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# HONDURAS
# SHELTER AND URBAN DEVELOPMENT
# SECTOR ASSESSMENT

Prepared for USAID/Honduras
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George Peterson, Team Leader
Donald Gardner, Housing Finance
Timothy Smith, Housing Finance
Duke Banks, III, Urban Development
David Jickling, Urban Development
Jeffrey Telgarsky, Urban Development

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# CHAPTER ONE

# INTRODUCTION AND ECONOMIC CONTEXT

## PURPOSE AND FOCUS OF STUDY

This report provides an assessment of the shelter and urban development sector in Honduras. It has been prepared to help orient USAID's policies and programs.

"Shelter and Urban Development" are not presently conceived within Honduras as forming a single sector. There is no sectoral aggregation of this kind in any of the Government's economic reporting, or in its development planning. There are no implementing institutions which regularly deal with both shelter issues and urban development issues, with the exception of a few municipal governments, which do so through different departments within the municipal structure. The financial institutions that provide credit for the two activities are separate, and subject to different types of regulation.

The question then arises whether it is more useful to view Shelter and Urban Development as a single sector or as two different sectors. There are, of course, important points of intersection between the two activities. The physical development of urban areas is largely dictated by the demand for housing and the derived demand for urban land. The functioning of the urban land market simultaneously determines where urban development will take place and, to considerable degree, how much housing will cost. It helps shape the costs of public service delivery.

Household connections to the infrastructure network are another point of intersection. As indicated in Appendix 1.1, about half of all deficient housing in Honduras exists, not because of inadequacies in the physical structure of the housing unit, but because of lack of one of the key public services: drinking water, wastewater removal, or electricity. The installation and financing of these infrastructure connections is quintessentially an urban development activity, but also a critical element of housing policy.

In this paper, we have taken the position that Shelter and Urban Development are best viewed as two complementary but separate sectors. They are more closely related than most sectors, and therefore there are benefits to developing policies and managing programs for them in a coordinated fashion. But, as laid out in this report, the goals for the two sectors are quite different, as are the implementing institutions and implementing strategies. More is to be lost than gained by trying to compress these differences into a single sectoral framework.

We therefore have analyzed the shelter sector and urban development sector separately. The Executive Summary considers what the two sectors (or sub-sectors) have in common, and how AID management policy can best capitalize on their complementarity.

## NATIONAL ECONOMIC BACKGROUND AND CONSTRAINTS

Both shelter and urban development policies must fit within a national development strategy, and are constrained by the same national fiscal and economic realities. This section briefly reviews the national-level economic picture in Honduras, giving emphasis to those characteristics that have direct impact on housing or urban development.

### Low Household Income and Slow Economic Growth

Honduras is a poor country that has suffered slow economic growth during the 1980s. During the 1970s, Honduras was able to make significant economic progress, averaging 4.8 percent annual gains in GDP over the decade. This growth was founded on the recovery and expansion of traditional agricultural exports and an increase in manufacturing output under a protectionist tariff regime. The 1980s, however, have witnessed economic stagnation, produced by deteriorating terms of trade, exhaustion of the easy import substitution possibilities in Honduras' small domestic market, reductions in net capital inflows during the latter half of the decade, and the political uncertainty of the region. GDP growth during 1980-87 averaged 1.7 percent. Combined with population growth, the IMF estimates that per capita income declined from US$667 in 1980 to US$565 in 1987 (in 1980 dollars). This leaves Honduras as the third poorest nation in the Western hemisphere, after Haiti and Bolivia.

According to official figures, real per capita incomes revived modestly in 1988 (rising by 0.8 percent). However, if 1988 output data are adjusted for inflation at the higher level suggested by USAID's analyses, there was a further decline in real per capita income.

The constraints imposed by low household incomes are often under-estimated in discussions of shelter and urban development policies. For example, the analysis of Housing Needs and financing capability performed by The Urban Institute (Appendix I.1) concludes that if the minimum housing needs of below-median income families were to be met in full, through owner-occupied housing, while restricting household spending to ability to pay, some 57 percent of housing costs for this target group would have to be met from public subsidies.[1] Expressed in other words, income levels in Honduras are so low that, even if housing institutions were capable of delivering shelter in packages that incorporate minimum building standards and even if shelter finance at 14 percent interest rates were available to all borrowers, more than half the present housing deficit would remain, especially in rural areas.

In an environment of low household incomes, and consequently low economic demand for housing and public services, there are clear limits to what can be accomplished by policies designed to encourage market-based mortgage financing of individually owned homes, or by fiscal systems that rely on the population's voluntary taxation of itself to finance public services. This reality does not imply that deep subsidies are a necessary component of public policies in the sector. It does, however, imply that sector programs and cost recovery goals must be designed to take into account the limitations of household ability and willingness to pay.

## Savings and Public Finance

Contributing to the slowdown in Honduras' economic growth has been a decline in capital investment and the savings rate. Gross fixed capital formation fell from 24.6 percent of GDP in 1980 to 14.8 percent in 1987. Private sector investment has fallen even more precipitously (see Table 1.1).

Historically, Honduras has had a low level of domestic savings and has depended on foreign savings to finance much of its investment. This dependence reached new heights in 1980-85, when well over half of all domestic investment was financed by overseas savings, most of it channeled to Honduras in the form of official transfers rather than commercial loans. Foreign capital was used above all to fill the public sector deficit. The fiscal deficit averaged 10.3 percent of GDP during 1980-85; 69 percent of this was financed by foreign savings.

Table 1.1

**Savings and Investment 1970-87**
(percent of GDP)

| Item | 1970 | 1975 | 1980 | 1985 | 1987 |
|---|---|---|---|---|---|
| Savings | | | | | |
| Domestic | 12.5 | 7.9 | 12.7 | 7.6 | -- |
| Private | -- | -- | (9.7) | (5.8) | -- |
| Public | -- | -- | (3.0 | (1.7) | -- |
| Foreign | 8.4 | 10.0 | 13.3 | 9.7 | -- |
| Total Savings | 20.9 | 17.9 | 26.0 | 17.3 | 15.8 |
| Investment | | | | | |
| Fixed | 18.5 | 21.2 | 24.5 | 17.5 | 14.8 |
| Private | (12.0) | (14.0) | (15.2) | (7.4) | (7.8) |
| Public | (6.5) | (7.2) | (9.3) | (10.1) | (7.0) |
| Changes in Stocks | 2.4 | -3.3 | 1.4 | -0.2 | 1.0 |
| Domestic Investment | 20.9 | 17.9 | 25.9 | 17.3 | 15.8 |

Since 1986, the situation has changed. Official capital flows have slowed considerably, and international donors have assigned priority to reducing the fiscal deficit. The GOH was able to reduce the nonfinancial public deficit to 6.3 percent of GDP in 1987 and, according to preliminary figures, somewhat less in 1988. (Most of the spending cuts, however, have come from the capital budget.) At the same time, the government has had to turn to the local financial sector to fund a greater share of its still large deficit. This has had two effects. First, monetary policy, which had been tightened during 1984-86, became more expansionary. M2 increased 21.9 percent during 1987, before tight monetary policy was reinstated in the second half of 1988.

Second, the GOH has used various strategies, including a sharp increase in the reserve requirements on bank deposits, to capture funds in the banking system so that they can be used to finance the public deficit at less than market cost. Although there is disagreement as to how much of a constraint this has created so far for private investment--there also is a weak supply of economically viable private investment projects and thus weak demand for private sector borrowing[2]--it is clear that over the intermediate and longer term, the low level of funds available for domestic investment, because of weak domestic savings and crowding out by public sector deficits, is an important restriction on Honduras' growth potential.

These macroeconomic conditions establish the context for any sectoral programs in the areas of shelter and urban development. Housing must compete with other sectors that are potentially constrained in access to domestic credit. To perform its role the shelter finance system should be able to contribute to domestic resource mobilization as well as steer capital into housing investment. The public sector deficit must continue to shrink if more noninflationary capital financing is to be made available to the private sector as a whole. This implies that both shelter policies and policies for strengthening local government need to be designed without creating further long-term net demands on central-government subsidies.

## Foreign Exchange Constraint: Its Impact on Financial Markets

Another principal constraint on economic growth is the limited availability of hard-currency foreign exchange. Merchandise exports have slumped during the 1980s, following a decade of vigorous growth. Weaknesses in the prices and outputs of the main export crops and failure to increase nontraditional exports (linked to the increasing overvaluation of the lempira) have been the main factors behind the slump. Only since 1986 have exports recovered to their 1980 levels. Preliminary figures indicate that 1988 was another year of very low export growth.[3]

Import growth has closely tracked the performance of exports, with Honduras typically running a small trade deficit. Since 1980, when the free convertibility of the lempira was suspended, the GOH has had to ration foreign exchange and impose import controls. While these controls have kept the trade deficit small, they have hampered the ability of local producers to obtain the imported inputs and investment goods necessary to improve their competitive position.

Honduras' current account shows a substantial deficit due to the deficit on invisibles (primarily shipping costs and interest payments on foreign debt). Thus, the country has had to rely on external capital flows to balance its international accounts. Net capital inflows increased rapidly during the first half of the 1980s (reaching US$277 million in 1984), but have since fallen to only US$33 million in 1987. This situation has caused the country's foreign exchange reserves to be run down (to only US$53 million in July 1988).

With increasing debt service obligations coming due to commercial banks and official lenders and foreign exchange earnings stagnant, Honduras has found it more and more difficult to remain current in debt repayments. Arrears in both principal and interest built up during 1987 (US$132 million) and 1988. Negotiations currently are underway to clear these so lending from official sources can resume.

The above developments have increased pressure on the lempira. In parallel markets the lempira has fallen to around Lps. 3.3 to the dollar from the official rate of Lps. 2.0 to the dollar. There is widespread expectation that the lempira will be devalued, either formally or through expansion of the CETRA system that allows exporters in certain sectors to sell a portion of their foreign exchange to importers at market rates above the official exchange rate.

The risk of devaluation has important consequences for the shelter and urban development sectors, as for the rest of the Honduran economy. Wealth holders have been unwilling to place their savings in lempira-denominated financial assets. One result is capital flight. The World Bank estimates that over the period 1980-84 more than US$330 million left the country in capital flight, the equivalent of 40 percent of the increase in external debt during the period.[4] Those investors that do purchase lempira-denominated financial assets have insisted on shortening the maturities of debt instruments, in an attempt to reduce their risk exposure. For the housing finance sector, which relies on long-term mortgage financing, the reduction in domestic financial savings and the unwillingness of private wealth holders to provide funds for long periods has placed special pressure on traditional credit arrangements.

A further effect has been created by investors seeking to shift holdings from financial assets to real assets, like housing and urban land, in the expectation of a surge in inflation. This activity lies behind the recent run-up in housing and land prices. Experience from other, high-inflation countries indicates that the flight to urban real estate will accelerate swiftly if there is a further upturn in inflation or an imminent threat of devaluation. The price escalation that occurs once urban land and housing are viewed largely as portfolio alternatives to financial assets pushes shelter solutions out of reach for large portions of the income distribution.

## Inflation and the Relative Costs of Housing

The rapid growth of the money supply in 1987, as well as the de facto partial devaluation of the lempira, have already produced an inflationary response. Official data place the 1988 inflation rate at 4.5 percent and project 5.0 percent inflation for 1989. However, estimates from the Economic Office of USAID/Honduras place 1988 inflation in the range of 10-15 percent, with similar expectations for this year.[5] At these rates, the government-imposed interest rate ceiling of 17 percent makes many forms of risk-bearing loans, including long-term housing mortgages, relatively unattractive. There is considerable importance to clarifying actual inflation rates in Honduras. At the official inflation rate, mortgage loans and urban development loans, even when subsidized, carry positive real interest rates, as high as 12 percent, and have done so for a number of years. At the inflation rates now estimated by

USAID/Honduras, typical loans in both sectors carry zero or negative real interest rates, placing a much different light on attempts to generate domestic savings for sectoral lending.

The combination of general inflation, special price pressure on land and housing costs, and sluggish income growth has led to a severe deterioration in households' ability to pay for housing. This is shown in Table 1.2. Real housing costs have risen at a time when real per capita income and real wages have fallen, making housing much less affordable to broad bands of the population. (Note, however, that official underestimation of the Consumer Price Index may exaggerate how rapidly housing costs have risen relative to the CPI.)

Table 1.2

**Housing Costs vs. Household Income**
(Index Numbers)

| Year | SECPLAN Housing Cost Index (Housing/CPI) | IDB Real Wages | Housing Costs/Wages | IMF Per Capita Real GDP | Housing Costs/Per Capita GDP |
|---|---|---|---|---|---|
| 1981 | n/a | 100.0 | n/a | 100.0 | n/a |
| 1982 | 100.0 | 115.2 | 100.0 | 94.7 | 100.0 |
| 1983 | 104.7 | 104.7 | 115.2 | 91.3 | 108.6 |
| 1984 | 111.3 | 95.8 | 133.8 | 90.8 | 116.1 |
| 1985 | 116.6 | 91.3 | 147.1 | 90.6 | 121.9 |
| 1986 | 119.7 | 87.0 | 158.5 | 90.2 | 125.7 |
| 1987 | 121.1[a] | 83.2 | 167.7 | 91.1 | 125.9 |

[a]Constructed by authors from BCH data.
Sources: SECPLAN, Sobre la Movilización de Recursos Financieros para la Vivienda de Interes Social (1987), Inter-American Development Bank, IMF, Central Bank of Honduras.

## Role of the Housing and Urban Development Sectors in National Development Strategy

Neither the housing nor urban development sector has been assigned a clear role in national development planning, largely because no tightly focused development strategy has been articulated by the GOH.

In other countries, the housing sector often has been asked to play a specific development role. For example, Turkey has deliberately used high inflation to cut into workers' real earnings, in order to establish cost competitiveness for the country's exports. Between 1980 and 1985/86, Turkey, though it had rapidly growing real per capita income (2.4 percent per year), experienced the steepest reduction in real earnings per employee (-3.5 percent per year) of any country in its income class. Studies confirm that the reduction in real wage levels has been a key component in the country's spectacular export growth. However, this policy placed serious strains on household budgets. As a consequence, Turkey in 1984 launched a Mass Housing Fund, financed from dedicated tax revenues, that greatly stimulated housing production at subsidized costs. The strategy had the effect of relieving some of workers' real income losses, without increasing the cost of export goods production, as would have been true of wage increases.[6]

A similar role for the housing sector in Honduras probably is inappropriate. Its success depends on the underlying cost competitiveness of the country's manufacturing exports; in Honduras, falling real wages have done little to contribute to export growth, because of other constraints. Rather, Turkey's experience illustrates the way in which housing policy can be made to serve development policy, once the latter has been well defined. In Honduran development planning, shelter is viewed merely as a consumption good which is of interest to the public sector only on equity grounds. The sole economic goal established for the housing sector has been the short-term one of generating construction employment.

The national development plan produced by SECPLAN also defines a redistributive role for investment in the urban sector.[7] The plan calls attention to the marked regional differences in income levels and job growth (See Appendix II.1 for discussion.). It states that it is a national development objective to narrow these regional differences by focusing public investment on laggard regions and smaller towns. It offers the hope that such investment will deter migration to the two metropolitan areas of Tegucigalpa and San Pedro Sula.

In practice, these investment principles have been ignored. Honduras is too poor a country to be able to turn down high-yielding investment opportunities in the name of regional equalization; and in other countries, the strategy of trying to slow migration to big cities by public investment in secondary towns has proved to be an expensive illusion.[8] The practical investment planning that is underway in SECPLAN and elsewhere gives priority to road investments to open the Aguan Valley and Olancho regions and other land-rich areas in the East of the country; to introduce irrigation to areas with agricultural potential in the South, where nontraditional exports such as melons and shrimp are also experiencing rapid growth; to improve international transport access to the central region by building a new airport; and to provide infrastructure support for manufacturing in the North, particularly around areas that can establish effective free zones for exports.

Under almost all growth scenarios, Choluteca will emerge as a more important marketing center in the South; the industrial corridor around San Pedro Sula will experience comparatively rapid manufacturing and population growth; and Juticalpa, Olancho and other towns in the East will be called upon to support the agricultural development of that region. This anticipated pattern of development may give broad guidelines for selecting priority urban areas for infrastructure investment.

Two factors, however, severely constrain the opportunities for investment in local economic development. There is a large amount of excess capacity in the industrial sector, resulting from over-investment in the 1970s and early 1980s that was induced by expensive public subsidies. Although there are no reliable quantitative studies of capacity utilization in Honduras, it has been judged that the low capacity utilization rate of existing capital is the primary deterrent to new investment in manufacturing.[9] This implies that there is likely to be a low payoff to local development strategies that try to encourage investment in private capital plant.

At the same time, Honduras' pattern of agricultural output creates relatively few opportunities for urban investment. Honduras has an extremely low rate of domestic elaboration of agricultural product. In the central region, for example, 80 percent of farm production is consumed by those living on the farms. Most of the agricultural production not consumed by producers is either exported abroad as raw product or shipped to urban areas, also as raw product. This pattern of usage leaves little room for investment in agro-industry.

## Summary

The constraints limiting Honduras' economic development are severe and well-known. However, with few exceptions, USAID programs in the shelter sector have not addressed them. The goal of these programs has been to produce significant amounts of housing, despite the constraints, by injecting foreign capital into the sector. The programs have had some success as production stimulants, but they have not led to a self-sustaining system that can gather domestic capital, channel it into housing, or promote domestic savings in support of national economic growth. If anything, foreign capital has tended to displace domestic savings.

Investment in Honduras is not constrained only, or even primarily, by the low availability of domestic funds for private investment. There is also a shortage of viable investment opportunities. This reality must help define the content of "urban development" programs. Unlike many other countries, Honduras does not face an identifiable backlog of private investment projects that could be unleashed by elimination of local government red tape or by modest local government investment in infrastructure to support it. There is potential for vast wastefulness in organizing government decentralization around the hope that local governments can stimulate local economic development. At this stage of their growth, Honduras' local governments can contribute most to national economic efficiency by providing cost-effective local public services and helping to rationalize local land markets, rather than by trying to promote local private manufacturing or export investment.

**Footnotes, Chapter 1**

1. This represents the difference between the cost of minimum housing, financed through 14 percent mortgages, and the amount of household income presumed to be available for housing expenditures. Based on the pattern of consumption expenditures found in household surveys in Honduras, the lowest income quintile was assumed to be able to spend 15 percent of household income on housing in urban areas, the second quintile 20 percent, and the third quintile 25 percent. Rural households in each quintile were assumed to be able to spend a 5 percent greater share of income on housing (see Appendix I.1 and PADCO, "Diagnóstico y Pronóstico de Necesidades de Vivienda en Honduras; 1985-2005" (Washington, D.C.: 1986) and The Urban Institute, "Developing a Housing Finance Strategy for Honduras" (Washington, D.C.: 1986).

2. See Richard Webb, Roberto Abusada, Julio Velarde, Credit Policy in Honduras in the Context of Macroeconomic Constraints (Report to USAID/Honduras, May 1988) for a discussion of demand constraints and financing constraints on investment.

3. The IMF's preliminary data for 1988 imply a 3.6 percent growth in exports; USAID figures imply growth of less than one percent. Both estimates are nominal figures, unadjusted for price changes.

4. World Bank, Honduras Country Economic Memorandum (April 1987).

5. Personal conversation with economic officers, USAID/Honduras. In part, the higher estimate of inflation is based on a study of the price behavior of the unregulated elements of the consumer price index.

6. The Urban Institute, "Cushioning Adjustment Costs in Turkey: The Use of Debt or Subsidies to Finance Housing" (March 1989).

7. CONSUPLANE, Estrategia Nacional de Desarrollo, 1986-89 (1986).

8. For example, Andrew Hamer, "Urbanization Patterns in the Third World: How to Create a Basis for Efficient Growth," Finance and Development (March 1982), and Suselo Hendropranoto, "Experiences in Providing Urban Services in Secondary Cities in Indonesia," paper presented to the 1984 African Conference on the Problems of Urbanization in Africa, Dakar.

9. SECPLAN, Sintesis Diagnostico Socio-Economico de la Region Central (Marzo 1988).

# CHAPTER TWO

# SHELTER SECTOR GOALS AND SECTORAL PERFORMANCE

## SECTORAL GOALS

The principal goal of shelter sector policy in Honduras must be a structural one: to develop a shelter provision and finance system that can meet the minimal housing needs of the population at different income levels from domestic resources.

The system's functioning should be relatively stable over the economic cycle and in the face of the economic changes likely to occur during the next decade. It should support economic development objectives outside the shelter sector, particularly by avoiding distortions in the sectoral flows of capital and by encouraging domestic savings.

In addition to these general goals, the Government of Honduras, in a statement of shelter sector policy endorsed by the Cabinet of Ministers, has embraced the further principle that:

> Housing production and housing finance should be provided primarily by the private sector. Government should play a facilitating, not a direct, role in shelter provision, by ensuring that the private housing finance system can function effectively, and by ensuring that adequate land and infrastructure services are available to support shelter development.[1]

This policy guideline has been supported by USAID/Honduras, as well. It reflects recognition that housing built or financed directly by government can satisfy only a small part of the population in need of housing services.

Side by side with structural goals for the shelter sector there have been established short- and intermediate-term production goals. USAID's description of the sectoral goals of its new housing program, for example, states that the shelter system should produce 200,000 units of formally financed housing over the next six years, just for the target group eligible for participation in the Housing Guaranty program. Reaching this goal would necessitate more than quadrupling the current rate of formal-sector shelter provision. Structural reforms are not necessarily inconsistent with ambitious production targets such as this, but in the past spurts in housing output, particularly for those with below median incomes, have been achieved through infusions of external capital which have left the domestic shelter finance and delivery system largely untouched. If structural reforms are to be realized, there may well have to be some tradeoff with short-term production maximization.

## SECTORAL PERFORMANCE

Shelter sector performance can be judged from several perspectives. The previous chapter pointed out that during the 1980s shelter costs have risen considerably faster than other elements in the consumer price index. This reflects both pressure on land prices[2] and increases in the costs of construction materials, especially imported materials.[3] In this section we examine more closely the record of housing production and shelter-system finance.

### Adequacy of Housing Production

In any country with low household incomes it is inevitable that housing production will fall short, in volume and quality, of what the population wants and needs to be adequately housed. Limitations on household ability to pay prevent many households from buying or building adequate homes with their own resources, and parallel limitations on governmental capacity to pay prevent the public sector from providing the subsidies that would be necessary to fill the gap. Honduras' record, however, reveals especially serious shortfalls in formal-sector housing production, suggesting that there are system failures that go beyond low household income levels.

### Housing Production and Investment in Honduras vs. Other Countries

Honduras produces less legally recorded housing, and invests less of its domestic product in housing, than almost any other country of its income class or region. Measured in terms of new dwellings produced per 1,000 inhabitants, Honduras' reported (i.e., formal-sector) rate of housing production during the period 1980-85, the latest period for which comparable data are available, averaged less than one-sixth that of Costa Rica, less than 40 percent that of Panama, and just over half that of El Salvador.[4] That the Honduran formal-sector housing system produces housing only for the relatively affluent is indicated by the fact that the average formal-sector house built in Honduras during this period cost substantially more than the average formal sector house built in Costa Rica, despite the latter country's much higher average level of household income. During the period 1983-85 the average house produced by the Honduran private sector had 110.5 square meters of floor space vs. 79.3 square meters for the average house built in in Costa Rica.[5]

Table 2.1 shows that Honduras also ranks at or near the bottom in a broader comparison of investment in residential construction as a share of different countries' gross domestic product. The first set of comparator countries is drawn from Latin America, the second set from other countries in Honduras' per capita income class. There is, of course, no "correct" ratio for housing investment in relation to GDP. The diversion of an unusually large share of capital formation to housing at the expense of income-earning investment can retard economic growth, and may pose just as serious a development problem as under-investment in housing. However, Honduras' very low rate of residential investment--in recent years roughly half that of other countries--implies that formal-sector housing institutions are not doing their normal job of gathering resources and channeling them to the housing sector. Honduras' low production has occurred despite unusually large external capital assistance to the housing sector.

Housing Needs vs. Housing Production

The presumption that Honduras' formal sector housing production is inadequate is fortified by the results of housing needs studies. Needs studies are a tool that can help provide perspective on whether the shelter system is providing housing on a scale commensurate with national housing requirements. They must be interpreted with caution, however, since needs studies, even in advanced countries, invariably demonstrate that there is a large gap between actual housing production and the level that is "needed" to meet minimum housing standards.

Table 2.1

**Residential Construction as Share of GDP**
(percent)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Chile | 4.2 | 5.2 | 3.6 | n/a | n/a | n/a |
| Colombia | 2.3 | 2.3 | 2.3 | 2.6 | 2.6 | n/a |
| Costa Rica | 2.8 | 2.1 | 2.0 | 2.4 | 2.8 | 2.6 |
| Dominican Republic | 6.3 | 4.6 | 4.5 | 4.0 | 4.0 | n/a |
| Ecuador | 2.8 | 2.9 | 3.5 | 3.3 | 2.7 | 2.6 |
| El Salvador | 2.0 | 1.9 | 2.6 | 3.1 | 2.9 | n/a |
| Panama | 2.6 | 3.0 | 2.8 | 2.7 | 2.8 | 3.4 |
| Venezuela | 6.8 | 5.7 | 4.2 | 3.5 | 2.0 | 1.6 |
| Jordan | 12.2 | 12.6 | 11.9 | 11.1 | 10.9 | 10.3 |
| Morocco | 3.3 | 3.6 | 3.4 | 3.7 | 4.1 | 5.0 |
| Philippines | 4.3 | 4.8 | 4.6 | 4.4 | 4.4 | 4.5 |
| Turkey | 2.7 | 2.1 | 1.9 | 2.0 | 2.0 | 3.6 |
| Average | 4.4 | 4.2 | 3.9 | 3.9 | 3.8 | 3.9 |
| HONDURAS | 2.6 | 2.2 | 2.5 | 2.2 | 2.0 | 1.9 |

Sources: World Bank country studies; CAMACOL, El Upac, la Politica Economica y la Construcción: 1976-87 (Bogota, 1987); UN Construction Statistics Yearbook 1985 (1988); IMF International Financial Statistics (1989-January).

