are the logical organizations to manage it. Negotiations should begin with them on how to structure and finance the program. Such discussions should include CHF, because of its experience with the institutions involved, and INVA, because it may be operating a parallel program using government resources.

BANMA. A thorough audit of BANMA's financial position should be conducted as soon as possible. Negotiations for turning over voting control to the municipal shareholders should begin.

Analytical Studies

Given the magnitude of AID's historical involvement in Honduras' shelter sector, it is surprising how small an analytical base for policy intervention exists. AID in the past has jumped from broad sectoral overviews to specific project design. What is missing is an analytical understanding of how the markets in land development, shelter provision, and public investment function. This gap needs to be filled before further projects are proposed. RHUDO should give greater importance in staff assignments to preparation and monitoring of a year-long agenda for analytical studies.

Among the priority studies are:

1. Analysis of the Process of Informal Housing Production. This study should establish an empirical base at the household level for understanding informal sector shelter production and the principal constraints on its operation. Through household surveys it would determine: costs of house construction in the informal sector; patterns of home improvement over time and the factors affecting upgrade investment; sources of savings and credit used in investment, and their costs; household satisfaction with progressive housing.

2. Rental Markets in the Informal Sector. Almost nothing is known about low-income rental markets in Honduras. A study should establish who owns and invests in rental housing for this market, the sources and costs of financing, the physical characteristics of rental housing and its cost to occupants relative to owner-occupied housing, tenant satisfaction, and the effects of rent controls and other restrictions on rental production and costs.

3. Informal-Sector Savings Behavior. One important opportunity to increase domestic resource mobilization lies in tapping informal sector savings. A study is needed of how much informal households now save, in what form they hold their savings, the purposes for which they save, and the potential effectiveness of different mortgage-linked savings plans in augmenting savings or channeling it into the national finance system.

4. Competitive Structure of the Savings and Loan Industry. The S&L system has done a poor to mediocre job in generating deposits. There is a presumption that this record reflects the lack of competition in the industry. However, closer study is needed of how the overlap of S&L and commercial bank ownership affects competition for deposits and loan margins, as well as how greatly the pattern of development lending is distorted by developer ownership of financial institutions.

5. Default Risk in Mortgage Lending. Well-functioning capital markets require accurate information on repayment risk, as does intelligent design of a program of policy intervention. There is no such information in Honduras. The GOH should require standardized audits to identify the mortgage default experience in all sector lending institutions. AID then should commission a study to determine the extent of institutional variation in defaults and the reasons for these differences, and recommend steps to reduce repayment risk.

6. Analysis of the Additional Borrowing Capacity of Local Governments. Taking into account household ability to pay, local revenue sources and and their growth rates, and outstanding levels of indebtedness, how much capacity exists for further municipal borrowing, at different interest costs? A city-by-city analysis of this question is a logical prerequisite to determining the level of loan program appropriate for the urban development sector.

7. Design of an Urban Development Loan Program. Analysis should be coupled with negotiations with municipal officials and private developers to determine how a loan program can best operate in the municipal development sector. Among the key questions to be addressed: What type of security will private-sector lenders demand before lending to municipal governments? Can this security be provided? Can a program be designed that lends funds directly to private developers of low-income land parcels, subject to public control over the land to be developed?

8. Analysis of Infrastructure Cost Differentials. The municipal stake in steering land development to particular locations is the reduction in infrastructure costs that it makes possible. Two or three model studies should be performed jointly with local governments to identify the cost differentials associated with alternative land development choices. Besides obtaining information for specific localities, the studies should aim to produce a simple manual that can guide this type of calculation in other municipalities, and be used in technical assistance efforts.

9. Preparation of an Urban Development Technical Assistance Strategy. A general technical assistance strategy for working with local government will be required. A preliminary assessment can be made at this point; elaboration of the strategy should await clarification of the status of the new municipal law.

10. Potential for Service Decentralization. Significant decentralization will require transfer of some service responsibilities from central to local government. A study should be commissioned to identify local capacity, offer training, to assume greater responsibility for service delivery in the areas of health care, education, and drinking water supply. The study

would include analysis of current local government roles in service provision, and current use of the local budget funds earmarked for education by national law. It would recommend a strategy for gradual service transfers.

11. Analysis of the Effect of the Infrastructure Standards Law on Shelter Costs and Land Market Operations. This study would examine the cost impacts of existing law that requires private landowners to install complete infrastructure services before selling land parcels for development. It would also examine the impact of the law on the pattern of urban development and its role, if any, in stimulating land invasions.