In the case of Honduras, almost three-quarters of the existing housing stock was classified by the 1988 Census of Housing as inadequate--either because of structural deficiencies or because it lacked access to adequate household water supply, electricity, or sanitary waste removal[6] (see Table 2.2). It is estimated that a total of 45,600 new housing units would have to be built each year, and another 11,200 units upgraded annually, in order to eliminate Honduras' housing needs backlog over a 20-year period and provide for population growth. This level of housing production is more than four times the peak formal

Table 2.2

**Housing Needs Estimates and Recent Production Levels**
(000s units)

**Housing Stock as of 1988**

| | |
|---|---|
| Total Number of Units | 809.3 |
| Number of Inadequate Units | 598.1 |
| Need replacement | (373.1) |
| Upgradeable | (225.0) |

**Output Levels**

| Item | Annual Needs | Recent Actual Production |
|---|---|---|
| New construction | 45.6 | 7.0[a]<br>33.0[b] |
| Upgrades | 11.2 | N/A |
| Housing Investment as percent of GDP | 8.0% | 2.4%[a]<br>5.5%[c] |

[a]Formal sector only, estimated average production, 1986-88.
[b]Total housing activity, estimated as average rate of total housing construction, 1974-88, applied to 1988 base.
[c]Total housing activity, estimated from Urban Institute Housing Quality Model, based on observed changes in housing stock. Includes investment in on-site infrastructure connections.

Sources: 1988 Census of Housing; Housing Needs projections by The Urban Institute, updated for 1988 census data; Urban Institute Housing Quality model.

sector production level recorded in 1987. As a percentage of GDP, housing investment would have to be more than triple the actual level recorded in the national income accounts in recent years, or about 8 percent of GDP. The methodology underlying these estimates, more detail on the numbers, and a comparison of different needs studies with preliminary census data, are presented in Chapter One of Appendix One to this report.

According to the needs estimates, approximately 85 percent of the housing investment required in Honduras could be financed by households themselves, without exceeding guidelines regarding the share of household income that can be devoted to housing expenses. The remaining 15 percent of housing "needs" could be covered only by public subsidy, or by squeezing other necessities out of the household budget. The total subsidy amount necessary to meet needs in full is just under Lps. 90 million per year. However, among households with below median incomes, the subsidy needed is more than half of total housing costs. These subsidy needs are highly concentrated in rural areas, where two-thirds of all new housing units are required and where household incomes are lowest.

In combination with the international comparisons, the needs studies point up some basic conclusions about the performance and potential of Honduras' housing sector:

✦Formal sector shelter institutions are building and financing only a very small part of the housing that the country needs. The performance record is markedly poorer than in other countries of the region or of the same income class.

✦Even if shelter institutions <u>did</u> function well, by providing credit to all families that wanted and could afford it, and by building houses of truly minimum standards, substantial numbers of families could not afford to acquire minimum-standard homes. (The minimum dwelling unit is defined as one built of permanent materials, with access to drinking water, electricity, and a safe form of human waste removal; it is estimated to cost Lps. 8,300 in 1986.)

✦A comprehensive shelter sector policy therefore must define alternative housing goals for the lower part of the income distribution, beyond immediate access to owner-occupied housing.

✦These alternative goals would recognize the continuing need for smaller, less expensive rental housing to accommodate part of the urban population.

✦They would recognize the need for progressively built and upgraded housing in urban areas. This goal implies that households have the right to look forward eventually to occupying a unit meeting minimum standards, but that at any point in time a significant part of the urban population will be living in below adequate quality housing, while saving to finance future improvements. That is, the urban housing deficit never will be fully eliminated.

✦Finally, the alternative goals would recognize that, given rural income levels, it is not within the financial capability of the government to provide minimally acceptable housing to all rural households. Greatest priority instead should be given to programs that can augment rural income generation.

Many of these goals have had de facto adoption in Honduras, but none has been adopted explicitly in any official document. All housing sector plans continue to aim at "eliminating" the country's housing deficit by some date over the next 10-20 years.

Cyclical Stability of Housing Production

Housing construction is an inherently cyclical activity. In market systems, demand for residential construction is highly sensitive both to changes in interest rates and changes in household incomes and employment levels. In systems that have publicly allocated credit and significant volumes of public construction, market cycles can be dampened or further exacerbated by government decisions about credit availability, restrictions on import materials, and the government's own rate of housing construction.

Exaggerated swings in residential construction have undesirable consequences. Household expectations about obtaining housing are likely to be frustrated when housing readily available in one period becomes unavailable in the next. Moreover, studies in advanced countries have demonstrated that strong cyclical swings add significantly to average housing costs, since most housing tends to get built in the periods of peak construction, when pressure on materials prices, as well as land and labor costs are greatest.[7] There are also inefficiencies to having construction firms go out of business at the bottom of each cycle. In the Honduran economy, unemployment is so high that swings in residential construction do not place much pressure on unskilled labor costs, but skilled labor, land, and imported building materials are all factors in limited and inelastic supply, whose prices are likely to be sensitive to housing production levels.

Although the data are incomplete, Honduras' housing sector obviously has a high degree of cyclical volatility. The cyclical swings seem to fit the election cycle more closely than an economic cycle, and are more pronounced for public-sector output than for private production. Table 2.3 summarizes the data available on recent formal-sector swings in housing output. Besides the fact that the annual variations are large--much larger than the swings reported by the BCH for all construction spending--it can be seen that housing production has hit bottom at each election year, then turned cyclically upward with the launching of a new presidential term. A new president comes to power, obtains external support for housing finance, and launches new programs. Depending on external circumstances, these are translated swiftly or more slowly into actual construction. By the end of the presidential term, projects have been completed and the political momentum for new production diminishes; output falls drastically. After the election, a new period of preparation and lobbying for external financing begins.

Preliminary signs indicate that Honduras is now entering the down years of the most recent housing production cycle. Our interviews with sectoral institutions indicate that the pipeline of housing being built, or for which financing has been secured, has been depleted. Production levels in 1989 and the first part of 1990 should decline substantially from the previous two years.

How Much Does Formal Sector Production Matter?

The foregoing comparisons demonstrate that the formal shelter sector in Honduras has fallen far short of adequate production levels, and has been subject to steep fluctuations in output. The shortfall may not have great significance, however, if households are able to provide housing for themselves, outside formal sector institutions.

INVA, SECPLAN, and PADCO have variously estimated that the informal sector in fact is responsible for producing between 70 percent and 85 percent of all new housing units in

Table 2.3

**Cyclical Swings in Formal-Sector Urban Housing Production**
(units completed)

| | New Public or Quasi-Public Housing[a] | Public Upgrading | New Private Housing[b] | Private Housing Tegucigalpa Only |
|---|---|---|---|---|
| 1980 | 1,398 | 221 | 2,090 | 623 |
| 1981* | 708 | 160 | 2,737 | n/a |
| 1982 | 3,723 | 283 | 5,004 | 2,109 |
| 1983 | 2,681 | 1,275 | 1,679 | n/a |
| 1984 | 1,969 | 509 | 1,691 | n/a |
| 1985* | 639 | 380 | 1,130 | 759 |
| 1986 | 2,818 | n/a | n/a | 917 |
| 1987 | 7,559 | n/a | n/a | 1,240 |
| 1988 | 5,462 | n/a | n/a | n/a |

*Election year.

[a]Output built or financed by INVA, FEHCOVIL, FOVI and pension funds. From institutions' data.
[b]Housing completed by private sector as registered in Tegucigalpa, San Pedro Sula, and La Ceiba. Corresponds to 12 months ending September 30.

Honduras.[8] Most of these units probably escape the counting that goes into national production reports and national income statistics.

One measure of the effectiveness of informal sector construction is implied by the preliminary data from the 1988 Census of Housing. The Census reveals that, despite very low levels of formal sector housing production, the total number of occupied housing units rose at a faster rate than population. That is, for the last 14 years total housing was being built faster than new households were being formed. As a consequence, average occupancy rates declined, often sharply. Significant relief from overcrowding was achieved, especially in the larger urban areas. For example, 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.[9]

Overall, 346,000 new units were added to Honduras' occupied housing stock between 1974 and 1988, implying that on average some 27,000 new units per year were built over this period.[10] This compares to a total of 17,771 housing units that have been financed by all of the private savings and loan associations over their lifetimes.[11]

The activity of the informal sector, as revealed by the Census of Housing, far exceeds the housing production levels that Honduran planning institutions believed was being achieved. Estimates as late as 1987 by SECPLAN, INVA, the Chamber of Construction, and the Society of Civil Engineers all estimated that housing was being built at a rate far below household growth, and that as a result the country was falling even farther behind in sheer numbers of housing units.[12] In fact, these diagnoses labeled inadequate volume of housing production as the number one problem of Honduras' shelter sector. It is now clear that total housing production, in fact, has performed remarkably well.

It is apparent, then, that the data for formal sector production do not present a remotely adequate picture of total housing activity. Most housing has been built without formal-sector financing and without formal-sector participation in production. For this reason, the shortfall in formal production, and its cyclical volatility, matter substantially less than it would if there were no informal sector to pick up the slack. Greater informal sector activity also accounts for a good part of Honduras' apparent poor performance in international comparisons.

Nonetheless, it would be wrong to dismiss the poor performance of the formal sector as inconsequential. Much of the housing produced by the informal sector is physically inadequate and most is without access to infrastructure services. Without access to formal sources of lending, households must wait until they have accumulated larger amounts of their own savings to begin to build a structure, and must spread out construction over a longer period of time.[13] When they do borrow, they borrow from informal sources at higher costs. Breakdowns in the formal sector system of shelter provision also have produced specific inefficiencies in the housing market. Land invasions in the larger cities have exacerbated the costs of public service provision, since households tend to invade those areas that are least accessible for public infrastructure installation. Land tenure is another point of breakdown. It is estimated that more than half of informal-sector households in Tegucigalpa lack legal title to the land they possess.[14] Because of their uncertain legal status, these households are often reluctant to make the investment necessary to improve their dwellings to meet adequacy standards, even if the objective risk of their being displaced from the land may be small (see Chapter 3, Appendix III).

Just how much it matters that the formal financing and construction system of the shelter sector fails to reach large parts of the population is not known, and cannot be known until there are more complete studies of how housing is built and financed in the informal sector. In terms of sheer volume of production, the informal sector has done a far better job of building housing for itself than the formal sector has of expanding to serve the mass housing market. This suggests that future formal-sector policy should look for ways to support informal sector production, by filling gaps in a process that is working fairly well, rather than try to supplant it through preemption by formal sector processes of mortgage lending and construction.

## Functioning of the Housing Finance System

Housing finance must fit within a national system of credit flows and savings generation. Housing finance institutions should help mobilize aggregate domestic savings by tapping savings markets that cannot be reached by other financial institutions. To fit into a market-based system of credit allocation, credit lines to different types of housing finance intermediaries should be provided on comparable terms, and on similar terms as loans to financial intermediaries in other sectors of the economy. To ensure adequate financing for the housing sector, housing finance institutions should help match long-term mortgages with long-term sources of savings.

The Honduran housing finance system departs fundamentally from this market-based model. A fundamental policy question is how much market-based reform is feasible or desirable, given the entrenched nature of institutional behavior and incentives.

Overview of Housing Finance

A large variety of financial institutions in Honduras help finance the housing sector. Tables 2.4 and 2.5 provide an overview of these institutions and the approximate magnitude of mortgage financing that they provide. The tables distinguish between conventional and "nonconventional" finance institutions (NCFIs). The latter are institutions that themselves are legally incorporated and/or supervised under government regulations; thus, they are not informal sector organizations per se. However, typically their members or beneficiaries are informal sector households, the majority of whom fall below median income. The NCFIs also have distinctive forms of lending which set them apart from formal-sector institutions. In the case of housing loans, they often make part of the loan in the form of building materials; frequently, they do not impose explicit interest charges, but mark up the prices charged for materials to include implicit interest costs.

Several facts stand out from the tables. One is the relatively small importance of savings and loan associations in the total finance picture (Table 2.4). The savings and loans were set up in Honduras around 1970 to be the primary vehicles of housing finance, and have been supported by external donor policy for most of the subsequent period. However, the total assets of the savings and loan associations remain less than 10 percent of those of commercial banks. Deposit growth in 1988 was less than 5 percent of commercial bank deposit growth.

Another fact that stands out from the tables is the already large, and rapidly growing importance of public employee pension funds, both in total domestic finance and in the housing finance picture. These funds are now producing an annual cash surplus estimated at about Lps. 240 million, an amount which is climbing rapidly each year. They will continue to generate strong cash surpluses for at least the next decade, until the first generation of retirees begins to receive pension payments. About a third of the available annual funds of the public employee pension systems are now being invested directly in housing (see Table 2.5);

Table 2.4

**Assets and Asset Growth of Honduran Financial Institutions**
(millions of lempiras as of 1988)

| Institution | Assets | | Current Annual Growth in Assets[a] | |
|---|---|---|---|---|
| | | | Total | From Deposits or Contributions |
| Major deposit-taking institutions[b] | | 4,767 | | |
| Commercial banks | 3,369 | | 418 | 389 |
| Savings and Loan Associations | 330 | | 58 | 17 |
| Development Banks | 1,093 | | 57 | 35 |
| Pension Funds | | 1,281 | | |
| INJUPEMP | 500 | | 122 | 86 |
| INPREMA | 400 | | 80 | 52 |
| IPM | 170 | | n/a | n/a |
| IHSS | 211 | | 35 | 92 |
| Other | | | | |
| Insurance companies | xxx | | 47[c] | n/a |
| Nonconventional Institutions | | | | |
| Credit unions | 106 | | 15 | 11 |
| Housing cooperatives (FEHCOVIL) | 37 | | 1[d] | very small |

[a]For banking institutions, insurance companies and credit unions, growth in most recent 12-month period; for pension funds, current year projection. Figures represent net growth.
[b]Subtotals do not add to total because of cross-transactions between classes of institutions.
[c]Total annual growth in loans.
[d]Excludes international funding.

Sources: For deposit institutions, Boletín Estadistico, Banco Central de Honduras (June 1988); unpublished data of individual pension funds, insurance systems, credit unions, and housing cooperatives.

Table 2.5

**Magnitude of Housing Finance, by Institution**
(annual financing, millions of lempiras)

| Institution | Amount of Mortgage and Other Shelter Financing: Average 1980-85 | 1986 | 1987 | 1988 |
|---|---|---|---|---|
| Deposit-taking institutions | | | | |
| Commercial banks | n/a | 44(est.) | 85(est.) | n/a |
| Savings and loans | 37 | 49 | 69 | n/a |
| Pension funds | | | | |
| INJUPEMP | 9 | 13 | 19 | 26 |
| INPREMA | 11 | 13 | 16 | 24 |
| IPM | n/a | n/a | 6 | 10 |
| IHSS | 0 | 0 | 10 | 0 |
| Insurance companies | n/a | 7 | 9 | n/a |
| Nonconventional institutions | | | | |
| Credit unions | n/a | n/a | 4 | 6 |
| Housing cooperatives | 2 | 1 | 14 | 14 |
| PVOs | n/a | n/a | n/a | 6 |
| INVA[a] | 14 | 11 | 17 | 10 |

NOTE: Loan financing is not fully comparable. For commercial banks, 75-85 percent of residential loans are construction loans. Mortgage loans made by pension funds are for much longer terms than mortgage loans of S&Ls. Figures for pension funds exclude construction-stage financing for projects subsequently taken out by mortgages financed by the pension funds.

[a]Does not include capital funds used to cover INVA's operating cost deficit or other institutional expenses.

Sources: Unpublished data of individual institutions: Boletín Estadistico and unpublished data of Banco Central de Honduras for deposit-taking institutions.

additional amounts are deposited in the savings and loan system. The share public pension systems funds invested in housing has been climbing steeply (Table 2.5).

The large amount of commercial bank financing shown in Table 2.5 is somewhat misleading, since the great majority of commercial bank lending to the shelter sector is for short-term construction finance, which is turned over rapidly. A much smaller part of S&L lending is for construction finance. At the same time, residential mortgages provided by the S&Ls are for shorter periods (one S&L has reduced its maximum term to five years) than the mortgage loans provided by the pension funds, which are for 20 to 30 years. The importance of the pension funds to net sectoral financing, therefore, is greater than the totals of annual gross new lending in Table 2.5 would indicate. The pension fund figures also exclude short-term construction financing that is rolled over into mortgages.

Domestic Resource Mobilization

Honduras' housing finance institutions have been particularly weak at mobilizing domestic savings--one of the primary functions that they should be performing in a well-functioning financial system. Table 2.6 summarizes the sources and uses of funds of major institutions in the housing finance sector. As can be seen, most of the financing devoted to residential investment has come not from voluntary domestic savings, but from one of four sources:

- ✦captive savings, generated by mandatory contributions to public pension plans or social security

- ✦external savings, transferred to housing finance institutions in the form of international grants or loans

- ✦government borrowing, procured by issuance of full faith and credit government bonds by the central bank.

- ✦government tax resources transferred to the sector as subsidies for INVA.

In each of these cases, funds are generated essentially independently of the domestic housing sector or domestic housing finance institutions. Public pension plans, for example, collect

Table 2.6

**Sources of Funds Used for Housing Finance by Major Institutions**

| Institution | Total Funds and Period (millions of lempiras) | | Sources or Uses of Funds |
|---|---|---|---|
| Savings and loan assns. | 235 (outstanding mortgages 9/88) | Sources: | |
| | | 95 | deposits & earnings (includes approx. 30 in deposits from pension funds & social security) |
| | | 140 | FOVI/FINAVI rediscounting |
| FOVI | 48 (1989 financing plan) | Sources: | |
| | | 18 | AID HG |
| | | 5 | CABEI |
| | Note: in prior years, higher percentage was funded from foreign sources. | 12 | sale of domestic bonds |
| | | 4 | insurance companies |
| | | 9 | repayments |
| INJUPEMP | 138 (assets invested in housing sector, 1988) | How Invested: | |
| | | 120 | mortgage loans to members |
| | | 12 | S&L deposits |
| | | 6 | FOVI bonds |
| FEHCOVIL | 37 (lifetime housing finance) | Sources: | |
| | | 8 | AID |
| | | 12 | CABEI |
| | | 1 | CHF |
| | | 10 | FOVI |
| | | 1 | INVA |
| | | 5 | Repayment, fees & other |
| INVA | 76 (capital investment 1980-84) | Sources: | |
| | | 9 | Domestic Credit |
| | | 35 | International Credit & Grants |
| | | 12 | GOH Transfers |
| | | 13 | Repayments |
| | | 7 | Other |
| | 33 (capital investment 1985-86) | 11 | Domestic Credit |
| | | 4 | International Credit & Grants |
| | | 3 | GOH Transfers |
| | | 8 | Repayments |
| | | 6 | Other |
| | 1987-88 Capital Budget (est.) | 60% | International |
| | | 20% | Repayments |
| | | 10% | Domestic Credit |
| | | 10% | GOH Transfers |

Source: Compiled by authors from unpublished data of individual constitutions.

their funds as a function of separate legislation, designed to finance the systems' retirement benefits; these funds could be invested elsewhere in the economy. From a market point of view, Government of Honduras full faith and credit bonds are essentially interchangeable, whether they are called Housing Bonds and issued by FOVI or designated something else. Given overall limits on domestic debt issuance, Housing Bonds compete directly for issuance authority with government credit issued to help finance other sectors of the economy.

Maneuvering by the housing finance sector to capture a larger share of the savings generated by pension funds and external donors, or to tap a larger share of the public savings transferred to government through general obligation debt instruments and tax revenues, can increase investment in the housing sector. However, it does so at the expense of diverting savings from other investments in the private and public sectors. The housing finance system would make a far more valuable contribution to national development if it also generated funds from new savings sources, thereby adding to the pool of investible funds.

Growth of Nonmarket Credit Allocation

Housing finance in Honduras has been steadily moving away from a market model of credit allocation. In a market-based system, financial intermediaries compete for savings by offering market rates of interest on deposits, and compete for loans by lending at market rates of interest. The commercial banks and savings and loan associations offer the closest approximation to market allocation of credit in Honduras.

In contrast, the fastest-growing source of housing finance--the public pension systems--increasingly embrace a model of nonmarket credit allocation. The pension funds collect their savings from mandatory employer and employee contributions. In principle, these funds, once in the hands of the pension system, could be offered to financial intermediaries on a competitive basis, as in fact has happened in the past and continues to happen to a small degree (see Table 2.6).

More than 90 percent of the pension funds' investment in the housing sector, however, occurs directly. The funds develop housing projects themselves, sell finished houses to members, and finance members' mortgages at below-market interest rates. In the case of

INPREMA, the teachers' pension fund, mortgage loans are made to members for 20 years at 9.5 percent. In the case of INJUPEMP, the public employees' pension fund, mortgage loans are made to members for up to 30 years at a sliding interest-rate scale between 10 and 11.5 percent. INVA also provides mortgage and home improvement loans at below-market rates, as do credit unions and most PVOs. All of these organizations report excess demand that they cannot satisfy, thereby necessitating administrative allocation systems to determine who will qualify for the subsidized financing.

In a market-based system of housing finance, different lenders would make mortgage loans at approximately uniform rates of interest, differentiated only by credit risk, normal market competition, or public policy regarding deliberate subsidization of certain beneficiary groups. By contrast, Table 2.7 summarizes actual mortgage lending terms from various institutional sources. Rates to the ultimate borrower, as well as the cost of money to the lender, vary widely and apparently without coherent pattern.

Ability of Shelter-Sector Finance to Withstand Future Economic Events

The Honduran housing finance system has evolved in a manner that makes it vulnerable to economic events likely to occur in the next decade.

Structurally, the housing finance sector is ill-equipped to deal with an outbreak of inflation. Deposits in the banking system, including those made by pension funds and insurance companies, now have a maximum term of one year. Mortgage loans are typically made for periods of 10 years or more, with no provisions for interest-rate adjustment. An outbreak of inflation would precipitate savings withdrawals or an upward escalation of interest rates on deposits, threatening decapitalization of financial intermediaries. It is true that some stability is provided to the S&L system by FOVI rediscounting, which provides S&Ls with a fixed interest rate spread regardless of future interest rate behavior. But this protection for the S&Ls is purchased at the expense of financial risk for FOVI. FOVI faces the possibility of having to refinance its domestic housing bonds, which are redeemable upon demand, at higher interest rates, while it is locked into the interest rates it has granted to S&Ls on the mortgages it has financed.

Table 2.7

**Interest Rates in Housing Sector**
**Selected Institutions and Programs**

| Institution | Program | Interest Cost to Institution | Institution's Lending Rate | Rate to Consumer |
|---|---|---|---|---|
| Savings & loans | deposits; market mortgages | 10-11% | 18%[a] | 18%[a] |
| Savings & loans | FOVI rediscounting, HG | 10% | 15%[a] | 15%[a] |
| INVA | upgrading, external finance | 0 | 5% | 10-30% |
| | upgrading, domestic finance | 5% | 5% | 10-30% |
| | other programs | 0-17% | 5-15% | 7-18% |
| INJUPEMP | member mortgage loans | 0 | 10-12% | 10-12% |
| FEHCOVIL | external financing member mortgage loans | 0-11% | 4-14% | 4-14% |
| FACACH, credit unions | share capital & deposits; member mortgages | 4-8% | 6-14% | 6-14% |
| FACACH | external funding; member mortgages | 0-13% | 4-15% | 4-15% |

[a]Includes 1% insurance.

Apart from FOVI discounting, lenders for housing are now able to protect themselves against future inflation only by shortening mortgage terms or withdrawing from the mortgage market. Throughout Latin America, surges in inflation have broken the back of national housing finance systems.[16] Since the probability is high of an outbreak of inflation in Honduras at some point in the next decade, it is prudent to prepare for such an eventuality now.[17]

A second future event--this one certain to occur in the intermediate term--is the disappearance of the pension funds as a source of loanable funds to the housing sector. The pension funds' cash surplus is a transitory condition. It results from the fact that the pension funds are still young, and have yet to take on the responsibility of paying out significant retirement benefits. However, over the next decade the first generation of retirement will begin, then quickly accelerate. With it will vanish the cash surplus that the pension funds are generating. In fact, INPREMA already faces a Lps. 300 million actuarial deficit in the teachers pension fund. According to actuarial projections, the Health and Maternity portion of the social security system faces a cash deficit of Lps. 281 million by 1996, unless emergency transfusions continue to be made from the retirement fund.[18] Both of these deficits are growing rapidly. At some point in the not-too-distant future the pension funds may find, as social security already has found, that they do not generate enough cash to cover their current liabilities, and must withdraw deposits from the financial system rather than add to them. Thus, while it is logical of the housing finance system to try to draw on capital flows from public pension funds for the next decade, it must also prepare for the fact that by the end of the decade, this source of capital supply will begin to disappear.

Well before the date when pension fund contributions are needed to cover pension fund retirement obligations, the GOH is likely to intervene to absorb more of their free cash flow to help cover the public sector deficit. In fact, the GOH recently decided that all of its employer contributions to the teachers' pension fund for 1988 (Lps. 35 million) would be made in the form of below-market 10-year bonds, rather than cash. This decision has the effect of forcing INPREMA to use most of its 1988 cash flow to help finance the public sector deficit at below-market rates, rather than invest in private sector investment, including housing. The temptation to the GOH to continue tapping these captive funds is great.

Finally, the risks to the rest of the fiscal system of relying on pension funds to provide housing finance need to be borne in mind. Throughout Latin America, pension funds and housing funds alike have been depleted by this linkage. When the first wave of pensioners comes of age, pension funds can quickly find themselves in serious financial jeopardy if their contributions have been used to finance housing mortgages at negative real interest rates or if default experience is high. Brazil's National Housing Bank which was funded in this way is now defunct. Mexico's National Housing Fund for Workers had to receive emergency support from the National Bank.[19] Panama's social security system was virtually bankrupted by bad loans to housing finance institutions.

## Summary

Honduras' housing finance system functions primarily to channel into the housing sector funds that are generated abroad or by mandatory contributions elsewhere in the Honduran economy. It does not add importantly to domestic savings.

The majority of housing credit is now extended at below-market interest rates, bestowing windfall gains on those who receive loans, while necessitating administrative allocation of mortgages. Most of the capital flowing into housing finance intermediaries carries rates of interest that also are below market, or appears to be "free," because it is generated automatically by salary withholding. Increasingly, the institutions generating these capital flows are themselves expanding into the banking and residential development business, rather than providing funds to traditional housing finance intermediaries, like the savings and loan associations. Although this is most obviously true of the public pension systems, it is also true of insurance companies and credit unions. An institutional disintermediation is occurring, replacing market allocation of housing credit by administrative awards of below-market credit financed from captive savings sources.

The entire housing finance system is highly vulnerable to an upsurge in inflation--an event that has destroyed housing finance institutions elsewhere in Latin America and has a high probability of occurring at some point in the next decade in Honduras.

**Footnotes, Chapter 2**

1. Consejo Superior de Planificación Economica (CONSUPLANE), Politica Nacional de la Vivienda (Tegucigalpa: 1986).

2. The first comprehensive land-price data for a metropolitan area are being assembled as part of the UMVIDE and PADCO project, Urban Land Study for the Municipality of San Pedro Sula, 1989-2001 (1989).

3. The Cámara Hondureña de la Industria de la Construcción recently began careful monitoring of materials' prices in the construction sector. Although the data are difficult to interpret in the absence of an index showing the component weighting in different types of construction, the average unweighted price increase was 13 percent in the last six months of 1988.

4. United Nations, Construction Statistics Yearbook, 1985. (New York: 1988).

5. Ibid.

6. SECPLAN, Censo Nacional de Población y Vivienda, 1988, Resultades Preliminares (Tegucigalpa: November 1988).

7. William Gibson, Brookings Papers on Economic Activity (1972).

8. Ramon Santelices T., Sobre la Movilizacion de Recursos Financieros para la Vivienda de Interes Social (SECPLAN, 1987); INVA, Plan de Vivienda, 1988-2000 (1988); PADCO, Diganostico y Pronostico de Necesidades de Vivienda en Honduras (1986).

9. Censo Nacional de Poblacion y Vivienda 1988 (Table 5).

10. The annual production estimates assume that part of the vacant housing stock in 1988 was also produced since 1974.

11. Data on mortgages financed were provided by CAHDEAP, and are as follows:

**Total Mortgage Loans for Housing through 1988**

| Savings & Loan Associations | Number of Mortgage Loans | Total Financing (thousands Lps.) | Average Mortgage Loan (thousand Lps.) |
|---|---|---|---|
| La Vivienda S.A. | 3,609 | 49,627 | 13,751 |
| La Vivienda de Sula | 2,949 | 42,771 | 14,504 |
| Casa Propia | 971 | 15,540 | 16,004 |
| La Constancia | 6,382 | 95,730 | 15,000 |
| Futuro | 3,165 | 47,481 | 15,002 |
| Metropolitana | 695 | 11,126 | 16,009 |
| Totals | 17,771 | 262,275 | 14,759 |

Source: CAHDEAP

12. CONSUPLANE, Politica Nacional de Vivienda 1984-1988; INVA, Plan de Vivienda, 1988-2000. Cámara Hondureña de la Industria de la Construcción, El Ahorro como Fuente Principal del Financiamiento Habitacional de Honduras (1987); Colegio Ingenieros Civiles de Honduras, Problema de la Vivienda en Honduras (1981).

13. On the importance of "regularized" mortgage lending to the speed and feasibility of auto-construction, see Janet E. Kerley, Randolph S. Lintz, y Antoinette S. Rusin, "Investigación sobre la Vivienda Progresiva en Honduras y Costa Rica" (National Council of Savings Institutions: 1985).

14. Surveys by INVA and the AMDC indicate that more than half Tegucigalpa's neighborhoods identified as popular settlements lack proper title to the land.

15. Construction costs per square meter in self-help housing in Kerley's sample were Lps. 230 vs. Lps. 358 per sq. meter in INVA projects.

16. This, for example, was the experience of the savings and loan system in Bolivia, the Brazilian national housing bank, and the Colombia housing bank.

17. The housing finance sector's risk is compounded by the possibility of devaluation. The magnitude of dollar-denominated loans outstanding to the sector means that in the event of devaluation some part of the housing finance system may be asked to cover the shortfall between repayments on fixed-rate lempira mortgages and the new lempira equivalent of the original dollar loans issued by CABEI, HG programs, and other external sources. Such a development drastically decapitalized and nearly destroyed the Bolivian savings and loan system. Even if the GOH assumes formal responsibility for dollar repayments (per existing

loan agreements), it may try to recapture some of the housing sector's foreign exchange "losses" by widening spreads on its lines of credit to the sector.

18. Francisco R. Bayó, Informe de la Primera Etapa de la Consulta Actuarial, Programa de Cooperación Técnica Aspectos Actuariales y Financieros (Instituto Hondureño de Seguridad Social, 1987).

19. United Nations, Department of International Economic and Social Affairs, Housing and Economic Adjustment (New York: 1988).

# CHAPTER THREE

# SHELTER SECTOR CONSTRAINTS

This chapter identifies more precisely the major constraints that have prevented the shelter sector from realizing the goals set forth for it in Chapter 2. Wherever possible, we have ranked these constraints in priority order. However, since the constraints are of many different types, direct comparison among them is sometimes difficult.

## LACK OF SECTOR STRATEGY AND MARKET ORIENTATION

There is no agreed-upon shelter sector strategy in Honduras. There is no consensus regarding the volume or mix of housing that should be produced through the formal sector, and no agreement as to the type of support that should be provided to informal-sector production. There is no common policy with respect to mortgage lending terms or subsidy eligibility. There is no sectoral policy as to how the capital funds flowing into housing should be raised. There is no regular monitoring of basic sectoral information--such as aggregate housing output levels, aggregate financing flows, or changes in land and materials prices. Under these conditions, it would be a fortuitous coincidence if sector objectives were being met. That is not the case.

Various organizations have attempted to assert leadership for the shelter sector. SECPLAN has produced a statement of housing policy, but it has been widely ignored.[1] INVA has produced a national housing plan, which also has been ignored by other governmental agencies and the private sector.[2] FOVI and the Central Bank probably exert more de facto control over the housing sector than any other organizations--through the conditions placed on lines of credit and their regulatory influence over other financing sources--but, ironically, neither FOVI nor the other arms of the Central Bank have articulated goals for the housing sector. FOVI establishes its annual financing target, for example, by trying to forecast the magnitude of project financing that will be presented to it, then adjusts the target as the year proceeds if it proves incompatible with national credit policy. Even financial regulation of the sector is divided (see Chapter 2, Appendix I).

Three factors have hindered attempts to produce a shelter sector strategy. First, none of the sector's institutions possesses the technical or political capacity to frame a development plan that takes into account the respective roles of different organizations, or the ability to monitor its implementation through the private market. Both attempts to develop sector guidelines--by SECPLAN and INVA--were actually prepared by foreign consultants on short-term assignments.

Second, institutional rivalries so far have prevented organizations in the sector from collaborating together. Both SECPLAN and INVA complained that other organizations failed to participate in the sectoral planning efforts that they launched, and neither actively supported the other's effort.

Third, most of the institutions in the shelter sector prefer to insulate themselves from common sectoral policy and from market competition rather than strengthen this linkage. This has led to duplicative vertical integration within many institutions. Each of the public pension plans has expanded from pension fund financing into physical development of housing and direct mortgage financing. This allows the pension plans to establish their own policies for awarding below-market housing to members, without reference to sectoral guidelines. INVA has expanded from house and core-unit development by adding its own savings and loan association while setting up capacity to help buy land and legalize land titles in existing invasion areas and install community infrastructure. Whenever possible, it secures subsidized funding directly from overseas sources. These arrangements are aimed to free INVA from dependence on policy constraints and budget limits imposed by other institutions. The credit unions and housing cooperatives are following a similar course.

The constraint, then, is not merely that Honduras lacks a set of common policies toward the shelter sector, but that it has developed shelter-sector institutions that resist such policies and resist a market frame of reference. Most of the institutions have been built to obtain below-market financing, and exist to convert subsidized resources into housing for favored beneficiaries outside the market.

## FINANCE: RESOURCE MOBILIZATION

As pointed out in Chapter 2, housing finance institutions have contributed little to domestic resource mobilization. Savings and loan associations are raising net private deposits at the rate of Lps. 17 million per year, a small fraction of the amount needed to finance housing investment, and are the only specialized institutions in the sector attracting voluntary deposits. The constraints impeding more effective resource mobilization are:

### Lack of Programs Linking Mortgage Credit to Small-Scale Savings

Honduras does not use its mortgage finance system to induce saving. A good deal of research in developing countries has demonstrated that housing is the primary stimulus to saving among low-income households.[3] The construction, purchase, or progressive improvement of a dwelling is commonly the sole motive for regular saving during the economically active years. In other countries, the promise of mortgage credit has been able to mobilize significant financial savings within the informal sector. Mortgage-linked saving systems have been shown to accomplish three ends simultaneously: they boost net household saving, they increase the proportion of household saving held in the form of financial assets (as opposed to raw materials, durable goods, jewelry, etc.), and they introduce households to the formal financial network, increasing the proportion of their financial assets held in formal institutions.[4] They thus support aggregate resource mobilization, as well as the housing finance system.

In Honduras, there has been very little experience with mortgage-linked savings. Some years ago the Banco Atlantida operated an automatic saving plan in conjunction with some large private corporations. Employees authorized regular withholding from their paychecks; once they reached a prescribed level of saving, the workers became eligible to purchase a dwelling unit in a project sponsored by the company and to receive a mortgage from Banco

Atlantida. In the bank's view, the program worked successfully. Two commercial banks now operate mortgage linked-savings plans for individuals, though they are small scale and aimed at the upper middle class (in one case, the minimum house value is Lps. 60,000).

There are no systematic mortgage-linked savings plans for lower income households or for the informal sector, where the net payoff in domestic resource mobilization should be greatest. These households have fewer savings alternatives, and have the greatest difficulty in accessing the mortgage market, making the mortgage linkage of most value to them. Without access to formal savings institutions, households in the informal sector will still save for housing investment, but the savings effort will be less efficient, and will not be available to finance investment elsewhere in the economy. A measure of the saving potential in the Honduran informal sector is the fact that the average level of saving by credit union members is Lps. 1,920, more than 85 percent of which is in the form of long-term share capital which cannot be withdrawn unless the member terminates his/her membership in the credit union.

## Lack of Competition in the Savings and Loan Industry

Honduras and external donors have invested a great deal in the country's savings and loan system. The S&L associations not only are supposed to channel savings into housing but help generate domestic resources by competing for deposits.

Savings and loan associations in Honduras, however, do not effectively compete with the commercial banking system or with one another, because of their market structure. There are only six privately owned associations. Five of these are owned by commercial banking interests and the sixth is owned by a developer. Most of the S&Ls belong to financial consortiums that also control insurance companies and real estate developers. The savings and loan officials that we interviewed acknowledged that they are constrained by common ownership in their ability to compete with commercial banks for deposits. As senior partners in the financial system, commercial banks also dominate the regulatory process. One of the associations reportedly was quite successful in introducing several innovative ideas to increase deposits--e.g., a "super bingo" account--but the schemes ultimately were disallowed by the Central Bank, allegedly under pressure from the commercial banks who feared the competition for deposits.

Innovative deposit plans are one way that savings institutions can reach a broader base of savers. Another dimension of competition is the interest rate on deposits and the interest rate spread between loans and deposits. The S&Ls in Honduras do not compete on deposit rates; they offer a uniform set of deposit options. The spread on new mortgage loans exceeds 7 percentage points: all mortgage loans are now made at the legal ceiling of 18 percent, including a 1 percent charge to finance a loss reserve, while the Cámara de Asociaciones de Ahorro y Prestamo reports an average cost of funds of less than 11 percent. Fear of inflation and other economic uncertainties account in part for this wide spread, but the savings and loans in Honduras are "niche" institutions that are more valuable to their owners as small, high-spread operations than as vigorous competitors for deposits and growth.

## Displacement of Domestic Savings by Foreign Credit

Honduras depends to an unusual degree on foreign sources of capital to finance its shelter investment (see Table 2.6). Under current financing plans, this dependence will continue. For example, the US$100 million Housing Guaranty program scheduled for 1990-95 would by itself provide more than twice as much capital per year for housing as the current annual increase in private savings and loan deposits.

Foreign savings reach the shelter sector through specialized lines of credit that typically offer better terms than resources raised through deposits. FOVI lines of credit, for example, free the lending institution from all interest-rate risk. Several of the foreign lines of credit established with INVA have provided financing through donations or at two percent interest rates. The credit unions and housing cooperatives likewise have benefited from capital provided to them at far below market rates. Credit has been available in such abundant amounts that often the overriding preoccupation of the foreign agencies providing the credit has been to find ways to generate program demand to get it spent. The net effect of this easy credit has been to discourage competition for deposits and displace domestic savings.

In this respect, the housing sector reflects a phenomenon common to Honduran finance. Easily available foreign credit lines, provided on better than market terms, appear to have discouraged development of internal savings in many sectors.[5] At several points in the past both commercial banks and S&Ls have virtually suspended acceptance of new individual deposits because rediscount credit lines were sufficient for desired levels of lending, and available on more attractive terms.

## FINANCING: CHANNELING SAVINGS TO THE SHELTER SECTOR

No matter how successful it may be in generating new resources, in order to meet sectoral production targets, the housing finance system will have to find ways to transfer savings from where they are generated most abundantly--viz., pension systems, insurance companies--to where they can be invested in housing for the mass market. The present allocation of resources to housing by savings-surplus institutions is insufficient to meet sectoral production goals. Moreover, institutions receiving below-market capital have become reluctant to relinquish it to others, even at market rates.

There is a tendency to look at the capital-market experience of the United States and conclude that the operative constraint on inter-sectoral capital flows is the lack of a suitable instrument, such as a mortgage-backed security, that can match the long-term capital held by other institutions with the long-term mortgages needed to finance housing. Unfortunately, in Honduras the constraints are more basic than this.

### Repayment Risk

Mortgage lending, especially to the mass market, is perceived as involving a high degree of repayment risk. Unless this risk is eliminated, it is unrealistic to expect pension funds, insurance companies or other cash-rich institutions to invest in mortgage paper.

The repayment experience of some sectoral institutions tends to confirm the perception of riskiness in mortgage lending. At year-end 1987, INVA reported that its total delinquent accounts amounted to nearly 70 percent of its loan portfolio; over 51 percent of all loans were delinquent by more than 12 months.[6] The collection record of savings and loan associations is better, though the S&Ls cite repayment risk as the principal reason that they are unwilling to lend from own resources for the mass market.

Still, there are organizations serving the mass housing market that have maintained good repayment records. As of June 1988, FEHCOVIL had a delinquency rate of only 2.28 percent, rising at year end to 3 percent. The CHF housing program operating through FACACH reports a delinquency rate of less than 5 percent. Commercial banks have better-than-average repayment experience on real estate loans, though these are targeted for the affluent market.

Clarification of delinquency experience is an urgent priority for Honduras' shelter sector. The very facts regarding the repayment records of different institutions are unclear, because there is no external auditing of delinquency accounts, no public reporting of delinquency experience, and no uniform standard for calculating loan delinquencies. It is customary in Honduras to report delinquencies as the ratio of (payments due but not made) to (total loans outstanding). This figure is always far lower than the figure used in the United States and by some other Honduran institutions to report delinquencies, which is the ratio of (the total outstanding loan value of delinquent loans) to (total loans outstanding). Any program designed to increase domestic capital flows to housing lenders will have to first pierce the veil of ignorance surrounding repayment risk, for different classes of borrowers and different types of lending institutions, so that the market can properly assess the risks involved and the costs of insurance schemes can properly be estimated.

There are additional constraints, beyond low household incomes and poor collection practices, that help account for the wide divergence in repayment experience. One key factor is the employer's ability to withhold mortgage payments from payroll. The public pension plans enjoy their low delinquency experience because mortgage payments are withheld at source. Another important factor is the applicable foreclosure law. Court-ordered foreclosures under regular law require an average of two years to execute, and lending institutions go to great lengths to avoid foreclosure. Housing cooperatives, however, operate under different foreclosure standards. FEHCOVIL has taken advantage of the greater flexibility to achieve its very low delinquency rate. When members join a housing cooperative, they enter into a contract agreeing to abide by its rules, including the cooperative's right to evict them if they miss three monthly payments. Title to the properties is retained by the cooperative until the loan is fully repaid; thus, the cooperative can circumvent the regular foreclosure process in the event of default. FEHCOVIL reports that its eviction process takes about six months. The more cumbersome foreclosure law applying to the rest of sector adds to repayment risk.

**Term Intermediation Risk**

Although lenders have been shortening mortgage terms, residential mortgages remain the longest-term debt instruments in Honduras. Since mortgages are issued only at fixed interest rates, and, except for FOVI discounting, must be financed from short-term (maximum one-year) deposits, the lender assumes all of the risk associated with future inflation, future interest-rate escalation, and future devaluation. He also faces the possibility of liquidity risk, if economic events should influence savers to withdraw their deposits.

From the point of view of housing finance institutions, these risks could best be countered by matching long-term mortgage obligations against the long-term savings of other institutions. Such practices, however, merely transfer the risks of holding debt to the institutions generating the savings. If liquidity risk were the most important constraint, pension funds and insurance companies might be willing to make long-term commitments, since they face a time profile of cash demands that can be identified beforehand through actuarial studies. In Honduras, the much greater risk is the risk of future interest-rate and price changes. Even when pension funds and insurance companies buy government housing bonds from FOVI, they require bonds that are payable upon demand, in order to minimize their financial risk. The institutions emphatically stated in our discussions that they would not voluntarily buy mortgage-backed securities without a similar option to exchange them for cash upon demand.

**Institutional Preference to Use Savings on Behalf of Members**

Pension funds will be the fastest-growing source of savings over the next decade. The apparent decision of the pension funds to support housing investment directly, by building houses and providing mortgages for members, rather than by depositing funds in other financial institutions, will have a large impact on the structure of the housing finance system.

On the surface, the decision is a perverse one in almost every respect. The pension funds must turn themselves into banks in order to process mortgage applications and collect mortgage payments, and must act as developers to build their own housing projects. They have not proved to be efficient housing developers. One INJUPEMP project has stood vacant in Choluteca for several years. Another, underway in San Pedro Sula, still has no buyers.

Moreover, the pension funds are able to deliver housing only to a small fraction of their membership. Even INJUPEMP's 1988 production level of 789 units is modest in relation to its membership of 35,000. In the meantime, by making mortgage loans at below-market rates, the funds would seem to be jeopardizing their ability to pay future pension benefits.

From the members' perspective, however, the situation looks very different. The members have been promised pensions at a fixed-benefit rate, in return for their contributions to the pension system at a fixed rate. If earnings from contributions and investments do not suffice to pay the promised benefit, the GOH has an obligation to make up the shortfall (which obligation, of course, it may or may not honor). INJUPEMP reports that its actuarial studies indicate that it has a fully funded pension system, based on current contribution rates, even while making below-market mortgage loans. In these circumstances channeling all housing loans to members at below-market rates has the effect of increasing members' total compensation. If INJUPEMP used its funds instead to purchase mortgages from the S&L system, it would merely generate an actuarial surplus that would be of no use to its membership. The potential gains for those now receiving mortgages from the pension funds are large. An average loan of Lps. 30,000, made at INPREMA's interest rate of 9.5 percent rather than 18 percent, saves Lps. 212 in monthly interest at the outset, or almost 25 percent of the average teacher salary. Moreover, the actual repayment period is three times as long as that available from standard financial institutions.

The unwillingness of public employees to share the benefits of their forced saving with others is understandable, especially in view of the losses in real salaries that they have suffered in recent years. It is this fact that makes voluntary transfers of capital from the pension plans to other housing institutions unlikely, regardless of the secondary instruments that are authorized.

## Summary

The constraints preventing a better flow of domestic capital into publicly accessible institutions in the housing sector are real ones. The pension funds want to internalize their housing investments by providing below-market housing to their membership. Virtually all savers are unwilling to lend long-term to other institutions, at least within legal interest-rate ceilings. There is widespread fear of the repayment risk involved in financing home mortgages for the mass market.

Unanimously, our interviewees summarized this analysis by stating that they would purchase mortgage instruments only if these were guaranteed by the GOH and payable upon demand. In effect, they are unwilling to transfer greater sums to specialized housing institutions through market mechanisms. Instead, they demand a full faith and credit guarantee from the government. This implies that it would be the government that dictates inter-sectoral capital flows, by deciding which sectoral credits it will guarantee and in what amounts. The pension funds indicated that even in this case, their purchase of mortgage-backed securities would substitute for deposits in the commercial banks and S&Ls, not for housing production for their own members.

## THE LAND CONSTRAINT AND URBAN UPGRADING

The great majority of low-income urban housing is being built progressively through the informal sector. Such housing does not meet adequacy standards when first built, but is gradually upgraded over time. Land is critical to this process, and in this section we examine the principal land constraints impeding better performance in progressive housing construction.

### The Pattern of Land Development

Years of migration to the cities has diminished the supply of vacant, developable land. The land constraint is most binding in Tegucigalpa, where development has had to move farther up the hillsides and to more removed peripheral areas. Land supplies in San Pedro Sula are more abundant. It is estimated that at recent development rates, San Pedro Sula still has almost 15 years of vacant land supply within its urban boundaries.[7] Land supplies are not a serious constraint on development in most secondary cities.

The pattern of urban development is dictated both by the location of vacant land and the nature of its ownership. Invasions tend to move first into publicly owned land, then into land owned by "weak" private interests that are unwilling or unable to dislodge invaders. At the same time, on the supply side of the land market the activities of lotificadores determine which parcels of land will come onto the market for sale. Because price is the paramount consideration of most households seeking lots, current land development tends to take place in locations that are without public infrastructure and where access is difficult. The far-flung locations of new development, in turn, deter the urban upgrading process. Installation of roads, even if unpaved, water service, and minimal wastewater removal all require community investment. The low land values that attract households in the first instance are associated with higher social costs to equip the areas with basic infrastructure, and become a constraint on community upgrading.

Under current practice in Honduras, residents are not charged the cost of extensions of main water lines or roads, and thus there are no price signals to discourage location decisions that inflict high social costs.

## Land Development Standards

In theory, the law requires that private land owners fully install community infrastructure before offering land parcels for sale.[8] In practice, most land has been sold without infrastructure. The law then allows the municipal government to intervene by taking over the land, installing the infrastructure itself, and asserting legal claim to occupants' land purchase payments until the costs of infrastructure installation have been recovered.

The basic presumption behind this law defies the logic of progressive upgrading. A large part of the market cannot afford to buy fully serviced land. If landowners in fact complied with the law, land prices would be so high that most households could not satisfy their need for land through the market. Even more households would then be forced into illegal invasions. The entire premise underlying progressive upgrading is that both the individual house and community facilities will be improved gradually over time, as households acquire the ability to pay for upgrading.

Although the development standards law has not been enforced to prevent raw land sales, the AMDC in particular has used the law to intervene in numerous cases. Fourteen communities were formally intervened as of 1987, where the local government had seized land payments and was installing infrastructure at its expense. This process leaves the ownership of the land in legal dispute, and discourages the private market from supplying land without infrastructure. The legal imposition of unrealistic infrastructure standards ends by curtailing land supply, driving up land prices, and precipitating invasions.

## Land Ownership

Partly as a result of the above process, a good deal of land, especially in Tegucigalpa, is embroiled in disputes over ownership. It is estimated by INVA and the AMDC that more than half the informal settlements in Tegucigalpa lack clear land title.

In other Latin American countries, it has been demonstrated that lack of clear title deters residential owners from making improvements to their houses.[9] Owners are unwilling to commit savings to home improvements if they run the risk of losing their property. Provision of good title has been found to be a cost-effective way of generating additional investment in home upgrading.

Within Honduras, there is some skepticism regarding this impact. AID programs to provide rural land titles have been premised on a similar expectation that small farmers would invest in land improvements once their ownership status was formally resolved. However, follow-up studies have reported very little investment of this kind.[10] Since, after their first year of residence, urban occupants enjoy a good deal of de facto security against displacement, it is argued that they, too, may have already carried out all the investment in improvements that they find economically beneficial, and that cleaning up land titles will have little effect on households' shelter investment.

It should be recognized, however, that for an informal sector family, the house incorporates virtually all the family's savings, plus borrowing from others. Even a small risk of losing the investment, through someone else's effective claim of title, would reasonably discourage a risk-averse household from making further investment. Surveys in Tegucigalpa indicate that households report it is their intention to invest in housing improvement once title is resolved.[11]

This is a question that is best answered empirically through demonstration projects. In the past few months one community has entered into an agreement, under INVA auspices, to purchase from private owners the land it invaded.[12] There are plans to provide the area with financing for home improvements and to support community financing of infrastructure facilities. This experiment should be monitored closely to determine just how much of an impact on upgrading title resolution has in the Honduran setting.

## RENTAL MARKET CONSTRAINTS

A large part of the urban poor population in Honduras lives in rental accommodations. The rental market, however, has been virtually ignored by official housing policy.

Data on tenure status are not yet available from the 1988 Census, but in 1974 it was found that almost half of all families living in Tegucigalpa were renters. (Of a total housing stock of 47,000 units, 22,800 were owner-occupied, 22,100 were occupied by renters, and 2,100 had "other" status.) A total of 12,900 units, more than a quarter of all occupied housing and more than a third of mass market housing, consisted of only a single room in cuarterias or mesones. These are rooming houses, usually made of precarious materials, where the occupants share toilet, laundry, and water facilities. A study conducted by the Unidad de Investigaciones y Estadisticas Sociales de la Municipalidad de San Pedro Sula found 5,200 rooming units in San Pedro Sula, in what was described as a partial inventory of cuarterias, and estimated that just under 30 percent of the city's poor and moderate income popoulation lived in rental housing.[13]

Cuarterias often are a product of the land settlement process. Informal-sector households build separate rental houses at the back of their lots, or may add on rental rooms to their own dwellings in order to generate income. Other cuarterias are large dwellings in the old part of town that either were originally built for rental to low income families or have been subdivided for this purpose.

The 1988 Census will reveal rental trends specific to Honduras, but elsewhere in the region and in other countries it has been found that, despite public policies that strongly favor owner-occupancy, the proportion of rental housing is holding constant or even rising.[14] This development is fueled by the disappearance of easily invadable land in large cities, and by rising urban land prices, both of which make owner occupancy more difficult to achieve.

Cuarterias fill various special niches in the low-income housing market. The closest detailed household surveys of those living in cuarterias are for San Salvador.[15] In many respects the surveys there reveal surprising findings. The rental households living in cuarterias were found to have lived in the same unit for a longer period of time (average:

6.6 years) than the average squatter or slum family living in its own house. Heads of household had an average of 2.5 years more education than the average head of an informal sector family living in its own dwelling unit. There was obvious specialization in work, and housing budgets, as well. The overwhelming majority of household heads living in cuarterias worked in informal services and commerce, and lived much nearer to where they worked. Unlike families living in their own units, relatively few (6 percent) performed income-earning activities in their homes. Rental households were, on average, younger and more likely to be headed by a female than other informal-sector households.

Although generally ignored by public policy throughout Latin America, the importance of cuarterias to urban housing supply was dramatized in San Salvador when an estimated 800 mesones holding 9,000 families were destroyed by the October 1986 earthquake. When rebuilding options were examined, it became clear that the households' own housing goals could be achieved much less expensively by building or rebuilding rental housing than by building independent units.

It is not clear how efficiently the rental housing market is performing in either Tegucigalpa or San Pedro Sula. The UMVIDE study reports an average rental cost of 55 lempiras per month for a single room, a much higher price per square meter than owner-occupants of separate units pay. A study of Tegucigalpa households moving into early INVA projects found that the average rental payment before moving had been 82 lempiras per month (median: 60), and that a large majority of households regarded their housing situation as improved after moving.

At least two potential constraints on the rental housing market deserve examination. One is the impact of Honduras' rent control law. Studies in other countries have found that the combination of rent controls and restrictions on informal sector invasions can cut into the supply of available low income housing and drive up housing prices in both markets.[17] Honduras rent controls, however, may be supervised so laxly that they do not have a significant impact on supply.

Probably more important is the difficulty of obtaining capital for rental construction. In the San Salvador survey it was found that the great majority of cuarteria owners were themselves members of the informal sector, and that more than half of the owners lived in the meson they rented. In trying to obtain capital, they were handicapped by their informal-sector status, as well as by the absence of any government programs that supported capital supply for rental investment.

Given the importance of rental housing to the urban housing market, it is important to determine how well the rental submarket is performing, and whether public policy can intervene effectively in removing constraints on it. At present, public policy has elected to tilt strongly in favor of owner-occupied individual units, but a rationale for this uneven intervention has never been spelled out.

**Footnotes, Chapter 3**

1. CONSUPLANE, Politica Nacional de la Vivienda (1986).

2. INVA, Plan de Vivienda, 1988-2000 (1988).

3. Michel Chretien, Contractual Savings Schemes for Housing: International Comparisons and Applications in Developing Countries (World Bank Discussion Paper UDD 92, 1986); Robert C. Vogel and Paul Burkett, Mobilizing Small-Scale Savings (World Bank Industry and Finance Series, Vol. 15, 1986); V.V. Bhatt and Jacob Meerman, "Resource Mobilization in Developing Countries: Financial Institutions and Policies," World Development (Vol. 6, No. 1, 1978), pp. 45-64.

4. For example, in a carefully controlled survey of 550 Indian households, regression analysis found that participants in the Home Savings Plan, a contract savings scheme offered by the Housing Development Finance Corporation of Bombay, saved about 5.3 percent more of their assets in financial form than control households, and had a total household saving rate that was 3.7 percentage points higher. That is, average household savings, after control for other variables, increased by approximately one-third. Raymond J. Struyk with Mark Friedman, The Impact of Housing-Linked Contract Savings Schemes on Households' Holdings of Financial Assets in India (Urban Institute: 1989).

5. Webb, et al., Credit Policy in Honduras in the Context of Macroeconomic Constraints (op. cit.). On the displacement effect of easily accessible credit lines in other sectors, see the series of papers in Dale W. Adams, D. H. Graham, and J. D. Van Pischke (eds.), Undermining Rural Development with Cheap Credit (Westview Press: 1984).

6. See Chapter 2, Appendix I of this report.

7. UMVIDE and PADCO, Urban Land Study for the Municipality of San Pedro Sula, 1989-2001 (1989).

8. Decreto Ley No. 833 (1978).

9. E. Jimenez, "The Value of Squatter Dwellings in Developing Countries," Economic Development and Cultural Change (Vol. 30, No. 4, 1982) pp. 739-52; E. Jimenez, "Tenure Security and Urban Squatting," Review of Economics and Statistics, (Vol. 66, No. 4, 1984) pp. 556-67.

10. Grenville Barnes, The Cadastre-Based Land Information System in Honduras (Land Tenure Center, University of Wisconsin, December 1987).

11. Instituto de la Vivienda, Estudio de Prefactibilidad para el Proyecto de Legalizacióny Ordenamiento de Terrenos Urbanos Invadidos y Mejoramiento Habitacional, PROLOTE (May 1988).

12.Residents of the colonia Izaguirre, who have occupied their parcels for eight years, have agreed to purchase the land from the original private owners at a price of Lps. 9.41 per square vara.

13. UMVIDE and PADCO, Urban Land Study for the Municipality of San Pedro Sula, 1989-2001 (1989).

14. For example, one-third of the population of Mexico City now lives in rooming houses. Living Conditions in Developing Countries in the Mid-1980s: Supplement to the 1985 Report on the World Social Situation (United Nations: 1985).

15. These are reported in Maria Tova Solo, Mesón Reconstruction Programs for El Salvador (Report prepared for Cooperative Housing Foundation, 1988).

16. Kerley et al., "Investigación sobre la Vivienda Progresiva en Honduras y Costa Rica" (op. cit.)

17. Graham Tipple, "The History and Practice of Rent Control in Kumasi, Ghana" (World Bank: 1987).

# CHAPTER FOUR

# SHELTER SECTOR POLICY CHOICES AND RECOMMENDED POLICY AGENDA

This section examines the main policy choices facing the shelter sector, and recommends a priority policy agenda. The order of policy discussion follows the listing of constraints in Chapter 3.

## SHELTER SECTOR STRATEGY

Honduras urgently needs a coherent national shelter policy and a strategy for implementing it.

It is apparent that none of the institutions now operating in the sector can by itself command the credibility to frame such a strategy. Nor can any of the existing institutions chair a working committee that will enlist the effective participation of other sectoral institutions. SECPLAN and INVA already have tried such approaches, and failed.

Honduras should form, and USAID should support the formation of, a joint public-private committee, under the chairmanship of the Office of the Presidency, charged with establishing overall sector goals and policy, and designing a sectoral financing and implementation strategy. The committee should be composed, at a minimum, of representatives of the savings and loan associations, credit unions, commercial banks, public pension funds, insurance companies, housing cooperatives, other PVOs operating in the shelter sector, and the Central Bank, FOVI, INVA, SECPLAN, SANAA, and local government.

Over the past three years, since the United Nations Commission on Human Settlements (UNCHS-Habitat) recommended the development of explicit national shelter sector strategies,[1] a number of countries have done so, and a good deal of evidence has been accumulated regarding the approaches that have had greatest impact.[2] One essential characteristic is that the group developing sectoral policy represent both public and private sector organizations. Another is that the group not be chaired by one of several parallel implementing organizations in the sector, but by a representative of the Prime Minister or President, who can effect policy changes, including changes in credit policy, where appropriate. Finally, it is essential that the committee be supported by a fully staffed secretariat that can assemble data, track down laws and regulations, and perform analytical studies for the committee; and that a core working group be selected from the larger committee, which will be responsible for the preparation of work products.

In the case of Honduras, it would be logical to work with the President-elect, so that upon his accession to office, such a shelter sector policy committee can be set up at once, with a mandate to prepare a sectoral strategy statement that has the endorsement of participating parties within a specified time frame, such as six months. The resulting strategy would provide a framework for external funding support as well as for GOH internal policies.

## FINANCE POLICIES

### Savings Mobilization and Mortgage Finance for Below-Median Income Households

A dual strategy should be followed to enhance the contribution of shelter finance institutions to domestic savings mobilization. To help generate savings from the informal sector, mortgage-linked savings plans should be introduced by institutions serving this part of the population. To increase the domestic savings contributions of the savings and loans, the terms of external lines of credit should be revamped so that foreign savings can be tapped only on a matching basis--i.e., only if resources raised from deposits are targeted to the same mortgage market. Policy priority should be given to a study of how competition in the S&L industry can be increased.

(a) Mortgage-linked savings plans.[3] It was pointed out in Chapter 3 that moderate income households have been shown to increase their rate of savings when doing so will make them eligible for mortgage finance or other borrowing opportunities. Most of the recent proposals for housing finance reform in Honduras have incorporated the idea of contract savings, wherein households become entitled to receive a mortgage loan once they have met a certain threshhold of savings (in both time of regular deposits and amount saved). However, they also recommend establishment of a new national housing fund, financed largely by government and employer contributions.[4] Since the GOH is not paying the government obligations it now owes for social security (and only part of the obligations it owes as employer), it is unrealistic to expect that it can make a new additional contribution, pegged to salaries but earmarked for housing. Employers also will resist a mandatory payroll contribution of this kind. (If the GOH can afford payroll contributions, its priority should be to fund its obligations under the Social Security system, whose unfunded status threatens a future policy crisis.)

Instead, there exist many opportunities for voluntary contract savings arrangements within the existing private sector financing system. The GOH and USAID should support:

✦Linking S&L mortgage lending and housing development to regular saving from employee paychecks in private companies. Payroll withholding produces the greatest financial savings among moderate-income households and virtually eliminates mortgage repayment risk. It is the mechanism used to fund employee contributions to public pension plans, and several years ago was used successfully by Banco Atlantida in a housing program sponsored with private companies. Employees voluntarily join the savings plan. Once they are enrolled, regular savings are withheld by the employer, until enough savings are accumulated to qualify for a mortgage in a company-sponsored housing development. Thereafter, continued withholding is used to pay off the mortgage.

✦Voluntary contract savings plans, wherein an S&L or commercial bank promises to provide mortgages to savers meeting published standards with respect to length and regularity of savings and amount saved. Two banks currently operate modest programs of this type. They can and should be expanded.

✦Voluntary contract saving plans operated by credit unions or jointly by credit unions and housing cooperatives, under which savers become eligible for mortgage financing once a threshhold of regular saving through the credit union is reached (see Chapter 3 of Appendix II).

USAID should encourage contract savings by setting aside a portion of its HG credit lines to finance mortgages for such programs. An external line of credit is essential to program success, since the majority of contract savers, while adding to total savings, eventually become net borrowers under the scheme. When first set up, contract savings schemes almost always generate demands for mortgage credit that exceed savings internal to the system itself. That is, they partially finance themselves from interal savings, but still must rely on credit provided through the rest of the housing finance system.

(b) Matching Requirements for External Credit Lines. To generate more domestic resources from savings and loan associations, those S&Ls drawing on HG lines of credit through FOVI should be required to match HG funds with some of their own capital, raised from deposits. That is, savings and loan associations should be required to allocate some of their own capital to the target market as a condition of program participation. This requirement, if effective, would both augment capital flows to this segment of the housing market and provide incentives for adding to overall deposits, in order for S&Ls to continue to serve the profitable upper income mortgage market. To make participaton attractive, the capital matching requirement should be accompanied by relaxation of the mortgage rate ceiling on loans financed by the funds.

(c) Competition in the Savings and Loan Industry. The S&L industry is structured to avoid competition where possible. Developers who are members of the same financial consortium have preferential access to development loans, often to the exclusion of other developers. S&L mortgage lending is tied to construction lending by a commercial bank member of the same financial group. As the industry is now structured, there is no incentive for individual S&Ls to expand, by providing credit to rival developers or competing vigorously for deposit growth.

One option to infuse greater competition involves regulatory policy. Regulators should make clear that the introduction of innovative savings plans by S&Ls and rate competition on deposits is encouraged, not prohibited.

More fundamental steps will require greater understanding than we now possess of the S&L industry structure, and its effect on lending and deposit behavior. A study should be commissioned of the economics of the savings and loan industry, and alternative strategies for augmenting competition. Among policy alternatives to be considered would be requiring S&Ls to sever ownership ties with individual developers or commercial banks, and steps that would encourage new entry into the industry. Completion of such a study should be a prerequisite to reform of the S&L law, which as proposed by the industry would increase S&Ls flexibility in lending and lower their cost of funds (see Chapter 2, Appendix I).

## CHANNELING CAPITAL TO THE HOUSING SECTOR

A program to boost domestic capital flows to housing and channel large volumes of external resources to the low-income market must deal with the specific constraints that now impede these flows.

### Capitalizing Mortgage Funds through Nonconventional Lenders

To greatly increase mortgage flows to the mass housing market it will be necessary to enlist the participation of nonconventional financing institutions (NCFIs). These also are the institutions that can most reward administrative strengthening. Whereas the S&Ls do not see below-median income households as their natural market, the NCFIs view home finance for this group as their mission. NCFIs have a number of advantages over more traditional lenders in addressing low-cost housing needs. Of foremost importance, they are generally situated in low-income communities, working alongside intended beneficiaries. They are viewed with less skepticism or distrust than government-sponsored agencies, and have specialized in providing financing to the market. By utilizing existing community affiliations, they can exert peer pressure to bring about loan recovery.

With the grant resources it has committed to the shelter sector, USAID should give priority to setting up revolving mortgage funds in selected NCFIs. Grant monies could be blended with HG loans or domestic borrowing to establish larger funds that still can draw upon below-market capital. In operating the revolving funds, lenders would be expected to charge interest rates close to those prevailing in middle-class mortgage markets, but would be expected to pay for all operating costs and default losses from the interest-rate spread. Such a model builds on the experience that USAID has had with rural housing programs, where PVO lending for rural upgrading has been financed in similar fashion through INVA. The Cooperative Housing

Foundation also has nurtured programs of this type, working in conjunction with USAID. The analysis in Chapter 3, Appendix I suggests that NCFIs could support an initial urban lending activity at the level of some Lps. 50 million.

To help strengthen cost recovery standards, NCFIs could qualify for seed capital only after an independent audit confirmed that default and delinquency levels did not exceed prescribed maximums (see below). To help strengthen domestic resource mobilization, NCFIs could be required to meet the same type of domestic-resource matching imposed on S&Ls, perhaps through housing-linked savings plans. Subsidized mortgage funds would be available only to highly-targeted income groups.

## Combating Repayment Risk

The provision of domestic capital to the shelter sector is greatly hampered by ignorance regarding true repayment risk. No reasonable policies for attracting market-based capital to the sector can be devised until this ignorance is removed.

✦Reporting and Audits. Uniform standards for reporting mortgage delinquencies and defaults should be established and imposed by regulation on all mortgage lenders. Minimum standards for reserves to cover bad mortgage loans should be established. All mortgage lenders should be required to report regularly on delinquency experience and reserve adequacy. Annual external audits should be required of all sector lenders in order to enforce accurate, timely reporting.

✦Analysis of Delinquency Experience. Once the data on delinquency experience have been compiled, a study should be commissioned which examines and compares the delinquency and default experience of different sector lenders, and analyzes the reasons for the observed differences. Special topics to be covered in the analysis would include the importance of foreclosure laws in repayment experience,[5] and the importance of payroll withholding as a means of reducing repayment risk. Recommendations for changes in collection procedures, foreclosure regulations and other policies would be made.

✦Analysis of Insurance Options. Once in possession of delinquency and default data, the economics of insurance schemes can be analyzed. A study should be commissioned that examines the adequacy of the current 1 percent charge by S&Ls for default risk, as well as the reserve practices of other sectoral lenders. The study would estimate the costs of reestablishing a self-financing FHA-type insurance scheme, and the marketing appeal that FHA-type insurance would hold for potential suppliers of capital to the shelter sector, by protecting against repayment risk.

The financial sector's demand that capital provided to housing institutions be backed by government guarantees (in addition to mortgage and/or institutional security) should be resisted. The housing sector must establish that it can meet the test of market creditworthiness.

**Combating the Risks of Term Intermediation and Inflation**

The financial risk of being tied to long-term, fixed-rate mortgages also has deterred capital flows into the shelter sector.

Adjustable Rate Mortgages

From the perspective of the supplier of credit, the risks of inflation are best guarded against by adjustable rate mortgages (ARMs), where the interest rate is tied to an economy-wide interest rate or price index. These instruments shift financial risk to the borrower. An analysis of the feasibility of introducing ARMs into the Honduran market should be conducted. Such a study would examine:

✦Whether the mortgages now being written serve as partial ARMs. Mortgages at present commonly contain a provision allowing the 17 percent interest rate to be raised if the government ceiling on mortgage rates is changed; however, the legal status of this provision is unknown.

✦Whether there are satisfactory price or interest-rate indices in Honduras to which future ARMs interest-rate adjustments could be tied.

✦The market acceptance of ARMs. This would include analysis of whether there is likely to be consumer acceptance of ARMs; whether large potential suppliers of capital to the shelter sector would be willing to provide greater volumes of funds if protected against interest-rate or price fluctuations; and whether S&Ls and other mortgage lenders would pass on to consumers, in the form of lower mortgage rates, a reduction in their cost of funds or reduction of risk.

**Public Pension Funds as Housing Investors**

A fundamental policy choice affecting the shelter sector is whether pension funds should be required to withdraw from direct housing development and mortgage financing. In favor of such a requirement is the fact that pension funds are in the process of becoming inefficient bankers and developers, while impeding market-based flows of capital, and creating the risk of future unfunded pension liabilities. Against a prohibition of pension fund housing activity is the fact such action would halt the fastest growing source of housing finance, and almost certainly not to be replaced by voluntary transfers of the same magnitude to other housing institutions. Such a policy also would be seen to involve income redistribution away from pension fund members, which would engender political resistance.

Full market-based allocation of capital probably is too much to expect in the Honduran context. A compromise policy should be sought which requires the pension funds to move their mortgage interest rates for members toward market rates, while enforcing the fiduciary responsibility of the funds to earn adequate returns on all investments. Priority should be given to having the pension funds withdraw from direct housing development, where their greatest inefficiency is to be found. Pension funds would still be allowed to finance member mortgages at moderately preferential rates (a practice that is found in many developed countries, as well).

## Other Housing Finance Policy Priorities

Other, specific policy reforms that should be incorporated in a shelter sector strategy are:

✦Unification of Financial Sector Regulation. At present, regulation of the housing finance sector is chaotic. The Superintendency of Banking and Insurance regulates and supervises commercial banks, savings and loan associations, insurance companies, and INJUPEMP. The Controller General regulates and supervises INPREMA and INVA; the Institute fo the Development of Cooperatives regulates credit unions and housing cooperatives. The Military Pension Fund is independent. There is widespread feeling that FOVI exercises *de facto* regulatory control by virtue of its rediscounting criteria. If common financial policies are to be enforced throughout the sector, a unified regulatory system must be established.

✦Introduction of a FOVI Liquidity Facility. One factor that the S&Ls cite in explaining their reluctance to expand mortgage lending aggressively is liquidity risk. A FOVI liquidity facility could offer stand-by liquidity in the event of deposit withdrawals or a sudden refinancing of longer term obligations.

✦FOVI Rediscounting Facility. FOVI rediscounting gradually should be reoriented to provide financing to PVOs that serve the mass housing market. FOVI should work actively with PVO applicants to help them meet FOVI's requirements, both as institutions and in developing eligible mortgage packages for rediscounting. Once FOVI determines that a participating institution is competent and well managed, it should be prepared to rediscount its mortgages on certification that they meet FOVI's requirements. FOVI can restrict itself to spot checking the underlying mortgages, without detailed project review. That should be the function of the construction lender at the institution providing the bale-out financing.

## LAND POLICY

Two policy priorities should be established for the land market:

✦Support should be given to the PROLOTE program, which seeks to resolve legal title disputes on invaded or intervened land through voluntary purchase agreements between residents and the original private owners. INVA's initial agreement regarding colonia Izaguirre should be monitored closely to establish a rigorous basis for projecting the individual upgrading investment that can be induced by title resolution, with or without supporting investment in community infrastructure. If the experiment is successful in inducing investment, USAID/H should provide capital funds to expand the acquisition program. FEHCOVIL and other PVOs can serve as intermediaries in this process as well as INVA.

✦Financing of basic cost-recovery infrastructure at the community level should continue to be a priority (see succeeding chapters of report).

## RENTAL MARKETS

Because so little is understood about urban rental markets in Honduras, a study should be commissioned which would:

✦Analyze trends in rental occupancy as revealed by the 1988 Census of Housing.

✦Rigorously compare the costs of rental housing in different submarkets with the costs of owner-occupied housing.

✦Gather and analyze data on the demographic and income characteristics of rental occupants and owner-occupants in different submarkets.

✦Analyze the rate of new investment in low-income rental housing, the sources of capital finance, nature of investors, and obstacles to greater investment.

✦Examine the nature of rent control loans and their enforcement.

✦Conduct household surveys on the relative satisfaction with housing quality and costs of renters vs. owner-occupants.

✦Draw conclusions regarding the present role of rental housing in low-income and informal urban housing markets and whether there is a public interest in improving or changing the market's functioning.

**Footnotes, Chapter 4**

1. United Nations Commission on Human Settlements, Global Shelter-Sector Strategy (New York: 1988).

2. See the draft comparative case studies of four national shelter strategies (Kenya, Jamaica, Barbados, and Zimbabwe) prepared by The Urban Institute for the project, "Improving National Shelter Sector Strategies."

3. For further detail on the possible functioning of such plans in Honduras, see Phillip Rourk et al., Developing a Housing Finance Strategy for Honduras (The Urban Institute: 1986), and Banco Atlantida, El Ahorro como Fuente de Financiamiento Habitacional (Tegucigalpa: 1987).

5. For a recent example of this type of analysis, see David M. Madway, Revision of India's Mortgage Foreclosure Laws (The Urban Institute: February 1989).

## CHAPTER FIVE

## URBAN DEVELOPMENT:
## SECTOR GOALS AND SECTOR PERFORMANCE

### GOALS

Goals for the urban development sector are:

(1) To improve the quality, coverage, and cost-efficiency of local public service delivery. Local public services include drinking water distribution, wastewater disposal, health care, education, road construction and maintenance. These services are now provided by a mix of national and local government agencies.

(2) To strengthen local democratic institutions as the base for democratic decision making throughout Honduras. In particular, this goal assigns to elected local governments responsibility for establishing local budget priorities and setting expenditure levels that local citizens are willing to pay for through local taxes and service fees.

(3) To have local governments and the local private sector contribute to national development objectives through local investment and local economic planning.

The Government of Honduras, municipal government leaders, and USAID/Honduras have tentatively identified a strategy for achieving the objectives listed above--namely, through decentralization to local governments of part of the decision-making authority now exercised by central government. This strategy is so critical to sectoral policy that its successful design and implementation may be regarded as a priority "goal" in itself.

### OVERVIEW OF SECTORAL PERFORMANCE

The local government sector in Honduras needs strengthening in almost every respect. However, policy targets must be set selectively, with a commitment to assist in the implementation of changes over a number of years. The history of reform in the sector is one of excessively ambitious attempts at change, incorporated quickly in new laws or new institutions, but frustrated in the field by the inability to alter deeply ingrained practices.

## Centralization and Fiscal Structure

Although Honduras has a highly centralized structure of government, it has a greater base of local revenue raising on which to build than most other countries in Central America. Table 5.1 compares central, provincial, and local government shares of public revenue generation for a variety of Latin American nations. The share of public revenue raised by local governments in Honduras is higher than in other Central American countries, and even above the midpoint for the rest of Latin America. The principal difference in fiscal structure between Honduras and the larger, federalist nations is the absence of an intermediate layer of government that raises revenue and makes expenditures.

Nonetheless, the budgets of most Honduran municipalities are very small, and prevent local governments from taking on broad service responsibilities. In 1986, 65 percent of total local sector revenues were raised in Tegucigalpa and San Pedro Sula, which together had only 20 percent of the country's population. The other 287 municipalities raised an average of only Lps. 8.20 per capita.

A final distinguishing characteristic of Honduras' fiscal structure is the extremely low level of transfers from central to local government (Table 5.2). Over the period 1983-86, central government subsidios, subvenciones and other central transfers ranged from Lps. 1.8 million to Lps. 5.7 million per year.[1] This figure does not measure the full extent of central government assistance to localities (see Table 6.1), because it excludes local capital projects built by the central government, as well as emergency loans to municipal governments that may not be repaid, but it indicates that the "formal" transfer system is a very small part of Honduras' fiscal picture. Intergovernmental financing has grown somewhat since 1986, as a result of the one-year revenue sharing plan adopted in 1986-87 and the sharing of a portion of port revenues with local governments. However, transfers remain well below the norm for the region. The transfer program included in the proposed municipal law, which would distribute 5 percent of central government revenues to localities, reflects parallel changes that have been proposed or adopted in many other Latin nations--e.g., Guatemala

Table 5.1

**Revenues by Level of Government**
**(Percent, Average 1981-84)**

| Country and Level of Government | Percentage of General Government Revenues |
|---|---|
| Central America | |
| Costa Rica | |
| Local Government | 3.4% |
| Central Government | 96.6% |
| Guatemala | |
| Local Government | 5.1% |
| Central Government | 94.9% |
| Panama | |
| Local Government | 2.4% |
| Central Government | 97.6% |
| **HONDURAS** | |
| **Local Government** | **7.7%** |
| **Central Government** | **93.3%** |
| Other Latin America | |
| Argentina | |
| Regional Government | 27.1% |
| Central Government | 72.9% |
| Bolivia | |
| Local Government | 7.0% |
| Regional Government | 20.9% |
| Central Government | 72.1% |
| Brazil | |
| Local Government | 2.7% |
| Regional Government | 21.0% |
| Central Government | 76.3% |
| Chile | |
| Local Government | 7.4% |
| Central Government | 92.6% |
| Colombia | |
| Local Government | 7.8% |
| Regional Government | 18.7% |
| Central Government | 73.5% |
| Mexico | |
| Local Government | 3.2% |
| Regional Government | 13.8% |
| Central Government | 83.0% |
| Venezuela | |
| Local Government | 1.2% |
| Central Government | 98.8% |

Intergovernmental grants have been consolidated so as to exclude transfers from the revenues of recipient governments.

Source: Guarda, Urban Services Finance and Spatial Distribution Issues in Latin American Countries (World Bank draft discussion paper, December 1988); IMF, Finance Statistics Yearbook, various years; Honduras data from Central Bank of Honduras, Economic Studies department, National Accounts section.

(8 percent investment fund), Colombia (sharing with localities of sales tax receipts), Bolivia (sharing with localities of value-added tax receipts), Brazil (large increase in transfers included in new constitution), and Costa Rica (proposed turnback of central revenues and selected service responsibilities).[2]

Table 5.2

**Central Government Transfers to Other Levels of Government, 1983-85**

| Country Group | Percent of Central Government Expenditures as Transfers[a] |
|---|---|
| Industrial Market Economies[b] | 11.5% |
| Developing Countries[c] | 10.8% |
| Latin American Countries[d] | 8.5% |
| **Honduras** | **0.4%** |

[a]excludes unrecorded expenditures on behalf of local/provincial government by central government
[b]18 countries
[c]scattered sample
[d]Argentina, Brazil, Chile, Colombia, Mexico, Uruguay, and Venezuela

Sources: Guarda, Urban Services Finance; IMF Finance Statistics Yearbook; Honduras budget data.

Comparable data for other Central American countries are not available. However, a useful comparison with Guatemala can be made. As a result of the 8 percent central-government revenue sharing, central government transfers now finance about 85 percent of total local budgets. In Honduras, the proportion of central government finance is about 20 percent.

## Public Service Coverage and Costs

Honduras has an incomplete network of basic service coverage. Table 5.3 summarizes service coverage for cities with population over 10,000, as well as coverage by neighborhood area within the two largest cities. There is a large amount of variation in service coverage between individual municipalities. The general superiority of San Pedro Sula over Tegucigalpa in service provision is evident.

Table 5.3

**Local Public Service Coverage (percent)**

| Service | Secondary Cities (% of 86 urban areas with population over 10,000 with at least partial coverage) | Tegucigalpa (% of 314 communities or population with coverage) | San Pedro Sula (% of 68 communities or population with coverage) |
|---|---|---|---|
| Water supplies | 97 | 77 | 92 |
| (% of population with service)[a] | 51 | | |
| Sewerage | 17 | 62 | 76 |
| Electricity | 76 | 86 | 97 |
| Primary schools | 100 | 69 (in community) | 94 (in community) |
| Secondary schools | 81 | n/a | n/a |
| Health center | 53 | 8 | n/a (high %) |
| Community center | n/a | 21 | 51 |
| Public market | 47 | n/a | n/a |
| Public slaughterhouse | 64 | n/a | n/a |
| Street cleaning/garbage collection | 8 | 70 | n/a |
| Surfaced roads | 19 | 42 | 73 |

[a]Eight largest secondary cities.

Source: BANMA survey of secondary cities, as reported in Inter-American Development Bank, Honduras Municipal Development Program (November 1987); GITEC, Programa Integral de Mejoramiento Habitacional Urbano, Appendix 5 (March 1988); Water service coverage: household connections from BCEOM, Plan de Inversión, SANAA (1987); household occupied units from Census of Housing.

Some idea of local service responsibilities can be obtained from examining expenditure breakdowns for the 86 municipalities that would be eligible for borrowing under the new IDB-BANMA program.[4] The single largest expenditure function of local government now is "street cleaning," followed by operation of the cadastral system. Program spending of all types, however, is overshadowed by spending for "general administration." Between 12 and 13 percent of the budgets of local government are spent on real capital investment.

There are no standardized ways to compare public service quality, but Honduras' low literacy rates, poor child survival rates, and poor record of environmental and water quality all indicate that public service provision is precarious.

## Fiscal Performance of Local Government

The fiscal condition of Honduran local governments can be difficult to decipher, for the simple reason that when faced with a revenue shortfall, most local governments omit some of their legally obligatory payments. This creates the impression that the sector is running a cash surplus, or balancing its budgets, and has led to greatly erroneous interpretations regarding local budget position.[5] In fact, Honduras faces a deep deficit in its local government accounts, one which in proportional terms approximates the central government deficit. In 1986, actual current expenditures plus unpaid legal current obligations exceeded actual current-account revenues by 12.5 percent. Given that municipal governments are supposed to run surpluses on their current accounts, in order to help finance capital expenditures and make debt payments (both treated as capital expenditures), this current account deficit betrays a very weak fiscal condition.[6] The Distrito Central has by far the most dire fiscal situation. However, eight of ten other economically important towns singled out for investigation by BANMA and the World Bank were found to have consistently run current-account deficits as well.[7]

The failure to cover operating costs and repay debt has led to mounting municipal indebtedness and delinquencies. BANMA alone had Lps. 31.2 million in delinquent loan and guarantee accounts from municipalities at the end of 1988 (see Chapter 5, Appendix II).

Municipalities owed a cumulative deficit of Lps. 22.6 million for BANMA capital shares they were supposed to have purchased. Actual interest payments on debt rose from 11 percent of municipal budgets in 1982 to 17 percent of budgets in 1986.

## Local Economic Development and Planning

The national planning law, passed in 1986, is a good example of attempts to legislate fundamental reform without adequate preparation or analysis. The law purports to fundamentally overhaul Honduras' planning system and to establish "bottoms up" economic planning, in which local and departmental governments play key roles. According to the law, each department is supposed to create a departmental planning council, which consists of (1) the political governor, (2) the head of the departmental planning unit, (3) a representative of each of the national departments with offices in the department, (4) a representative of each of the autonomous agencies with offices in the department, (5) a representative of the municipal government of the department capital, (6) a deputy from each political party, (7) a representative (and alternate) of the armed forces, (8) a representative (and alternate) of business organizations for each of the industrial, agricultural, and commercial sectors, (9) a representative (and alternate) of workers' organizations, (10) a representative (and alternate) of small farmers. A similar planning council is supposed to be created at the municipal level, as well as technical planning secretariats at both the departmental and municipal levels. Together, these organizations are charged with preparing local and regional development plans that coordinate local economic development with national economic planning.

This cumbersome apparatus has yet to yield any products. To date, seventeen of the eighteen departments in the country have formally created development boards (all except the Department of Morazan, which includes Tegucigalpa). Eight of these departmental boards now have full-time staff units with at least one technical planning officer. The staff members, however, are paid by SECPLAN, which reveals the strong central authority linkage. As of this date, no plans have been prepared and no departmental development principles have been enunciated. None of the boards prescribed for municipalities has actually been created.

**Footnotes, Chapter 5**

1. Dirección General de Asesoría y Asistencia Técnica Municipal, Ministerio de Gobernación (DGAATM).

2. For more discussion of other Latin fiscal decentralization plans, see Terence Grace, "Analysis of Legislation Impacting Municipal Government in Honduras," in Urban Institute, Vol. IV of Report on Honduran Municipal Law (March 1988).

3. INFOM, Estrategia Global para Enfrentar la Pobreza en el Pais (Guatemala City: March 1989).

4. Special study of BANMA/DGAATM, "Classificación Económica de Ingresos y Egresos" (1987).

5. For example, the Inter-American Development Bank assessment of its municipal development project concludes that "municipal governments have generated surpluses ranging between 14 percent and 33.6 percent of their income, which suggests the presence of a reasonable liquidity margin after coverage of their current and capital expenditures." IDB, Honduras Municipal Development Program (HO-0103) (1987), p. 15.

6. George E. Peterson, James C. Musselwhite, Jr., Jamil Reston and Sarah W. Wines, The Provision of Local Infrastructure Services in Honduras (The Urban Institute, October 1986).

7. World Bank, Municipal Development Pilot Project, Report P-4090-HO (May 1985).

# CHAPTER SIX

# URBAN SECTOR CONSTRAINTS

A number of different constraints prevent local governments from contributing more to democratic decision making and playing a more effective role in public service provision and economic development. This chapter identifies the most important constraints.

## CONSTRAINTS ON LOCAL PUBLIC CHOICE

According to the theory of local public choice, devolution of budget responsibilities to the local level should both strengthen democratic institutions and enhance service efficiency. In this model of the local public sector, citizens vote for the package of local services that they are willing to pay for. Candidates running for local office are expected to advocate, however imprecisely, alternative priorities for locally provided services, as well as alternative proposals about the level or mix of taxes and fees that should be used to pay for them. Local elections convey a mandate to implement the winning platform.

On occasion taxpayer-citizens have the opportunity to vote even more directly on tax and service packages. In the United States, municipal voters in many communities have a chance to vote directly on school budgets and school tax rates; voters in special assessment districts have a chance to vote on special levies to pay for infrastructure installation or higher levels of specialized services. Under the betterment tax structure now in effect in Honduras, community residents likewise have a chance to vote on plans to install, at community expense, community infrastructure facilities or local hookups to city-wide water distribution systems.

These expressions of taxpayer-voter choice obviously strengthen local democracy, by giving citizens a direct voice in public service delivery. At the same time, they should increase the efficiency of the local public sector. Economic efficiency may be divided into two components. <u>Allocative efficiency</u> measures how well the mix of public services matches taxpayer-consumer demand. That is, given the costs of providing public services, the majority of citizens will want a certain level and mix of services. Allocative efficiency is a measure of whether the public sector satisfies this demand, or produces something else instead, which citizens value less highly. Productive efficiency measures how efficiently the public sector produces its chosen mix of services--i.e., how cost effective it is at delivering its service bundle.

Local voting mechanisms give citizens the opportunity to exert direct control over allocative efficiency. But voting mechanisms also provide a means of applying pressure for productive efficiency. As voters better appreciate the linkage between local tax rates and local public spending, they become more effective advocates for efficiency in service provision. Waste in government often becomes a local election issue. The greatest influence over productive efficiency can be exerted when local citizens combine voting controls over government with some competitive market options--i.e., if they have the option to choose between two or more ways of providing local water service, if the existing service is provided inefficiently, or if a municipality can go to alternate lenders of capital to finance infrastructure improvements, if the traditional lender is too costly or bureaucratically rigid.

Judged against this "model" of local choice in public service provision, the principal constraints on the Honduran system are easier to identify. The main constraints are twofold: first, local voters do not now have a chance to vote on alternative service packages and tax rates, and second, local governments do not have the authority to prepare their own budgets.

## CONSTRAINTS OF THE CHOICE MECHANISM

There is presently no mechanism in Honduras that allows taxpayer-voters to express their demand for local public services (except at the neighborhood level). Most of the constraints are imposed by the municipal law. Their removal lies at the heart of the proposed new municipal legislation.[1] The key elements are:

✦Unlinking national and local elections. Local elections are now an automatic byproduct of national elections. Municipal offices are automatically filled in relation to parties' local voting totals in the Presidential election. Since national issues naturally predominate in the Presidential election, voters have no opportunity to hold municipal officials responsible for local governance, or to express their preference between rival public service and tax packages. There is no incentive for local candidates to articulate local policy platforms. The proposed Municipal Law severs the connection between national and local elections, by prescribing that the two be held separately. This separation is fundamental to local fiscal choice.

✦Permitting Local Choice with Respect to Tax Rates and Fee Levels. At present, all municipal tax rates are established by national law, as are almost all municipal fee schedules. Local governments have no flexibility in rate-setting, and, as a result, limited flexibility on the revenue side of their budgets (they do have the option of pursuing tax collections more or less vigorously). A fundamental aspect of local fiscal choice is deciding whether citizens want to pay for more or better public services, given the tax price of raising local revenues. The proposed Municipal Law for the first time would give local governments a significant degree of choice regarding tax levies. The law continues to dictate which tax bases local governments can tap, but establishes a relatively broad range of tax rates within which public officials can exercise choice.

✦Eliminating monopolies on service provision. Current Honduran law is laced with monopolistic restrictions on local government choice. These impede local decision-making and inflict mandatory inefficiencies on municipalities. For example, municipal governments are required to deposit all cash holdings in BANMA, the municipal bank, where they earn no interest. Municipalities are required by law to designate a certain portion of local revenues to buy shares in BANMA, even though these shares convey no legal benefits for the municipality in influencing BANMA policy. By law, they must pay a designated percentage of revenues to the Honduran Municipal Association and to the national professional training institute whether or not they believe these organizations work usefully on their behalf (see Chapter 2, Appendix II for details on mandatory earmarking). The law confers exclusive powers of infrastructure network operation on central government autonomous agencies, like SANAA and ENEE, in communities where they are responsible for service provision. Current laws also have been interpreted as severely limiting local governments' rights to provide public services through contract with private organizations. Most of these restrictions have been supplanted in the proposed municipal law by language that explicitly authorizes local governments to exercise their own choice.

✦Small Household Share of Local Tax Burden. A little noticed but important aspect of local taxation in Honduras is the extent to which tax burdens are shifted to the business community away from households. This poses a serious constraint for local public service choices. The theory of taxpayer-voter demand requires that the households voting for service benefits also be the ones to bear the costs of service provision. Numerous studies in the United States and Europe have found that when voters can "export" local tax burdens to business, they disregard budget constraints and vote for far higher tax and service levels than when they have to pay the taxes themselves. Honduras presents an extreme case of local tax burdens that are skewed to the business sector. For example, in Choluteca, where the most recent detailed analysis of revenue sources was conducted, only 11 percent of current-account revenues are paid directly by local households; the rest are paid by business.[2] Charges levied on commercial establishments and rental charges for the use of market stalls account for almost 60 percent of Choluteca's current-account income.

In secondary cities as a class, households appear to pay about 20 percent of locally raised revenues.[3] The proposed municipal law would make fiscal choice through taxpayer-citizen voting more difficult by tilting local revenues even more strongly toward the business sector, by raising current fee levels.

## BUDGET PREPARATION

The budget is the embodiment of the local financing and services plan. It is the fundamental document for achieving both fiscal and political accountability. Unfortunately, in Honduras local budget preparation and execution are not taken seriously.

### The Budget Cycle

Municipalities now participate only in the first stage of their own budget preparation (see Chapter 2, Appendix II). They are required to prepare, by November 15th of each year, a draft budget for the next fiscal year beginning January 1. The draft budget is submitted to the Dirección General de Asesoría y Asistencia Técnica Municipal (DGAATM) of the Ministerio de Gobernación for review.

The draft budget contains revenue and expenditure projections, and are supposed to by law be balanced (i.e., projected revenues must equal or exceed projected expenditures). In projecting both revenues and expenses, the municipal government must use various forms provided by the DGAATM. These forms contain 200 separate line-item classifications for types of revenue and no less than 451 separately coded classes of expenditures. Revenues are projected by mechanically applying the legally established tax rate to the legally inscribed tax base for each class of fees or taxes. No adjustment is made for past experience in actual revenue collection or in anticipation of delinquent accounts. This gives the budget an air of unreality, since only a part of the budgeted revenue is ever received. In the eight municipal budgets we examined in detail actual revenue collections reached only 40 to 55 percent of the "budgeted" level.

On the expenditure side, the municipality merely lists individual expenditures in line item fashion. Even though the Ministerio de Hacienda has prepared a detailed Program Budget Manual, which by law is supposed to be used throughout the public sector, only seven of the 289 municipalities submit a program budget. Even these are "program" budgets only in the sense that different operating units are identified and line-item expenditures listed for them separately. No program description or output targets accompany the budget.

The DGAATM reviews the budget according to a number of mechanical criteria--e.g., it makes certain that all legal earmarkings to repay BANMA debt, purchase BANMA shares, and contribute to the Association of Municipalities are shown in the budget, whether or not the municipality has made these payments in past years or intends to do so in the present year. Salary totals for personnel are adjusted so that they do not exceed 45 percent of the total budget. Offsetting changes are made in other expenditure items to maintain budget balance. All of these adjustments are made in Tegucigalpa, typically without consultation with the municipality. At no point is a comparison made with previous year actual spending or actual revenue collection.

The budget then is sent to the Departmental Council, where it gets further review and may be changed again. When approved by the Departmental Council it is sent back to the municipality as final. Article 206 of the current municipal law has been interpreted as preventing municipalities from making salary changes or personnel cutbacks once the budget has been approved.

<u>Implications</u>. The entire budget process is conducted as a mechanistic exercise undertaken solely to comply with the law, but without content. The budget sets no priorities and reveals no program. Year after year, "budgeted" revenues exceed actual revenues by 100 percent or more. The budget is not the municipality's own creation, and is not presented to the local citizenry for discussion. There is no accountability to the municipal council as to

whether funds were spent as budgeted or programs carried out as proposed, and no regular auditing of accounts.

Under these conditions, it is impossible to identify just what services a municipality delivers or how much they cost, let alone to expect the electorate to pass judgment on local government efficiency. The proposed municipal law takes a great step forward in assigning to municipalities the responsibility to prepare and approve their own budgets.

## ADMINISTRATIVE IMPLEMENTING CAPACITY

Management capacity in Honduran municipalities is very limited. This makes it imperative that training be an important part of a plan to implement local government strengthening. Since there are almost endless training needs, however, it also is important to establish priorities for training and to understand what other constraints must be removed from the system to make training effective.

### Employee Turnover

Past local government training programs have had a poor record of success. The principal reason for poor performance has been the extremely high rate of turnover among trained employees. Some of this turnover results from the better earnings opportunities that employees have, once trained, outside government, but a more important factor seems to be the indiscriminate replacement of workers when there is a change of local administration. In most Honduran municipalities no attempt is made to preserve administrative competence when there is a party turnover.

The devastating effect that turnover has on training can be illustrated by BANMA's and DGAATM's training programs. In 1987 BANMA performed a follow-up study of those receiving municipal training from BANMA during the past three years. It found that 85 percent of the 172 employees it trained in 1984, no longer worked for local government in 1987. More than half the workers trained in 1985 did not work for local government in 1987, less than two years later.

DGAATM reports similar experience with its training program in local cadastral systems. Follow-up studies found that 90 percent of municipal employees completing the course did not work for local government three years later. DGAATM has attempted to compensate for this turnover by training other local personnel, outside government, in the same courses it provides to municipal workers. The theory behind this is that a new administration could discharge existing workers, yet still find trained personnel of the appropriate party to replace them. No information is available, however, on whether any graduates of the training programs have ever moved into cadastral positions in this way.

Until a means is found to retain trained personnel, training programs (no matter how well designed or how costly) are likely to have little impact on continuing administrative capability.

The proposed municipal law recognizes the problems of turnover, but adopts a cure that may be worse than the disease. It stipulates that municipal employees are to be given civil service status, so that they can be removed from their jobs only for cause.[4] Civil service reform under the best of circumstances is an expensive and lengthy process; it requires preparing job descriptions and job classifications for all local positions, then matching current employees with these jobs. In Honduras, immediate adoption of civil service standards could lock into their jobs many workers who lack professional skills or education.

**Restrictions on Mutual Self-Help**

Some Honduran municipalities--most conspicuously San Pedro Sula--do have administrative expertise in project administration, planning, accounting, and other areas of local government. It would be logical for this expertise to be shared with smaller municipalities that lack it. Likewise, basic capital equipment that is too expensive for one community to purchase on its own, can be economical if shared among several.

Honduran law is now being interpreted so as to prevent mutual self-help. For example, it is difficult for one municipality to help another when a water pump breaks down, or to lend personnel or construction equipment to another municipality. The law of the "Contraloria" prohibits all expenditures made outside a municipality's territory, unless there is formal action by both municipal corporations and approval by the Departmental Council.

One positive development has been the emergence of municipal associations organized at the department level. The Municipal Association of Cortes was organized with a common fund, overseen by mayors in the department. The fund was to be used to give accounting and auditing help to small municipalities, and to help improve cadastral controls. However, the association requires personeriá juridica to operate. The DGAATM has refused to approve the association's application for legal status, and even has gone so far as to request from the government a legal ruling against the application, on the grounds that local municipal associations would compete with the national municipal association. The application of the Municipal Association of Cortes for personeriá juridica has now languished without action since August 1987. This situation reflects the inefficiencies inflicted on municipalities by monopolistic constraints on their freedom of action. (It should be pointed out that the director of DGAATM is also the director of the Association of Municipalities.)

## Training Gaps

Although Honduran municipalities could benefit from better administration in all aspects of local government, the three priority constraints are:

### Budget Preparation and Implementation

The budget is the critical instrument for management control and public participation in local government. Of all local government responsibilities, it is the function that is now performed to the poorest standard. Preparation of a financially meaningful budget that can be used for internal program management and public debate is a prerequisite for local democratic decision-making.

### Tax Collection

As long as municipalities collect 50 percent or less of the revenues they are owed, they will remain financially constrained. Moreover, democratic fiscal choice at the local level rests on the presumption that taxpayers pay the taxes they owe. The next section provides more information on the most important gaps in the tax collection process.

Project Planning and Management

In the short run, the most visible and important public services that local governments can provide are extensions of the coverage of basic infrastructure networks, like water and wastewater systems, and streets. Local governments, however, lack the capacity to plan, finance, and execute such projects on their own. Historically, all of these steps have been performed on behalf of secondary cities and smaller communities by central government agencies. Removal of the constraint on local project management capacity would go a long way toward establishing confidence in local government.

In all of these areas, it will be necessary to change the role of central institutions in order to reinforce local administrative capability. DGAATM's mechanistic requirements for budget preparation must be eliminated. Access to central funds for feasibility planning for through the Honduran Pre-Investment Fund should be open to municipalities directly, rather than available only for projects referred by central agencies like BANMA and SANAA.

## REVENUE CONSTRAINTS

There is a universal tendency among local officials to identify their principal constraint as lack of money, and to believe that this constraint should be removed by greater transfers from the central government. In point of fact, Honduran municipalities now have on the books laws that allow them to raise adequate operating revenues at the local level; the proposed new municipal law would augment this revenue raising authority. There are, however, serious structural constraints in the fiscal system that keep it from working adequately.

### Local Revenue Generation and Tax Collections

Revenues in Honduran municipalities are inadequate in the first instance because of poor rates of local tax and fee collection.

There are no reliable comparative statistics on local tax collections or delinquencies in Honduras. However, for the eight secondary cities whose budgets we examined, actual revenue collections averaged only 47 percent of legally due revenues as reflected in the budgets.

Until now, strategies for increasing local revenue generation have concentrated on comprehensive cadastral reforms. These programs set up mapping systems, install property registrations systems, document individual property holdings, and add unregistered properties to the tax rolls. The success of the programs is reviewed in Chapter 3 of Appendix II. The evidence indicates that cadastral reforms have not proved to be an especially efficient instrument for revenue generation. Eight representative local programs--carried out by DGAATM, BANMA, and the Dirección Ejecutivo de Catastro--were found to have raised property tax revenues between 22 and 129 percent; but because the programs are expensive to implement and property tax rates are so low, only about half of the programs would have paid for themselves if financed at market rates of interest. There are, of course, additional benefits to land management from having a good cadastral system. However, the strictly financial return to a municipality is modest, unless accompanied by more vigorous tax collection.

In terms of revenue generation, there is better and faster payoff to upgrading tax collection methods and to reassessing properties in line with market values. San Pedro Sula's property revaluation effort in 1985, for example, added Lps. 635 million to the property tax base, and produced just under a 60 percent increase in property tax receipts. The UMVIDE study estimates that assessed property values for tax purposes are still only about 50 percent of market value. Assessed values in other cities may trail market values by a greater margin.

## Transfers from Central Government

Although municipal governments must look to their own tax bases for most of their revenue growth, they have a right to expect some fiscal support from the central government. As previously noted, Honduras has one of the lowest rates of central transfers of any fiscal system in the western hemisphere. Over the period 1983-85 regular transfers represented only

0.4 percent of central government revenues. Table 6.1 shows that, though there has been some increase in central transfers and shared taxes since 1986, the amounts involved are still modest.

Table 6.1

**Central Government Transfers to Local Government**
**(millions of lempiras)**

| Type of Transfer and Year | Amount |
|---|---|
| Subsidios/subvenciones[a] | |
| 1984 | 5.7 |
| 1985 | 1.8 |
| 1986 | 0.7 |
| Revenue Sharing | |
| 1986-87 (one year only)[b] | 8.0 |
| Shared Port Receipts[c] | |
| 1987 | 13.4 |
| 1988[d] | 6.8 |
| Local Capital Projects, Employment Generation | |
| Cumulative 1988[e] | 28.4 |

Note: Excludes unrecorded emergency payments on behalf of municipalities.

[a]Paid by Ministerio de Gobernación y Justicia, Ministerio de la Presidencia, and specialized ministries.
[b]Paid at rate of Lps. 2 per inhabitant.
[c]By law 4 percent of port authority revenues are to be returned to localities with ports.
[d]As of year-end 1988, payment for fourth quarter 1988 had not been made.
[e]Total value of local capital projects completed, underway, or with final approval, as of April 1988.

More importantly, the structure of central government assistance (see Table 6.1) establishes serious disincentives for responsible fiscal behavior at the local level. Rather than make regular, predictable transfers, the central government agencies build capital projects for favored individual municipalities, or may intervene to bail out a municipal budget emergency or even to pay municipal Christmas bonuses. Central-level assistance programs are created and then scrapped after a single year. If the central government runs short of cash, it simply fails to make the transfer payments stipulated by law, as it has done with shared port taxes.

Perhaps the most revealing form of central-government assistance to local governments is the Central Bank's practice of lending funds to Tegucigalpa to allow the municipality to pay Christmas bonuses to its employees. At year-end 1988, Lps. 15.7 million of such "loans" were overdue for repayment.

**Capital Financing**

Capital financing for the urban development sector suffers from the same problems as capital financing for the shelter sector, but in greater degree. The financial intermediaries serving municipal governments contribute virtually nothing to domestic resource mobilization, and have failed to channel more than a tiny flow of domestic resources, wherever raised, to municipal capital formation.

The Banco Municipal Autonomo (BANMA) is the public sector bank charged with providing municipal capital finance. It was created with a capital donation from the GOH and the funding support of external donor organization, in the hope that once underway, it would be self-sustaining from domestic capital sources. BANMA is supposed to raise share capital from municipalities (by law, each municipality must contribute 5 percent of annual revenues to purchase of BANMA capital shares), receive deposits from municipalities and individuals, and issue bonds to other domestic financial institutions.

None of the domestic sources has proved a reliable source of funds. As of year-end 1988, municipal governments had contributed Lps. 13.3 million in share capital to BANMA, but another Lps. 22.6 million was past dues as municipal share purchases (Table 6.2). Deposits have fallen precipitously. At year-end 1984, they constituted more than 25 percent of BANMA's third party funds; by year-end 1986 they had declined to 6.6 percent. Municipalities by law are supposed to deposit all cash funds in BANMA, which pays no interest on municipal deposits. The decline in deposit levels reflects the difficult financial position of the municipalities, their unwillingness to deposit funds without receiving interest payments, and the municipalities' general disillusionment with BANMA as a financial intermediary.

Table 6.2

**Municipal Paid in Capital to BANMA**
(12/31/88, thousands of lempiras)

| | Distrito Central | San Pedro Sula | La Ceiba | Puerto Cortes | All Others |
|---|---|---|---|---|---|
| Payments due | 12,213 | 8,322 | 1,443 | 900 | 12,970 |
| Capital paid in | 3,221 | 6,547 | 144 | 314 | 3,106 |
| Capital past due | 8,992 | 1,865 | 1,299 | 586 | 9,864 |
| (percent) | (73.6) | (22.4) | (90.0) | (65.1) | (76.1) |

BANMA has sustained its operations only through the issuance of nonmarket bonds (at 8 percent) to INJUPEMP and other government agencies, and, above all, through capital infusions from overseas. Between 1980 and 1988, 89 percent of all BANMA capital loans were financed by external resources, principally AID, IDB, and the World Bank. Like many other countries' municipal development banks, BANMA has become almost exclusively a vehicle for channeling international funds to the urban sector. Even so, over the past four years it has been a negative net lender to local governments, receiving more in debt amortization than it has lent out in new loans. More than three-quarters of all BANMA lending during this period has been refinancing of existing loans. As a domestic bank, BANMA has broken down; it cannot attract domestic capital and it cannot collect on outstanding loans.

BANMA's reliance on foreign capital reflects a dependence that now runs throughout the municipal sector. Because local governments cannot gain access to domestic capital markets, either by borrowing directly from commercial banks or by borrowing from BANMA, they are forced to rely on foreign capital for their capital formation. The approximately Lps. 70 million in local capital formation being financed by USAID alone (through employment generation at HG urban upgrading) is equivalent to about nine years of capital expenditures for the entire sector from local budgets.

BANMA's inability to recover municipal loans (see Chapter 5, Appendix II) jeopardizes the future structure of capital financing, as well. At year-end 1988, BANMA faced Lps. 31.1 million in past-due loan payments from municipalities, a 33 percent increase over the previous year. Attempts to reschedule loan payments had not helped the situation. Of more fundamental importance, the poor repayment record of municipalities has established them as noncreditworthy. Commercial banks indicated that with one or two municipal exceptions, they regarded the repayment risk as so high that they would not lend to local governments under any circumstances. Commercial bank officers expressed the opinion that BANMA's lack of seriousness in loan collection had destroyed the municipalities as subjects of credit.

## MAJOR SERVICE DECENTRALIZATION

Over the long run, Honduras' ability to achieve significant governmental decentralization will depend upon whether it can transfer parts of major service functions from central government to local government. Health services, water distribution, and education are the services most frequently mentioned in this context, both in Honduras and in other countries attempting decentralization.

### Health Care

The health system in Honduras has four levels of treatment centers arranged in a hierarchical manner: primary care centers, clinics, hospitals, and tertiary care institutions. In theory, patients are supposed to be referred from level to level based on their required treatment. In practice, however, lower level institutions tend to be by-passed by patients who are seeking curative rather than preventive care and who feel hospitals provide better quality service.

Health care institutions used to be funded solely by the central government and invariably exhausted their budgets before the year's end. The government continually had to come up with more funds to keep the system functioning. Since the late 1970s, health care institutions have been allowed to set their own fees for services in order to supplement their funding from the central government. The revenues from these fees are deposited with the Ministry of Health (MoH); revenues from a particular hospital are available for use only by that hospital. The regulations governing these fees state that the revenues cannot be used to supplement staff or salaries--in practice, no control over the use of revenues is exercised.

The director of a medical institution has sole jurisdiction over the setting of fees and use of the revenues. In the past, hospitals were run by local boards of trustees. However, the central government found these boards too politicized and replaced them with directors appointed by MoH at the center. As well, all staffing decisions for professional and technical staff are made by the central ministry.

Within this context, the only realistic opportunities for a greater local government role would seem to be in the selection and oversight of the directors (and hence policies) of local health centers.

Transferring government budget responsibility from the center to the local level is sensible only if local government is more efficient at raising revenues than the central government and equally competent in administration (untrue for the great majority of municipalities). Finally, regional hospitals and specialized tertiary care facilities (which serve a national clientele) would necessarily remain under the control of MoH. Local administrative control over primary health care units and clinics would create the potential for conflict, as has occurred in other countries, over whether patients should be passed from the locally controlled level to the nationally controlled level, and which branch of government should pay for which treatments.

**Education**

At present, education is a national function financed and supervised by the national government. However, municipalities are required by law to earmark 8 percent of their operating budgets to the support of local education. Virtually nothing is known about how this money is spent, or even whether the earmarking requirement is being implemented. A prerequisite for any programmatic recommendations in the education field is a study of local education financing and local education program objectives, under the current law.

**Water Distribution**

Water distribution is a mixed responsibility in Honduras. Most of the larger towns, with the exception of San Pedro Sula, have their water service handled by SANAA, the national water authority. The majority of smaller towns have responsibility for their own water distribution. Waste water removal is a local function in all muncipalities.

The present system of water distribution is not working well, which makes it a potential candidate for return to local authorities. SANAA runs substantial financial deficits in most years, in large part because Congress has not allowed it to implement rate increases.[5] The serious water supply shortage in Tegucigalpa has captured most of SANAA's technical attention, leading to long delays in the implementation of externally financed investment programs in the secondary cities where coverage rates remain low.

Except for San Pedro Sula, where DIMA has compiled an excellent management history, local governments do not have an impressive track record of water management, either. In fact it was the perceived weakness of local authorities that made the IDB insist upon transfer of local water systems to SANAA as a condition for cities' participation in its water investment program.

Nonetheless, there are some opportunities for efficiencies from returning water systems to local control. Water and sewer systems are best managed and priced in conjunction with each other. As municipalities accept greater responsibility for wastewater control, there will be efficiency advantages to coordinating wastewater investment with investment in water distribution. Almost all developing countries have found that, because the principal benefits of wastewater removal are external (i.e., not enjoyed by the household itself but by neighbors or the region as a whole), it is infeasible to recover the full costs of wastewater systems through user charges. Rather, pricing strategies commonly add a wastewater charge to the charge for water consumption. By dividing responsibility for the two service functions, society has complicated pricing systems and assigned to local government the service for which cost recovery is administratively most difficult.

Finally, DIMA has established its record of fiscal responsibility because it has a pricing flexibility that the national government has denied to SANAA. Under DIMA's agreement with the World Bank, water charges must be adjusted upward in line with distribution costs. If other local takeovers of water distribution systems were accompanied by similar pricing freedom, and if local governments were determined to place their water systems on a self-financing basis, devolution could contribute importantly to narrowing the fiscal deficit of central autonomous agencies and the public sector at large.

**Footnotes, Chapter 6**

1. The Urban Institute, Reform of the Municipal Law, Final Report (March 1988).

2. Dirección General de Urbanismo, SECOPT, Esquema de Ordenamiento de la Ciudad de Choluteca (1988)

3. In estimating the incidence of local taxation, it was assumed that both property taxes and service fees and charges were split equally between households and the business sector.

4. Michael Murphy, "Municipal Administration," report prepared for Urban Institute Municipal Law project (January 1988).

5. A report on SANAA's financial situation is now being prepared by USAID by Cooper Lybrands.

# CHAPTER SEVEN

## POLICY PRIORITIES IN THE URBAN DEVELOPMENT SECTOR

A policy strategy for the urban development sector should start with reform of the municipal law, then proceed to strengthening local governments' fiscal and administrative capacity, so that municipalities can take advantage of the greater freedom they will have under the new law. In order to coordinate urban development programs with shelter programs, substantive priority should be given to land development and infrastructure investment policies, which are critical to both sub-sectors.

Besides the objective constraints discussed in the previous chapter, there are limits to local commitment to decentralization. At present, the mayors and private leadership of only a handful of cities assign high priority to enlarging the responsibilities of local government. (Among these localities are San Pedro Sula, Siguatepeque, La Ceiba, Choluteca, and the smaller towns represented by the Municipal Association of Cortes.) Initial training efforts and resources should be concentrated on those localities that want to assert local leadership, rather than be spread around numerous municipalities and municipal organizations, many of which would have to be persuaded to launch local initiatives. Once several key cities can demonstrate program results, demand should emerge from other municipalities for participation.

Neither technical and financial assistance to individual municipalities, nor system-wide reform of the municipal law and the process of central government control and financial aid, will suffice on their own to strengthen local government. The two fronts must be attacked simultaneously. Local administrative capacity to collect taxes, for example, should be strengthened at the same time central government aid formulae are changed to provide incentives for better collection.

## MUNICIPAL LAW REFORM

The proposed new municipal law is now before Congress. It is likely to be modified further before Congressional passage. Even after passage, the law should continue to be examined to determine the need for clarifications or modifications, once there has been experience with implementing it. Other laws will have to be changed to conform to the spirit of the new municipal legislation.

For these reasons, it is important that USAID have a focused view as to the critical content of the proposed municipal law, and the areas of the law as now drafted that pose problems for the urban sector.

The core content of the new law that needs to be preserved in any revisions is:

✦Separation of local from national elections. The ability to vote for local officials, based on their performance or fiscal platforms, is fundamental to local fiscal choice. Such voting cannot occur when local offices are filled as an automatic byproduct of local party voting in the national election.

✦Authorization for local governments to change tax and fee levels. Local governments already have the legal power to provide a broad range of public services and to enhance service quality in the areas they think most important. They do not have the option of raising local tax and fee levels to pay for service improvements, however. Flexibility on the revenue side of the budget is critical to local choice.

✦Municipal preparation and approval of the local budget. The central government's process of budget preparation and approval stifles local initiative and steers the municipality away from a simple program budget--where the costs of carrying out basic programs are made clear to the voters--toward a mindlessly complex array of revenue and spending numbers. Budget responsibility needs to be clearly vested in local governments.

✦Predictable, stable revenue assistance from the central government. The entire fiscal system needs stability and predictability, even more than immediate revenue. Stable flows of funds can be used for long-term planning, and can be dedicated to special purposes like debt repayment in order to open up access to commercial lending markets. A formula-based central revenue sharing program is a critical element of municipal reform.

✦Permission to form voluntary municipal associations at the regional level and to collaborate in other ways for mutual assistance. Municipal self-help must be encouraged by the law, not prohibited. The proposed law should preserve its language granting municipalities the right to form local associations and to exchange assistance.

At least three elements of the proposed law deserve careful scrutiny because, in their present form, they hold dangers for the urban sector:

- Legal requirement of civil service coverage for municipal work force. The civil service provisions in the proposed law should not be adopted without a special study of what they mean and how they could be implemented. Universal civil service coverage runs the risk of freezing into their jobs most current municipal workers, possibly at higher salary scales. Given the inadequate training and preparation of current municipal employees, this would be highly undesirable. The proposed laws calls for establishing civil service coverage at once. That is impossible. The special study should propose a timetable and procedure for civil service conversion, recommend a minimum city size for which civil service coverage is appropriate, and recommend which positions are critical for coverage. It should estimate the costs of implementation. It should consider alternative means of reducing turnover of skilled municipal workers, and examine whether civil service coverage has reduced turnover and improved employee quality in central government agencies.

- Local revenue sharing. Local revenue sharing on the scale the new law proposes is fiscally infeasible, unless expenditure responsibilities are simultaneously transferred from central to local government. There is need for a formula-driven program of revenue sharing under current fiscal arrangements (see below). However, transfers on the scale proposed in the draft law should await identification of simultaneous expenditure transfers. One or more studies should be commissioned to examine if certain central government responsibilities could be better performed at the local level, and how service responsibilities could be transferred. This investigation would include analysis of how effectively local governments are spending the 8 percent of their revenues which must, by law, be devoted to local education, and whether there are opportunities for expanding local participation in schooling. It would also consider local ability to take over water systems.

  At the same time, it needs to be recognized that significant decentralization cannot occur in the short to intermediate term at zero cost to central government. If strengthening local government is a high priority to the GOH and international donors, resources should be directed to its achievement.

- Strategy for municipal training. A large amount of technical assistance and employee training will be required to strengthen local government. Article 229 of the proposed municipal law contemplates that the National University will create a municipal training and development institution having principal responsibility for the professional preparation of higher level municipal employees. Chapter 6 of Appendix II concludes, on the basis of the university's public administration program, that university training is likely to be too legalistic and to have too little field orientation to carry out this function satisfactorily.

A better vehicle for technical assistance and training is a rejuvenated Municipal Association. The Honduran Municipal Association is now moribund. It has no programs, no money, and no leadership. The director of the central government Dirección de Asesoriá y Asistencia Técnica Municipal is also the director of the Municipal Association; he has steadfastly advocated central control over local government. A strong technical assistance and training team, funded in part from international sources, could provide a core activity around which the Municipal Association could be rebuilt. New leadership for the Association should be sought from local officials.

## FINANCIAL REFORMS

Two priorities stand out for structural reforms in municipal finance: modification of central fiscal assistance so that it reinforces fiscal responsibility throughout the sector, and modification of the capital finance system.

Formula-Based Revenue Sharing. Central-government assistance to municipalities is now an ad hoc patchwork filled with perverse incentives. The worse a local government's budget condition, and the poorer its record of tax collection, the more plausible a candidate for central assistance it becomes. Unfortunately, as now drafted the proposed municipal law would only exacerbate this situation. It would distribute one-half of central government revenue sharing in inverse relation to local revenues. Such a formula would lavish funds on very small towns unable to absorb them, while creating a strong disincentive to local tax collection in all municipalities.

A new revenue sharing program should be designed to encourage local revenue generation. Payments should be certain, so that local governments can capitalize the revenue stream if they want, by earmarking it as security for commercial bank borrowing. The amounts of central government revenues involved should be consistent with the tight budget situation of the central government.

One revenue-sharing formula that meets these criteria is to have the central government transfer annually to each municipal government an amount equal to 25 percent of its actually collected local revenues in the preceding year, up to a maximum payment of Lps. 10 per capita, while guaranteeing some minimum level of payment to small communities.

This formula provides a strong incentive to local tax collection. It rewards higher local tax and fee rates, as well as more efficient collection of revenue due. It is easy to administer. It provides funds that would significantly increase local budgets but not increase them so greatly as to cause problems of absorption, and allows assistance levels to grow over time. At present levels of local spending and revenue collection, all municipalities except San Pedro Sula and Tegucigalpa would qualify for the 25 percent match; payments to the two largest cities would be constrained by the 10 lempira per capita ceiling. A formula of this type, guaranteeing a reasonable minimum level of assistance for small municipalities, could be designed at a first-year cost of less than 2 percent of Central Government revenues. This amount could be partially offset by using one half of the port tax transfer to help finance it, as well as by prohibiting other Government transfers to local governments except in the case of natural emergencies.

## Capital Finance

The domestic capital financing system for municipal governments has collapsed. At the root of this failure are two basic facts: municipal governments are very poor credit risks, and BANMA as the sector's financial intermediary has proved unable to perform its functions of attracting domestic capital, appraising and making loans, and collecting on loan payments.

BANMA's new agreement with the IDB for a US$13.5 million lending program ensures that BANMA will continue in existence. USAID should support structural reforms within BANMA, based upon giving municipal governments a greater role in bank management, while limiting BANMA's activities to development banking. That is, BANMA should drop its commercial banking activities and its broad technical assistance programs. It should restrict its role to municipal lending which carries an explicit subsidy from the GOH or external sources, plus the technical assistance necessary to administer BANMA-financed projects.

For market-rate capital finance, USAID should encourage the establishment of private, commercial lending to municipalities, as well as to private developers who will develop land parcels consistent with municipal planning. Establishing a domestic flow of capital for municipal capital formation, however, requires reducing the repayment risk associated with municipal lending. One fundamental strategy for achieving this end is linked with stable central government revenue sharing. Local governments should be encouraged to earmark part of their annual transfers as repayments on new bank loans. Banks lending to a municipality thus would have first legal claim on the transfer payments, reducing their risk. Such a device has been used to secure commercial bank lending to local governments in a number of countries, including Colombia under its new decentralization program.

The security provided by central revenue sharing payments, of course, depends upon the banks' assessment of the seriousness of the central government commitment. The historical record of changes in transfer programs, coupled with central government's failure to pay all amounts legally due, has bred skepticism in Honduras' commercial banks.

A priority goal for USAID should be to help set up a program that allows future revenue sharing payments to be pledged as repayment security for commercial bank loans. Such a program may require establishment of an AID-financed capital reserve fund to further reduce repayment risk during a transition period.

At the same time, credit costs to local governments should be adjusted to reflect local credit histories and credit risk. At present, no market discipline is exerted over repayment. Municipalities failing to repay old loans continue to be eligible for new loans, and do not have to pay higher interest rates, as they would in the marketplace. All USAID-supported municipal lending programs should incorporate differentiated interest rates, based upon repayment history. Until there are seen to be economic and political costs attached to failure to repay loans, the present extraordinarily high delinquency rates will continue.

## TECHNICAL ASSISTANCE, TRAINING, AND POLICY PRIORITIES

Technical assistance and training (TA) for Honduran local governments will require a lengthy and costly commitment.

It is strategically prudent to think of two types of TA. A program of broad assistance to strengthen local governments will be feasible only if a new municipal law is approved. The national system of governance must reinforce local efforts to undertake new responsibilities. At present, there is little demand by local officials to take on new functions. If, in addition, the national legal structure frustrates these efforts, there is a very high probability of failure in trying to reform local government. Throughout Central America, as well as in Honduras during the 1970s, there repeatedly have been externally financed effor s to improve municipal government, which have failed in the absence of central government support. Local budgeting reforms, for example, are unlikely to succeed as long as the law prevents municipalities from approving their own budgets. Municipal commitment to local capital project design and local cost recovery is unlikely as long as most capital investment at the local level is planned and paid for by central government, without cost recovery.

In the absence of a new municipal law, AID should focus its TA efforts on land development. Within their existing legal authority, localities have the power to plan land development and devise means to steer development to areas where it can be accommodated most cheaply. The municipalities require assistance in analyzing the public and private costs of alternative development strategies. They also need assistance in designing programs to coordinate public and private investment decisions.

If a new municipal law is approved, more ambitious goals for strengthening local government strengthening become feasible. In addition to their other land development activities, localities then will require assistance in designing development strategies for the ejido lands which they will own. They also will be in position to take advantage of technical assistance and training in the key areas identified in the previous chapter:

✦local budget preparation and use of the budget as a management tool

✦improvements in local tax and fee collection

✦training in capital project design, implementation, and cost recovery.

Even if the new municipal law is approved, USAID must resist the temptation of spreading its TA efforts too thinly, either in the technical areas it addresses or in the number of localities with which it works. Concentration on the substantive areas identified above should be one part of the strategy. A program that initially focuses on the 16 largest municipalities outside Tegucigalpa and San Pedro Sula is another element of strategic concentration. This focus can be supplemented by rejuvenating the national Municipal Association and supporting the creation of regional municipal associations with the capacity to provide mutual self-help. But the magnitude of the job involved in changing local management practices should not be underestimated. It can be accomplished only if resources are focused, and continuing support provided for eight to ten years.

# HONDURAS
# SHELTER AND URBAN DEVELOPMENT
# SECTOR ASSESSMENT

## APPENDIX I
## SHELTER SECTOR STUDIES

Prepared for USAID/Honduras
The Urban Institute
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George Peterson, Team Leader
Donald Gardner, Housing Finance
Timothy Smith, Housing Finance
Duke Banks, III, Urban Development
David Jickling, Urban Development
Jeffrey Telgarsky, Urban Development

Authors' Note

The principal authors of this Appendix are: Chapter 1, Margery Turner and Jeffrey Telgarsky; Chapter 2, Donald Gardner; Chapter 3, Timothy Smith. The volume was edited by George Peterson.

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# CHAPTER ONE

## HOUSING NEEDS ASSESSMENTS AND FINANCING CAPABILITY

## HOUSING NEEDS STUDIES

This chapter examines the magnitude of housing needs in Honduras, and compares needs estimates with recent rates of housing production and sectoral financing capability.

Housing "needs" commonly are divided into four categories:

(1) Replacement needs for existing deficient housing that cannot be upgraded.

(2) Upgrade needs for existing deficient housing that can be improved to satisfactory standards, either by improvements to the physical housing unit or by provision of access to drinking water, sanitary wastewater removal, or electricity.

(3) Construction of new housing units to relieve overcrowding of existing housing.

(4) Construction of new housing units to meet the needs of newly formed households, or the needs of households migrating from one location to another.

In making projections about the magnitude of housing needs, several key pieces of information must be utilized. One critical requirement is information about the current stock of housing: its physical condition, access to infrastructure services, and level of occupancy. In Honduras, these data are taken from the the Census of Housing. Existing needs studies draw on the 1974 Census of Housing and extrapolate to more recent dates. A new Census of Housing was completed in 1988; "needs" projections may be compared with the preliminary data now available from that survey. A second critical requirement concerns the standards of adequacy. A good deal of discretion is involved in setting the standards by which housing is deemed to be adequate or inadequate, as well as in judging whether deficiencies can be remedied by upgrading or require total replacement of the housing unit. In Honduras, it is customary to follow the Census classification and treat all housing classed as "improvised" as nonupgradeable. Housing classified as "semipermanent" is assumed to require upgrading. Each study specifies a physical description and cost estimate for permanent housing of "minimum" standards.

A third critical assumption concerns the future rate of household formation, and its spatial distribution. These assumptions determine the rate of new housing construction that



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will be necessary to satisfy population growth. Finally, an operational definition for "overcrowding" is needed. In Honduras, the most common approach has been to assume that a dwelling unit is overcrowded when it is occupied by more than one household.

Given these standards and empirical data on the existing housing stock, annual housing needs can be projected. Table 1 provides an overview comparison of the principal findings of the two major needs studies that have been prepared for Honduras, along with reference data from the 1988 Census. The PADCO/Urban Institute study of housing needs was conducted in 1986, using a standardized model that has been applied in several countries. The INVA estimates are contained in Plan de Vivienda, 1988-2000, published by INVA in 1988, and does not separately estimate all the needs categories described above (see next section). To place the studies on a comparable basis, both sets of estimates have been updated to make 1988 the baseline year. This permits direct comparison with preliminary results from the Census, reported in the third column of the table, which were not available at the time either study was conducted. In all cases, the deficit of currently inadequate housing is assumed to be eliminated in 22 years, between 1989 and 2010.

As can be seen from the table, the magnitudes of the estimated housing "needs" vary substantially. Although a number of factors contribute to this difference, two are paramount. The INVA projections assume a much higher quality of the existing housing stock than does the PADCO/Urban Institute study, and than is reported in the 1988 Census of Housing. Less than 16 percent of existing housing units are assumed to require replacement by INVA vs. 46 percent in the Census survey and almost 57 percent in the PADCO/Urban Institute study. Since all three analyses use the same definition of nonupgradeable housing, but only the Census data are based on current survey information, the Census data are the most credible. The INVA study also projects a very low, and apparently unrealistic, rate of future household growth, which reduces greatly the need for new housing construction. The Census of Housing does not project future household formation; rather the 3.6 percent growth rate shown in column three is the actual average rate between the 1984 and 1988 Census surveys.

## Table 1

### Housing Needs 1989-2010
### ('000s units)

| Item | PADCO/ Urban Institute Update | INVA | Census |
|---|---|---|---|
| Housing Stock 1988 | 766.4 | 778.1 | 809.3 |
| Current Deficit | | | |
| Need replacement | 434.5 | 124.5 | 373.1 |
| Upgradeable | 219.2 | 396.8 | 225.0 |
| Total deficit | 653.7 | 521.3 | 598.1 |
| Satisfactory | 112.7 | 256.8 | 211.2 |
| Household growth (%) | 3.3 | 1.9 | 3.6 |
| 1989-2010 Needs | | | |
| New construction | 1,188.9 | 686.0 | 1,366.8[a] |
| Upgrades | 219.2 | 396.8 | 225.0[a] |
| 1990 Production | | | |
| New construction | 44.0 | 25.6 | 48.5[a] |
| Upgrades | 10.0 | 18.0 | 10.1[a] |
| 2000 Production | | | |
| New construction | 69.1 | 35.9 | 61.8[a] |
| Upgrades | 10.0 | 18.0 | 10.1[a] |

[a]Numbers implied by Census baseline data.

Source: See text.



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According to the needs studies (excluding INVA), approximately 45,000 new housing units would have to be built in 1990 to begin to make inroads into the backlog of Honduras' housing needs, and another 10,000 housing units would need to be upgraded. This level of production actually is not greatly out of line with recent production rates, which averaged almost 25,000 between 1974 and 1988 and were higher at the end of the period. The great difference, however, is that the bulk of actual housing production has been "informal," and many of the newly built dwelling units do not themselves meet adequacy standards, either in terms of construction quality or access to infrastructure services.

Some other findings are common to all needs studies for Honduras:

Rural areas account for a disproportionately large part of the current housing deficit. Rural areas account for less than 60 percent of all housing units, but contribute 70 percent of the total housing deficit, and about 85 percent of the requirements for new construction, the most costly part of the deficit. The potentially manageable proportions of urban housing needs are further highlighted by the results of applying the same Urban Institute housing needs model to San Pedro Sula, using the most recent Census data. There it was found that only 12 percent of the housing stock required replacement, while 53 percent of the existing stock is in satisfactory condition.

The Census data also reveal a strong, unexpected decline in the overcrowding of housing units. According to the preliminary results of the Census, there was a 75 percent increase in the number of housing units between 1974 and 1988, as compared to only a 65 percent growth in population. This led to an overall decline in the number of persons per housing unit, which was especially great in the larger cities. In Tegucigalpa, the average number of persons per housing unit fell from 5.87 to 4.98; in San Pedro Sula, from 5.58 to 4.84; in El Progreso, from 5.64 to 5.33; and in La Ceiba from 5.34 to 4.89. This relief from overcrowding runs in contradiction to the trends in formal-sector housing production. It therefore illustrates just how powerful has been informal sector construction.

## INVA'S PROJECTIONS

Further understanding of Honduras' housing situation, as well as the capacity of housing institutions to analyze it, can be obtained from closer examination of the needs estimates. These are described in terms of the original studies, without placing the results on a comparable time basis, as in Table 1.

The INVA Plan de Vivienda 1988-2000 estimates that Honduras contained 778,100 housing units in 1988, about one-sixth of which were improvised or in need of replacement. A further 51 percent were classified as inadequate. These units showed deficiencies in terms of structure, access to services (water, sewer, electricity), or inhabitability (no explanation is provided of the standards used for this classification). The plan does not provide a breakdown of the distribution of the deficit of the number of houses between urban and rural areas. It does note, however, that the number of deficient houses in rural areas is about three times as high as in urban areas and that the number of good-quality houses in urban areas is more than six times higher than in rural areas. No mention is made of the number of units which suffer from overcrowding.

The plan estimates that between 1988 and 2000, some 520,000 housing solutions will be required to both keep up with the natural growth of the population and cut in half the current deficit of 521,300 units of inadequate housing. Table 2 summarizes the production and investment targets established in the plan. Annual production targets are thus in the range of 40,000 to 45,000 units, about equally split between new construction and upgrades. Average costs per unit are assumed to run from Lps. 40,000 (private sector) to Lps. 800 (informal sector) for new construction and Lps. 6,000 (private sector) to Lps. 400 (informal sector) for upgrading. Public sector unit costs are estimated at Lps. 8,800 for new construction and Lps. 1,500 for upgrading.

**Table 2**

**INVA Plan de Vivienda 1988-2000**

| Sector | Total | New Construction | Upgrades | Regularization |
|---|---|---|---|---|
| Units ('000s) | | | | |
| Public | 208.0 | 39.0 | 110.5 | 58.5 |
| Private | 81.9 | 42.9 | 26.0 | 13.0 |
| Informal | 230.1 | 178.1 | 26.0 | 13.0 |
| TOTAL | 520.0 | 260.0 | 162.5 | 97.5 |
| Investment (Lps. m) | | | | |
| Public | 721.5 | 487.5 | 188.5 | 45.5 |
| Private | 1,753.7 | 1,591.2 | 156.0 | 6.5 |
| Informal | 163.8 | 143.0 | 10.4 | 10.4 |
| TOTAL | 2,639.0 | 2,221.7 | 354.9 | 62.4 |

INVA estimates that the average annual level of investment required--a little more than Lps. 200 million--would require less than 3.3 percent of GDP to be devoted to housing investment. (Lps. 200 million actually is about 2.5 percent of 1987 GDP at market prices.) Three-quarters of the funding for the plan is assumed to come from domestic sources (Lps. 35.7 million from the public sector, Lps. 101.7 million from the private sector, and Lps. 12.6 million from the informal sector) with the remaining funds (Lps. 50 million per year in 1988 lempiras) being supplied by donors and other foreign sources.

## PADCO/Urban Institute Projections

This section summarizes in greater detail the estimates of current housing circumstances and housing needs, as projected by PADCO and The Urban Institute. It draws primarily from the Housing Needs Assessment study conducted by PADCO in 1986--"Diagnostico Y Pronostico de Necesidades de Vivienda en Honduras: 1985-2005"--and from the housing finance analysis conducted by The Urban Institute in the same year--"Developing a Housing Finance Strategy for Honduras." All tabulations presented here are drawn from the UI report,



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which revised the Housing Needs Assessment estimates slightly and supplemented them with estimates derived from the Housing Quality Model.

## Characteristics of the Housing Stock

There were an estimated 707,580 housing units in Honduras as of 1986. Almost three quarters of these units are located in rural areas, with only about 20 percent in the metropolitan areas of Tegucigalpa and San Pedro Sula, and less than 10 percent in other urban areas with population greater than 2,000.

**Distribution of Housing Units by Sector, 1986**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Housing Units | 147,780 | 61,130 | 498,670 | 707,580 |
| Percent of Total | 21 | 9 | 70 | 100 |

The majority of the country's units are owner-occupied by households who have secure legal tenure, but it is in rural areas that homeownership is most widespread. In Tegucigalpa and San Pedro Sula households are roughly evenly divided between secure owners, squatters, and renters. In smaller urban areas, fewer households lack secure title to their properties, but roughly one third are renters.

**Distribution of Housing Units by Tenure Status, 1986**
**(percent)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Secure owners | 38 | 53 | 86 | 73 |
| Renters | 35 | 33 | 14 | 20 |
| Squatters | 27 | 14 | -- | 7 |
| TOTAL | 100 | 100 | 100 | 100 |

These estimates of the tenure distribution by sector are based on a national survey of households conducted in Honduras in 1978, updated to reflect estimates of the changes that occurred between 1978 and 1986. More specifically, the Housing Quality Model (HQM) was used to simulate changes in tenure and housing conditions from 1978 through 1986, and the resulting distributions were verified (after several rounds of revision) by a panel of expert advisors participating in the housing finance strategy effort. Over the 1978-1986 period, the ratio of all owners to renters was assumed to remain constant in each sector. However, the HQM analysts were provided with estimates, based on surveys of households living in marginal urban neighborhoods, that roughly one third of all households in Tegucigalpa and San Pedro Sula and about 15 percent of those in smaller cities lacked secure title to their properties as of 1986.

Close to half (46 percent) of all housing units in Honduras are improvised structures and less than one-third (28 percent) are permanent structures. Again, however, the pattern varies dramatically across geographic areas. Most of the housing units in Tegucigalpa and San Pedro Sula are permanent structures, compared to less than half of those in other urban areas, and only 12 percent of those in rural areas.

**Distribution of Housing Units by Structure Quality, 1986**
**(percent)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Permanent | 78 | 46 | 12 | 28 |
| Semipermanent | 16 | 29 | 28 | 26 |
| Improvised | 6 | 25 | 61 | 46 |
| TOTAL | 100 | 100 | 100 | 100 |

These estimates are based on the 1978 household survey, updated by HQM simulations. Structure quality was initially inferred from the 1978 data on the basis of the type of unit, its imputed value, and its size. All apartment buildings and rooming houses were assumed to be constructed of permanent materials. All units designated in the survey as rancho, improvisado, or "intended for other than residential use" were classified as improvised dwellings. The remaining independent houses were classified as permanent if their value was greater than Lps. 6,000 in urban areas or Lps. 3,000 in rural areas, and semipermanent if their value was between Lps. 2,500 and Lps. 6,000 in urban areas or between Lps. 1,250 and Lps. 3,000 in rural areas. Finally, rural housing units valued at less than Lps. 1,250 were reclassified as semipermanent if they consisted of more than two rooms. These value cutoffs were consistent with the reported costs of public construction projects in Honduras and on the perceptions of the advisory group.

Only about half of all housing units in Honduras have access to adequate water and sanitation services. In urban areas, the standard of infrastructure adequacy that was applied for both the Housing Needs Assessment and the Housing Quality Model required access to piped water (either on or off the property) and flush or water sealed toilets. For rural areas, wells and latrines were also considered acceptable. Because the standard of adequacy differs across sectors, the share of units classified as adequate is about the same in rural areas as in metropolitan and other urban areas.

**Housing with Adequate Water and Sanitation, 1986**
**(percent)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Adequate services | 58 | 46 | 51 | 52 |

The 1978 survey of Honduran households provides data both on access to water service and on structure type. These data provided the basis for joint distributions of households by infrastructure adequacy and structure quality in each sector. For each structure type, the share of households with access to adequate water service was adjusted downward to reflect the share with access to both water and sewer connections. The downward adjustment was larger for poor quality structures than for permanent structures. Then changes occurring over the 1978-1986 period were simulated by the HQM.

Most households who live in the poorest quality structures (improvised units) also lack access to adequate water and sanitation services. Among those in semi-permanent or permanent structures, access to adequate services is much more widespread, but by no means universal.



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**Distribution of Housing by Structure Quality and Availability of Services, 1986 (percent)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Adequate Services | | | | |
| Permanent | 46 | 28 | 19 | 25 |
| Semipermanent | 11 | 14 | 5 | 7 |
| Improvised | 1 | 4 | 26 | 19 |
| Inadequate Services | | | | |
| Permanent | 32 | 18 | 5 | 12 |
| Semipermanent | 5 | 15 | 11 | 10 |
| Improvised | 5 | 21 | 34 | 27 |
| Total | 100 | 100 | 100 | 100 |

In addition to the problems of structure and infrastructure adequacy in Honduras, an estimated 11 percent of the existing housing units are occupied by more than one household. In other words, households are doubled up, so that additional units would be required to provide units for all households in Honduras. The estimated incidence of doubling-up is more than twice as high in urban areas as in rural areas.

**Housing Units Occupied by More than One Household, 1986 (percent)**

| Metro | Other Urban | Rural | Total |
|---|---|---|---|
| 18 | 18 | 8 | 11 |

These estimates are obtained from the Housing Needs Assessment application. They were neither verified nor revised as part of the housing finance analysis.

## Estimated Housing Deficit and Housing Production Needs

Honduras faces a substantial housing gap, and high levels of production and upgrading would be required to provide fully adequate housing for all households. The Housing Needs Assessment (HNA) model generates estimates of annual production and upgrading needs at five-year intervals for a twenty-year period. These estimates reflect the total number of units that would have to be built or upgraded in order to achieve the goal of a fully adequate housing unit for every household. Thus, there are four components of housing need:

(1) Production of new units to accommodate growth in the total number of households;
(2) Production of new units to eliminate doubling-up over a ten- to twenty-year planning period;
(3) Production of new units to replace all improvised units over the planning period; and
(4) Upgrading of all semipermanent units as well as permanent units that lack access adequate infrastructure services over the planning period.

In all, over 75,000 new units are needed to eliminate overcrowding, over 325,000 new units are needed to replace nonupgradeable dwellings (the vast majority of which are located in rural areas), and 202,635 units require upgrading of either structure or services to achieve full adequacy.

**Housing Deficit, 1986**
**(percent)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| Total units | 147,780 | 61,130 | 498,670 | 707,580 |
| Doubling up | 27,200 | 11,200 | 37,400 | 75,800 |
| Nonupgradeable Dws | 8,335 | 15,355 | 302,095 | 325,785 |
| Adequate & upgradeable Dsw lacking services or needing renovation | 70,845 | 28,665 | 103,125 | 202,635 |

In addition, forecasts of future production needs have been based on the following estimates of household growth rates for Honduras:



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**Estimated Annual Household Growth Rates, 1986**
**(percent change)**

| Metro | Other Urban | Rural |
|---|---|---|
| 5.3 | 4.4 | 3.0 |

Assuming a twenty-year planning period for the elimination of the existing housing deficit, while fully meeting the needs of new households, annual housing production levels would have to average close to 50,000 during the second half of the 1990s, and over 10,000 units would have to upgraded annually.

Due to anticipated population growth, these estimates yield housing production requirements that rise steadily over the next two decades, reaching 80,000 per year by 2005.

**Distribution of Housing Units by Sector, 1986**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| 1990 | | | | |
| New construction | 11,040 | 4,340 | 33,830 | 49,210 |
| Upgrading | 3,540 | 1,440 | 5,160 | 10,140 |
| 1995 | | | | |
| New construction | 14,450 | 5,120 | 39,430 | 58,990 |
| Upgrading | 3,540 | 1,440 | 5,160 | 10,140 |
| 2000 | | | | |
| New construction | 17,370 | 6,470 | 45,350 | 69,210 |
| Upgrading | 3,540 | 1,440 | 5,160 | 10,140 |
| 2005 | | | | |
| New construction | 20,960 | 7,550 | 51,560 | 80,070 |
| Upgrading | 3,540 | 1,440 | 5,160 | 10,140 |

Note that these needs forecasts are quite sensitive to the estimated number of housing units that require replacement or upgrading. For example, in 1990 the estimates indicate that a total of 51,560 new units are needed, of which only 25,590 accommodate newly forming households.



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The remainder are replacement units for households living in improvised units or doubled up with friends or relatives. Obviously, the estimated number of units scheduled for upgrading is also sensitive to the estimated number of households whose circumstances are deficient. Given the vagueries of data on both structure and infrastructure quality, the total level of production required to ensure adequate shelter and services for all could be either higher or lower.

## Housing Investment Requirements

The total resource cost of meeting Honduras' housing needs depends critically upon the per unit cost of producing fully adequate housing units. The HNA estimates of total investment levels are based on three different housing solutions. The first solution represents the minimum cost of a standard formal sector unit, newly constructed. The second solution represents the cost of minimally adequate but complete units typically developed under public sector programs. And the third solution represents the cost of upgrading an existing unit that is constructed of semi-permanent materials, lacks complete services, or both.

**Costs of Housing Solutions, 1986**
**(Lps. 1,000s)**

| | Metro | Other Urban | Rural |
|---|---|---|---|
| Formal Sector | | | |
| New construction | 10.8 | 10.8 | 4.5 |
| Minimally Adequate | | | |
| New constsruction | 8.3 | 8.3 | 3.6 |
| Upgrading | 2.0 | 2.0 | 0.9 |

These cost estimates were developed for the Housing Needs Assessment application conducted in Honduras in 1986, and reflect consensus estimates of the cost of producing minimal, but nevertheless complete housing units. Due to the lower standards of adequacy for water and sanitation services, both construction and upgrading costs are considerably lower in rural areas than in cities.

Given these per unit estimates of production costs, the HNA Model forecasts that the annual investment required to meet the needs of all households by the year 2005 would come close to Lps. 600 million annually during the 1990s, rising to over Lps. 1,000 million annually by 2005.

**Annual Housing Investment Requirements, 1986-2005**
**20-year deficit elimination schedule**
**(Lps. 1,000,000s)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| 1990 | 318.27 | 73.11 | 198.18 | 589.56 |
| 1995 | 412.02 | 89.44 | 242.82 | 744.28 |
| 2000 | 516.62 | 121.69 | 286.19 | 924.49 |
| 2005 | 655.12 | 151.79 | 330.04 | 1136.95 |

If this level of investment was achieved, between 7 and 8 percent of GDP would be devoted to housing investment. In contrast, actual housing investment is estimated at about Lps. 475 million annually over the 1986-1990 period--about 80 percent of the level required to make significant progress toward the elimination of housing needs.

This estimated level of housing investment is obtained from Housing Quality Model simulations of the 1976-1988 period, and includes funds from all sources--formal finance, government subsidies, savings, and informal finance, for on-site infrastructure as well as housing. This estimate is more comprehensive than standard published measures of national housing investment, which typically exclude investment occurring outside the formal construction sector.

In addition to requiring a substantial share of GDP, the elimination of the housing deficit in Honduras would require subsidies of Lps. 85 million to Lps. 100 million annually. These subsidies reflect the difference between the investment that households can afford to make and the total cost of providing them with fully adequate housing.

To estimate subsidy requirements, the HNA Model divides households into two groups, on the basis of their income. Those who can afford the first design solution--formal sector new construction--are assigned this solution, and are referred to as "nontarget" households. Households who can not afford private sector new construction are referred to as "target" households, and are assigned either a public sector minimum unit or upgrading. For these target households, subsidies are calculated as the difference (if any) between the maximum affordable investment level and the cost of the assigned solution. Not all target households necessarily require subsidies. In fact, some may be able to invest more than the cost of the solution to which they are assigned, and are assumed to do so.

Households' capacity to afford housing at different cost levels is estimated on the basis of historical housing expense to income ratios. More specifically, analysis of the 1978 household survey indicates that households spend between 15 and 30 percent of their income for housing. Higher income households are assumed to be capable of devoting a larger share of their income for housing, because food and other necessities consume a smaller share of their total resources.

**Share of Household Income Available for Housing**

| Income Quintiles | Metro | Other Urban | Rural |
|---|---|---|---|
| 1 -- low | 0.15 | 0.15 | 0.20 |
| 2 | 0.20 | 0.20 | 0.25 |
| 3 | 0.25 | 0.25 | 0.30 |
| 4 | 0.25 | 0.30 | 0.30 |
| 5 -- high | 0.30 | 0.30 | 0.30 |

Given these housing expense to income ratios and the mean incomes for each quintile, the Housing Needs Assessment Model calculates the capitalized value of income available for housing investment, using prevailing interest rates (14 percent). In other words, the HNA Model effectively assumes that financing is made available for all households who need new or upgraded units over the planning period.

The total estimated investment requirement is met from three sources: 1) investment by nontarget households, who can afford private sector solutions without assistance; 2) investment by target households, who cannot afford private sector solutions; and 3) public sector subsidies to target households. Household investment--by both nontarget and target groups--can potentially account for the lion's share of Honduras' total housing investment requirements. In 1990, for example, 85 percent of the total investment requirement can be contributed by households. Target group households, however, generally can contribute less than half of the investment necessary to meet their housing needs.

**Composition of Investment Requirements, 1986-2005**
**20-year deficit elimination schedule**
**(Lps. 1,000,000s)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| 1990 | | | | |
| Nontarget HH investment | 280.14 | 48.53 | 107.88 | 436.55 |
| Target HH Investment | 23.49 | 9.71 | 32.91 | 66.12 |
| Subsidies | 14.64 | 14.86 | 57.38 | 86.89 |
| 1995 | | | | |
| Nontarget HH investment | 368.79 | 62.22 | 117.41 | 548.43 |
| Target HH Investment | 25.15 | 10.97 | 75.58 | 111.70 |
| Subsidies | 18.07 | 16.24 | 49.83 | 84.15 |
| 2000 | | | | |
| Nontarget HH investment | 468.08 | 89.70 | 147.48 | 705.26 |
| Target HH Investment | 28.64 | 13.66 | 83.17 | 235.46 |
| Subsidies | 19.90 | 18.33 | 55.53 | 93.76 |
| 2005 | | | | |
| Nontarget HH investment | 600.00 | 115.99 | 177.77 | 893.78 |
| Target HH Investment | 33.31 | 16.41 | 90.55 | 140.27 |
| Subsidies | 21.81 | 19.39 | 61.72 | 102.92 |

Just as the total estimated level of production required to meet housing needs is sensitive to definitions of what constitutes acceptable housing, the estimated costs of meeting these needs (both in total investment and in subsidies) are sensitive to assumptions about the per unit cost of acceptable housing. Many household who cannot afford a completed unit, can afford the cost of an urbanized lot, and could ultimately construct adequate shelter on such a lot.

If the public sector's "solution" to housing needs was an urbanized lot rather than a completed unit, subsidy requirements could be dramatically reduced, since virtually all households could afford the full cost of the solution initially provided. The cost of a serviced lot is estimated at Lps. 4,000 in urban areas and Lps. 500 in rural areas. The only households who cannot afford this solution are in smaller urban areas in the first two income quintiles.

**Subsidy Requirements for Serviced Lots**
**20-year deficit elimination schedule**
**(Lps. 1,000,000s)**

| | Metro | Other Urban | Rural | Total |
|---|---|---|---|---|
| 1990 | | | | |
| Subsidies | 0.0 | 5.18 | 0.0 | 5.8 |
| 1995 | | | | |
| Subsidies | 0.0 | 5.52 | 0.0 | 5.52 |
| 2000 | | | | |
| Subsidies | 0.0 | 6.03 | 0.0 | 6.03 |
| 2005 | | | | |
| Subsidies | 0.0 | 6.28 | 0.0 | 6.28 |

Estimates of housing investment and subsidy requirements are also extremely sensitive to household income levels and prevailing interest rates. If incomes were higher and/or interest rates were lower, all households would invest more, fewer households would fall in the target group, and fewer of the remaining target households would require subsidies.

# CHAPTER TWO

# FORMAL SECTOR HOUSING FINANCE

## PLACE OF HOUSING FINANCE IN THE FINANCIAL SECTOR

The financial sector in Honduras includes four types of depository institutions consisting of 14 commercial banks, various government development banks, seven savings and loan associations (one of which is government operated) and some 83 credit unions (those who are members of the Federation of Savings and Credit Cooperative Associations).

It also includes six private insurance companies, the government Social Security Institute, and three major pension funds. There are in addition financieras which have links to the banks, some leasing companies and a large number of money lenders, some 2,000 of whom are formally registered in the Registry of Non-Bank Lenders at the Ministry of Finance, the rest being informal and nonregistered.

All of the above institutions, with the exception of the government development banks, make loans for residential housing to some degree. Housing loans by the commercial banks constitute a very small part of their portfolio and are generally short term in nature. The savings and loan associations have most of their assets in housing loans, while the credit unions are extensively involved in home improvement loans.

Generally, the Instituto Hondureño de Seguridad Social (IHSS--Social Security Institute) does not invest in housing (although there was one exception). However, the three major pension funds are significant lenders for housing for their members. The insurance companies do not lend or invest much in housing, and most of that is in loans to policyholders.

In addition to the above institutions which can be defined as financial sector institutions, the government's Instituto de la Vivienda (INVA--Housing Institute) develops and finances housing. It also acts as an on-lender of funds to private voluntary organizations (PVOs) which in turn make loans to beneficiaries for new construction and home improvements. INVA also operates a savings and loan, the government savings and loan referred to above.

Finally, the Federación Hondureña de Cooperativas de Viviendas (FEHCOVIL--Federation of Housing Cooperatives) acts as an on-lender of funds to housing cooperatives which make the financing available to their members.

To put these institutions in some perspective, the major deposit-taking institutions (this excludes the credit unions) had total assets of Lps. 5,419.9 million as of September 30, 1988, with investments, primarily loans and discounts, of Lps. 3,024.2 million. Out of this the commercial banks dominated with total assets of Lps. 3,446.3 million, while the savings and loan associations' total assets were only 10 percent of commercial bank assets amounting to Lps. 345.3 million. On the loan side the commercial banks had Lps. 2,094.2 million and the savings and loans, Lps. 250.9 million. Total assets of the credit unions are on the order of Lps. 120 million.

The pension funds, including social security, are major mobilizers of long-term resources. The Instituto Nacional de Jubilaciones y Pensiones de los Empleados Publicos (INJUPEMP--Public Employees' Pension Fund) now has some Lps. 500 million in its portfolio, the Instituto de Prevision Militar (IPM--Military Pension Fund) does not provide figures but has some 10,000 members, and the Instituto Nacional de Previsión del Magisterio (INPREMA--Teachers' Pension Fund) has Lps. 400 million in assets. Outstanding mortgages account for Lps. 120 million and Lps. 90 million of these totals respectively. Social security, on the other hand, has only a small loan to INVA included in its assets of Lps. 211 million.

## REGULATION AND SUPERVISION OF HOUSING FINANCE

The Superintendency of Banks and Insurance, which is part of the Banco Central de Honduras (BCH--the Central Bank), regulates and supervises the banking and insurance systems and, since 1985, the savings and loan system. Government development banks, the savings and loan functions of INVA, and INJUPEMP also are supervised by the Superintendency, the latter because it u .ns with central government employees.

INPREMA, the teachers' pension fund, is regulated and supervised by the Controller General, who also regulates other government agencies, including INVA. Credit union and housing cooperatives are supervised by the Institute for the Development of Cooperatives, a government institution. The Military Pension Fund is independent.

Prior to 1985 the savings and loan system was regulated and supervised by FINAVI, a government institution which also provided mortgage default insurance and rediscounting facilities to the savings and loan associations. With its collapse (see below for further details) the Superintendency took on its functions with regard to regulation and supervision of the savings and loans.

Despite this consolidation, housing finance lending is carried out by institutions regulated and supervised by three separate bodies--i.e., the Superintendency of Banks and Insurance, the Controller General, and the Institute for Development of Cooperatives--plus the independent Military Pension Fund. Although this team did not examine the coordinating role played by the Ministry of Finance, establishment of a common set of rules that apply to housing finance lending would be difficult under this structure.

With regard to the savings and loan system, whose primary reason for existing as a separate body is to be a major lender for housing, there currently exists some confusion as to its regulatory status. There is a savings and loan law which has not been changed since the demise of FINAVI. One school of opinion holds that the existing law needs only minor modifications, to remove references to FINAVI and make other clarifications.

Others feel that a new savings and loan law is needed. Supervision is not basically at issue. The savings and loans are now subject to standard oversight in terms of quality of portfolio, quality and adequacy of reserves, adequacy of capital, and quality of management. In fact, one savings and loan was "intervened" by the BCH a couple of years ago because of problems with loan quality and liquidity. Rather, this view holds that if the savings and loans are to compete effectively in the financial sector--i.e., with the commercial banks--they need expanded lending and deposit authority. This issue is discussed in more detail in the section on savings and loans.

There is no program of deposit insurance in Honduras nor is any contemplated at present, although at one time such a program was considered. Presumably depositors have confidence in the institutions and system with which they deal. When one bank did fail in the past, the government paid off the depositors. This obviously set a precedent, although there is no legal requirement that the government stand behind deposits. Nevertheless, lack of deposit insurance would appear to give the larger, more established commercial banks an advantage in raising deposits.

## THE INSTITUTIONS THAT MAKE UP THE SYSTEM

The Fondo de la Vivienda (FOVI) was created by government decree in October 1985 and started operations in January 1986. It is a government institution technically "owned" by the Ministry of Finance, although it is administratively part of the Central Bank. It is at least partly a successor to FINAVI, so in order to understand its role in the sector a brief description of FINAVI and its operations is provided.

### FINAVI (Former National Housing Finance Agency)

FINAVI was an independent agency of government created in March 1975. It failed in 1983 and wound up operations in 1984.

FINAVI had three primary functions: regulating and supervising the savings and loan system, which had its beginnings around 1970; providing rediscounting facilities to that system; and administering a system of mortgage default insurance (FHA program).

The initial capitalization of FINAVI came from the government but insurance companies were also required to participate. FINAVI raised additional money by selling bonds on the local market as well as receiving financing from BIAPE, CABEI, the government of Venezuela and AID.

In its early years FINAVI financed mostly middle-income housing with house prices ranging from Lps. 30,000 to a maximum of Lps. 60,000 in 1980-81. Under pressure to reach lower income families, FINAVI provided construction financing for major low income projects in 1982-83, sometimes dealing directly with developers.

A number of subprojects went unsold or were not completed and, among other things, FINAVI had to pay off on developer notes to suppliers which it had guaranteed. The end result was FINAVI's bankruptcy. FINAVI was abolished as part of a government effort to reduce the number of its agencies. Supervision and regulation of the savings and loan associations was assumed by the Superintendency of Banking and Insurance.

The mortgage rediscounting function was picked up by FOVI when it began operations in January. The FHA program was eliminated.

## FOVI

FOVI's primary function is to provide secondary liquidity to the savings and loan system and other participating institutions that lend for housing by rediscounting eligible mortgages. FOVI has no supervisory responsibilities with regard to the savings and loans, although it does maintain the FHA liabilities outstanding at the time FINAVI ceased to operate. It also assumed FINAVI's loan portfolio. It operates with a staff of about 20.

FOVI was capitalized at Lps. 10 million. In addition to its capitalization, its financing is provided by repayments from the FINAVI portfolio, loans through the Central Bank from AID (HG) and CABEI, and bond issues. Insurance companies also subscribe to special investment certificates which count toward their technical reserves.

FOVI's projected financing program for 1989 is Lps. 48 million, funded as follows:

**FOVI Sources of Finance**
**(1989, projected)**

| | Lempiras (millions) |
|---|---|
| AID HG | 18 |
| CABEI | 5 |
| Bonds | 12/13 |
| Insurance companies | 3/4 |
| Repayments | 9 |
| TOTAL | 48 |



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FOVI has had two bond issues so far. The first issue was December 30, 1987 for Lps. 20 million. The term is 20 years but the bonds are redeemable at any time. The bonds carry an interest rate of 9 percent per year for the first five years and then gradually increase up to 11 percent. The purpose of the increasing rate is to induce the purchasers to hold the bonds for a longer period.

FOVI's second issue was authorized for Lps. 40 million on December 30, 1988, but only Lps. 5 million have been sold so far (February 1989). The issue is divided into Series A and B. Series A are 4 percent bonds and count toward a depository institution's reserve requirements. Series B are for 8.5 percent. All FOVI bonds provide tax free interest to the holders. (The corporate tax rate is progressive with the highest rate 40 percent.) FOVI receives AID (HG) money through the BCH at 9.5 percent.

FOVI makes little marketing effort, beyond making sure that a bond issue is known. The bonds are sold through the BCH. Despite carrying below-market interest rates, demand for the bonds has been fairly good and there has been no problem selling the issues. Most of FOVI's bonds are purchased by financial institutions--i.e., commercial banks and savings and loan associations (according to FOVI management, savings and loans hold about one-half). However, anyone can buy the bonds, including individuals.

Insurance companies, a potentially significant source of long-term money, have not invested in FOVI bonds except for their mandatory holdings, which must total 10 percent of their reserves. This requirement is apparently satisfied, at least to some extent, by their holdings of FINAVI certificates of deposit which were specifically designed for insurance companies.

The FOVI financing program for 1989 is based on what it foresees project activity to be and not on some goal of financing housing needs. Given identifiable projects, BCH decides what level of bond issue FOVI can market based on current monetary and economic considerations.

FOVI's spread on HG money is quite modest--0.5 percent--but somewhat larger on rediscounting using its own resources. It rediscounts HG funds at 10 percent and funds from its own resources at 11 percent. The terms for eligible mortgages under each of FOVI's programs differ as set forth below:

**Terms for Mortgages Eligible for FOVI Rediscounting**

| | HG Funds | FOVI's Own Resources |
|---|---|---|
| Interest rate to beneficiary | 14% + 1% insurance | 15% + 1% insurance |
| Down payment | 5% | max. 10% |
| Term | 20 years | 20 years |
| Maximum sales price | Lps. 21,000 | Lps. 65,000 |
| Income maximum | Lps. 993 per month (in Tegucigalpa--less in in other cities) | na |
| Payment/income | 25% | 30% maximum |

As can be seen, the interest rate spread to the participating institutions is 4 percent using both HG funds and FOVI's own resources. Since the conditions are less onerous using FOVI's own resources, it would appear that savings and loans would prefer this form of financing. However, overall demand for all types of FOVI rediscounting is strong. The rediscounting essentially protects the savings and loan institutions from financial market risk by locking in a fixed spread, regardless of future market conditions.

All savings and loans associations must participate in FOVI's programs. Only one commercial bank has participated so far (Sogerin). FEHCOVIL has participated to a minor extent so far, along with INVA, the government's housing developer and one PVO. FACACH, the association of credit unions, has had an application pending for some time but it has not yet been approved.

FOVI's rediscounting of mortgages generally involves financing for new housing projects. A savings and loan (or other participating institution) will apply to FOVI to reserve a credit based on a project where it intends to provide the long-term mortgage financing. The project details are reviewed by FOVI's engineering staff, and FOVI must approve the project



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before it gets underway. In effect, FOVI makes a commitment to rediscount the mortgages based on the application and its review.

## FORMAL FINANCIAL INSTITUTIONS

### Commercial Banks

As stated above, there are 14 commercial banks in Honduras, two of which are foreign owned or with majority foreign ownership. Another, established by special law, is owned by workers, and the Military Pension Fund owns 60 percent of the Armed Forces Bank, BANFFAA. Commercial banks are restricted to a maximum of 10 years on repayment of loans and do little residential lending.

It should be noted, however, that out of the six privately-owned savings and loan associations five are owned or controlled by commercial banking interests. The interests of these groups also extend more broadly into the financial sector. Banco Atlantida, the largest bank with some 18 percent of the credit issued by the commercial banking system, is part of a holding company which also owns an insurance company, a leasing company, and a construction firm.

Although only commercial banks can take checking deposits (which are noninterest bearing) and the costs of individual savings deposits average only about 6 percent, Banco Atlantida indicated in interviews that its average cost of funds lies between 10 and 11 percent. Because of the very high 35 percent reserve requirement for commercial banks now imposed by the Central Bank, the effective cost of funds to the bank is much higher. With the government-set maximum lending rate now 17 percent, the resulting spreads are thin. There is little incentive for the commercial banks to engage in even 10-year residential lending, which is clearly more risky than their regular loans.

Banco Atlantida, for instance, has done little lending for residential housing in recent years. What little it does is for loans to families in the upper 10 percent of the income distribution and for a short term. In fact, the average maturity of all loans granted by commercial banks in 1986 was only 8.5 months.

As of July 1987, 12.4 percent of commercial banks' outstanding loans were classified as real estate loans; but this includes construction loans, which account for the bulk of commercial banks' lending to the sector. In some cases Banco Atlantida is prepared to finance real estate developments for 5-7 year terms, although residential construction loans are more likely to be one-year loans rolled over for the 2-3 year construction period.

Three of the commercial banks do make a number of residential housing loans: Banco Sogerin, which started as a mortgage bank; Bancahsa, which started as a savings and loan; and Banco Mercantil, which also started as a savings and loan. The latter two have a contract savings plan whereby if a participant saves up to a certain amount he is entitled to a mortgage loan of some multiple of the amount saved. Banco Mercantil, however, stated that its residential mortgage loans are limited and are for amounts over Lps. 60,000.

All commercial banks are eligible to apply for participation in FOVI rediscounting but so far only Banco Sogerin has been approved. One question that needs to be developed more fully in looking at an expansion of the housing financing system is why those commercial banks which own savings and loan associations do not expand their own lending for residential mortgages. That is, if the business has potential for the savings and loan, the commercial bank which raises money in essentially the same way as a savings and loan and which could participate equally in FOVI rediscounting should find it equally attractive to do so. Bank officers indicated that there were tax and management advantages to having residential lending take place through separate institutions.

The commercial banks are set up with their branches to have the potential to originate and service an expanded number of mortgages. In fact, mortgage servicing could become a sizable market. Banco Atlantida believes it could set up a network to efficiently service mortgage loans and to this effect has already begun looking into the possibility of servicing mortgage loans for the pension funds for a fee.

In summary, the commercial banks appear to view long-term housing finance as something that does not fit their traditional market and type of lending. To the extent that certain of the banks are part of a larger group of financial institutions which includes a savings and loan association, they to see that as the way to participate in housing finance. This, of course, separates out and insulates the bank from what they see as the more risky lending associated with long-term mortgage loans financed with short-term deposits.

## Savings and Loan Associations

The savings and loan system in Honduras, as stated earlier, comprises six privately-owned associations (no mutuals) and a seventh which operates as a department of INVA. Five of the six private associations are owned by commercial banking interests and the sixth is owned by a developer. All are members of an association for savings and loans, Camara Hondureña de Asociaciones de Ahorro y Prestamo (CAHDEAP) which, among other things, acts to present a common viewpoint on matters pertaining to legislation, regulation and supervision.

Total assets for the system as of September 30, 1988 were Lps. 345.3 million, with capitalization of Lps. 20.1 million, or about 5.8 percent. According to CAHDEAP, the six private associations currently have outstanding mortgage loans of Lps. 235 million, Lps. 95 million using their own resources and Lps. 140 million utilizing FOVI rediscount facilities. This would indicate that the associations lend primarily for long-term residential housing.

The savings and loans can and do make project construction loans and personal loans, although in the case of the former, it is more common for commercial banks to make the construction loan and the savings and loan association to provide the take-out financing for the home purchasers. The tie-in with commercial bank interests becomes obvious here.

Current savings and loan regulations permit personal loans up to Lps. 10,000 without a mortgage. Over Lps. 10,000, personal loans must be secured by a mortgage. The home improvement loans made by savings and loans average about Lps. 15,000. They have resisted entering the market for lower valued home improvement loans to lower income households.

Savings and loans do make loans for individually-constructed houses and for resales but these are a small pa.. of total lending. Most new loans originate out of developer projects.

The government-imposed interest rate ceiling of 17 percent has had the effect of bunching all of the loans made by S&Ls from their own resources on this rate. The term of the loan, its purpose and riskiness, the underlying security--none of these factors influences the rate of interest. The maximum legal rate is charged for all new loans. Without the interest rate ceiling, the lending rates for different types of loans would change to reflect risk differentials, and the portfolio mix might change as well, as S&Ls found it worthwhile to take on somewhat greater repayment risks that could be covered by higher interest rates.

The terms for mortgages eligible for rediscounting through FOVI fall into two categories as described earlier, permitting a 4 percent spread to the associations. These programs set maximum sales prices, maximum down payment requirements, 20-year repayment terms and, in the case of housing guaranty funds, income targets that should not exceed certain levels--e.g., Lps. 933 per month in Tegucigalpa.

Utilizing their own funds, S&Ls require down payments of 10-20 percent, with amortization periods up to 20 years. Recently, however, one of the associations that had been amortizing over a 10-year period reduced its loan period to five years. Thus, at a time when affordability is a growing problem in Honduras, at least one, and perhaps more, of the savings and loans is making mortgage loan terms more difficult. This reflects growing concern with economic uncertainty and a decision not to fund very far out into the future.

Monthly payments include an amount to cover premiums for hazard and life insurance. In addition, the savings and loans are permitted to charge an additional 1 percent on the outstanding balance to apply toward reserves for bad loans. Prior to its demise, FINAVI offered an FHA mortgage default insurance program, but this was discontinued when FINAVI was closed out. Thus the savings and loans must cover possible losses through the 1 percent charge.

Delinquencies in Honduras are a special problem. Although the savings and loans require good title to make a loan, the foreclosure process is cumbersome and lengthy, and an association will exhaust all other means before resorting to foreclosure. The major risk, according to one savings and loan, comes from unemployment. The tendency is for the associations to try to reduce risk by seeking higher down payments, shorter repayment periods, higher income borrowers, and more substantial properties, all factors which work against the lower income borrower but which decrease the savings and loan's risks and costs.

There is some feeling among the S&Ls that the 5 percent down payment requirement on HG loans, when coupled with the income limitation, create perverse incentives. Lower income families are able to purchase a house, move in, fail to make payments, yet occupy the house for several years until foreclosure is completed. By the time the process is completed, the savings and loan has lost its interest payments and must usually incur costs to fix up the unit to sell.

Partly because of this risk, the savings and loan institutions see their preferred clients, both savers and borrowers, as the "middle class," defined as households with Lps. 3,000 and higher monthly income, not only because their incomes are more stable and they are seen as less risky borrowers, but because they are families who are more likely to generate deposits.

Although FOVI rediscounting offers a stable source of funds which match up against the loan terms, some of the associations see FOVI's procedures as burdensome and their requirements as forcing them outside their normal market. In effect, they perceive FOVI's requirements as being an implicit form of regulation.

Resource Mobilization

Savings associations raise their money primarily through savings deposits, term deposits of up to one year, and a type of certificate of deposit known as a construction cashier's bond. The competition for savings is with the commercial banks.

S&L savings deposits pay 8 percent. The rate on term deposits varies according to the amount of the deposit, not the term, which never exceeds one year in Honduras at present. The rates are as follows:

| Lempiras | |
|---|---|
| up to 5,000 | 8.5 percent |
| 5,000-10,000 | 9 percent |
| 10,000-50,000 | 10.5 percent |
| 50,000-75,000 | 11 percent |
| 75,000-100,000 | 11.5 percent |
| over 100,000 | 12 percent |

Cashier's bonds carry a progressive rate starting at 8 percent and ending up at 11 percent. According to SECPLAN, the savings and loan system had some 84,000 depositors in 1986. CAHDEAP said that pension funds are the best source of deposits because of the large amount of funds that they must invest. Pension fund deposits, however, carry special risks. Because their deposits are large, pension funds tend to extract the highest rate they can from a savings and loan. When a term deposit comes due, they can squeeze the savings and loan for higher rates with the threat of withdrawal. An example was cited from several years ago when at least some of the associations had to go to the central bank for short-term funds to counteract what they felt was too high a rate to renew pension fund deposits.

According to CAHDEAP the average cost of funds to the system is now running about 11 percent. Savings and loans cannot open checking accounts as can the commercial banks. Since checking accounts do not currently pay interest in Honduras, the savings and loans feel this gives commercial banks a major advantage because it enables them to bring down their cost of funds.

CAHDEAP indicates that in general savings and loans require an individual to be a depositor for at least six months before obtaining a loan. Although some associations advertise that one can borrow without being a depositor, in fact customers are asked to open an account when applying for a loan. As a savings and loan executive put it, the associations want to link up the customer as both borrower and depositor. Thus, they feel they are competing for somewhat different clients from the banks.

There is the perception, nonetheless, that the commercial banks will oppose moves that the savings and loans might make to draw away deposits. One of the savings and loan associations was apparently quite successful with several innovative ideas to increase deposits--e.g., introducing a "super bingo" account. Eventually the schemes were disallowed by the central bank, allegedly under pressure from the commercial banks.

## Insurance Companies

Some, if not all, of the insurance companies are part of commercial bank groups. As far as the origination of residential housing loans goes, the insurance companies are not a major factor. As a mobilizer of stable long-term resources, however, they are more important.

In general, insurance company assets are invested mostly in tax-free government bonds or other short-term investments--e.g., deposits in banking institutions, including savings and loan associations. Insurance companies have not yet made loans to FOVI, except for a mandatory requirement which says that 10 percent of their technical reserves must be invested in FOVI bonds. Nevertheless, FOVI's projections for 1989 indicate that the insurance companies will take approximately Lps. 3/4 million of FOVI securities, in the form of special 8 percent CDs, which will qualify as reserves. This represents some 8 percent of FOVI's projected lending program for 1989.

Based on consolidated data we obtained, it appears that insurance companies made about Lps. 50 million in new loans in 1986, of which about Lps. 20 million, or 40 percent, was for real estate. Real estate includes commercial and industrial buildings and housing (including short-term construction loans). Approximately 10-15 percent of total lending activity represents housing loans.

**Table 3**

**New Real Estate Loans Originated by Insurance Companies (Lempiras 000)**

| | 1984 | | 1985 | | 1986 | |
|---|---|---|---|---|---|---|
| | Amount | Percent | Amount | Percent | Amount | Percent |
| Total new loans | 44,433 | 100 | 37,645 | 100 | 50,956 | 100 |
| Real estate loans* | 15,564 | 35 | 17,458 | 46 | 19,683 | 39 |

*includes commercial and industrial buildings and housing.

More recent data on new housing originations by two companies indicate that their lending for housing is not very significant, and highly skewed toward upper income brackets. In the case of El Ahorro, for example, the average cost of the unit financed is over Lps. 130,000. The interest rate in both cases is 17 percent, the maximum lending rate. One company will make loans for up to 12 years, the other only for five years.

One savings and loan executive whose association is part of a financial group which includes an insurance company said that the insurance company might make short-term deposits in the savings and loan but would not extend any longer term loan. Nor did he feel that the insurance companies would be interested, at present, in investing in mortgages or mortgage-backed securities.

Thus, as it now stands, insurance companies, while representing a potential source of funds, are not major participants in housing finance.

**Pension Funds**

In addition to the Social Security Institute (IHSS) there are three major pension funds which relate to public employees, the military and teachers. All of these institutions are major mobilizers of long-term resources.

Presumably the purpose of any pension fund is to provide retirement and other financial benefits, such as health coverage, to its members. To this end it should maximize the return on its portfolio to ensure that it can meet its goal adequately and in an actuarially sound manner. However, the pension funds in Honduras apparently see another purpose: to finance housing and home improvements, as well as provide personal loans, for their members. In addition to making housing loans, all three pension funds are now actually engaged in the development of housing projects.

If mortgage loans were being made at market rates then it could be argued that such investments are consistent with maximizing the return on pension funds' portfolios. However, the mortgages are well below market, being in the neighborhood of 10 percent. In addition, the pension funds are serving only a small percentage of their membership, mostly on the higher income side. Thus the result is to subsidize mortgage recipients at the expense of the rest of the membership.

When pension funds develop and finance housing, they must act exactly like a combination banking institution and developer, originating and servicing mortgage loans, including appraisal, acquiring land, getting permits, and overseeing construction.

Instituto Hondureño de Seguridad (IHSS-Social Security Institute)

IHSS is 25 years old and covers both health and pension benefits. It started as a pension fund in 1974. The Board of Directors includes the Ministers of Works and Health and three representatives from the private sector, one from the workers' union, one from the medical college, and one other.

Mandatory contributions to the two funds are as follows:



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**Contributions to IHSS as a percentage of Wages/Salaries**

| | Health Fund | Pension Fund | Total |
|---|---|---|---|
| Employer | 5% | 2% | 7% |
| Government | 2.5% | 1% | 3.5% |
| Employee | 2.5% | 1% | 3.5% |
| | 10% | 4% | 14% |

There is a ceiling of Lps. 600 per month on wages/salaries against which the above percentages apply--i.e., the most any worker would have to pay for social security is Lps. 24 per month. There have been several attempts to get this ceiling raised but these have been frustrated in Congress. The government has never made the contributions prescribed by law as the government share and has paid only half the share corresponding to it as employer.

IHSS has serious financial troubles. The payout for health benefits is exceeding the portion of contributions earmarked for the health system; therefore IHSS is tapping earnings plus "some capital" from the pension fund to make this up.

Total reserves of IHSS now stand at about Lps. 211 million. Net income after expenses, from both new contributions and investment income, totals Lps. 35 million per year. Pension payments are still small, about Lps. 5 million per year, but will shoot up dramatically in the next several years. Retirement is at age 65 with reduced benefits available at 60. The maximum monthly payment is Lps. 350.

Investments are 50 percent in BCH bonds and 50 percent in bank CDs and term deposits. The average return on the portfolio is 11-11.5 percent. The law says IHSS should give preference to investing in short-term BCH bond issues, deposits with the BCH, or to investments of "utmost reliability" with the approval of BCH.

Commercial bank deposits tend to be volatile, since, when the banks are liquid they do not want deposits. IHSS has some money now in savings and loan associations, although at one time BCH discouraged this because of the FINAVI problem.

In its only venture into the housing sector, IHSS invested Lps. 10 million at 9 percent with INVA to finance housing for the upcoming Pan American games. The units ultimately are to be sold. The other pension funds declined to participate in this project and IHSS was criticized in the press for its participation. IHSS said its decision was motivated by the overall social impact of providing finance for housing plus the job creation benefits, but indicated that it would be reluctant to become involved in similar projects in the future.

IHSS does see a supplemental role for itself in helping poor people and this might lead it eventually to make additional investments in housing. It sees its major concern, however, as remaining actuarially sound and has received some technical assistance to this end from the U.S. Social Security Administration.

Instituto de Previsión Militar (IPM--Military Pension Fund)

IPM has approximately 10,000 members, all of whom are officers, both regular and auxiliary. Little information concerning its financial activities is available, including its total assets. The fund owns 60 percent of the Banco de las Fuerzas Armadas (Armed Forces Bank), a commercial bank which in 1986 had about 8 percent of total banking system deposits. Members contribute 9 percent of their salary into the fund.

IPM does make loans for housing. Figures for 1987 indicate that the fund made 126 housing loans amounting to Lps. 5.9 million, for an average of Lps. 46,900 per loan. Most (90 percent) of the loans were for new houses in projects or individually constructed houses, with some improvement loans. The maximum loan amount is Lps. 90,000. Housing loans represent about 9.5 percent of the total portfolio.

IPM has been gradually raising the interest rate it charges from 10 percent in 1986 to 10.5 percent in 1987 and 11 percent in 1988. At the same time it has been lengthening the term from 10 years in 1986 to 15 years in 1987 and 20 years in 1988.

Up until this year IPM's mortgage loans were located in projects built by others. This year IPM plans to develop its own projects; one for 50 houses in San Jose de la Vega which will have 76 square meters of floor space at a price of Lps. 43,000, and another near Las

Lomas de Guinarro of 87 units estimated to cost Lps. 100,000-120,000. Most of the IPM housing loans to date have been in Tegucigalpa, San Pedro Sula and La Ceiba.

Instituto Nacional de Jubilaciones y Pensiones de los Empleados Publicos (INJUPEMP--Public Employees Pension Fund)

Membership in INJUPEMP now totals about 35,000. It includes employees in the executive branch of the central government but does not include the judicial or legislative branches nor municipal employees. It can include parastatals such as SANAA or the National Agricultural Institute but membership is not automatic; these institutions must apply. INJUPEMP is currently negotiating with three additional institutions which could add another 4,000-5,000 members.

INJUPEMP was created by decree in 1971 and began operations in 1976. The chairman of its board is the Minister of Labor; the board also includes three other ministers, two representatives of the Public Employees Association and a representative of the National Association of Retired Government Employees.

Members contribute 7 percent of their salaries/wages while the employing institution contributes 11 percent. INJUPEMP is now receiving Lps. 140 million per year from contributions and earnings from its portfolio, an amount which is growing rapidly. Operating expenses are about Lps. 4.5 million and beneficiary payouts amount to Lps. 13 million.

In addition to retirement benefits, INJUPEMP pays death benefits and disability benefits. An individual account is established for each employee which is credited with 4 percent interest per annum on the portion related to the employee's contribution. Retirement payments (an individual must retire at 65, can do so voluntarily as early as 58) are a function of what is in the account and salary and age at retirement. The maximum payment is 90 percent of salary with a minimum of Lps. 250 per month. The average age of participants is only 38 so the big payments are yet to come. The fund is represented as actuarially sound.

Based on the above figures, the fund currently has a net income of Lps. 122.5 million which must be invested each year. It is apparently a problem to keep fully invested in secure investments. The total portfolio is now about Lps. 500 million, of which Lps. 120 million is in residential mortgage loans and Lps. 80 million in personal loans. The remainder is invested in government bonds, deposits in the banking system, including savings and loans, and investments in income-producing real estate. Bank deposits are earmarked for on-lending to agro-industry and construction.

INJUPEMP prepares an annual investment plan for each year, but as mentioned above, there is only limited flexibility as to where investment can go. At times the banks are liquid and are not looking for deposits, sometimes government bonds are not available, and housing sites may not be available. According to INJUPEMP the government so far has not interfered with its investment planning (but see below re INPREMA problems).

With regard to housing loans, INJUPEMP does not require down payments. It lends for up to 25 years at an interest rate of 12 percent. For lesser repayment periods the interest drops to as low as 10 percent. Although individuals can obtain an individual housing loan to build a new house or to purchase a home in a project, INJUPEMP also develops housing projects for its members. Thus, INJUPEMP is carrying out the functions of a banking institution and a developer.

In developing a project it attempts to do so in line with what it feels its members need. It buys land, undertakes the appropriate studies, and contracts with a builder to do the project. INJUPEMP has made an effort to move toward more popular construction. Selling prices for current projects range between Lps. 11,000 and Lps. 35,000, which is quite low. According to INJUPEMP demand far exceeds supply in Tegucigalpa, although two sizable and more expensive projects in Choluteca and San Pedro Sula remain unsold.

A current project for 300 units in Tegucigalpa, projected to sell at Lps. 11,000, had 600 applicants (houses are presold before construction) which were awarded on a first-come, first-served basis. The question was raised as to why INJUPEMP did not develop more housing projects if the demand is so high and if keeping fully invested was a problem. The answer was that there is a shortage of serviced land available for development. INJUPEMP also makes home improvement loans at the same interest rate as for new homes, for a term of 3-10 years.

INJUPEMP works with the employing institution in the collection process, by deducting payments from pay checks. This system has worked well. Nevertheless there are some delinquencies, particularly when people leave government employ. Delinquencies are less than one percent on mortgage loans but 10 percent on personal loans.

For the future, INJUPEMP says it is trying to emphasize housing for lower income families, but land and infrastructure are so costly that it is difficult to produce affordable housing. INJUPEMP is not doing any sites and services projects, but an individual could get a personal loan to build a house incrementally.

INJUPEMP does not work with FEHCOVIL. However, individuals who are members of INJUPEMP could form a cooperative and get financing through INJUPEMP.

The following table puts INJUPEMP's lending for housing in perspective:

| | 1980-85 | 1986 | 1987 | 1988 | Total |
|---|---|---|---|---|---|
| Number of new loans | 1,910 | 387 | 504 | 789 | 3,590 |
| Total Amount in Lps. 000 | 55,539 | 13,313 | 18,694 | 26,276 | 113,822 |

Instituto Nacional de Previsión del Magisterio (INPREMA--Teachers Pension Fund)

All teachers up through the secondary school level, both public and private, must belong to INPREMA--it is a national system. University teachers are now in the process of creating their own pension fund. INPREMA has been in business since 1971. INPREMA's board includes four individuals from government, including the Ministry of Education, four from teachers' colleges, one from private schools and one from the Retired Teachers Association.

Members contribute 7 percent of their salaries and the government (Ministry of Education) contributes 12 percent for the public school teachers. The private schools contribute 11 percent for their teachers. Total contributions are now running about Lps. 52 million per year.



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In addition to retirement benefits members get disability payments and death benefits similar to INJUPEMP. Retirement is obligatory at 60 and can be voluntary as early as 50. Payments are 80 percent of salary at age 60, less if one retires earlier. The average salary of a teacher in the primary schools is Lps. 600-700 per month and in secondary schools it is Lps. 900-1,000 per month.

The total assets of the fund are Lps. 400 million. Investments of the fund are in government deposits and paper (about Lps. 160 million), deposits with commercial banks and savings and loan associations (Lps. 60 million) and Lps. 90 million each in mortgage loans and personal loans. The average return on their portfolio was stated to be 11.25 percent.

Both mortgage loans and personal loans are made at 9.5 percent. No down payment is required for a mortgage loan. The repayment period for mortgage loans is up to 25 years and payments cannot exceed 30 percent of income. The recipient must be actively employed as a teacher and have been a member of INPREMA for one year. INPREMA's housing loans cover new construction, acquisition of an existing house and home improvements.

INPREMA is now developing its own projects as are the other two pension funds. It has four projects underway: one in Tegucigalpa with 715 units to sell at Lps. 45,000-50,000; one in San Pedro Sula of 390 houses to sell at the same price; and two projects at La Ceiba and El Progress of 100 houses each to sell at Lps. 21,000-28,000. INPREMA has an engineering department that prepares plans and specifications and deals with contractors and also handles appraisals for individual houses. INPREMA imposes no minimum standard on houses it will finance.

INPREMA, like INJUPEMP, acts just like a bank in receiving applications for loans, appraising these applications and servicing the loans. Because it is able to work with the institutions on repayments which are deducted from paychecks, it has been able to keep delinquencies very low for the most part. This is not true for private school teachers, where most of its delinquencies are. When we asked about the possibility of using a bank to service its loan portfolio we were told that INPREMA is paying an insurance company Lps. 1 million to service its portfolio, which would be something more than 0.5 percent on a loan portfolio of Lps. 180 million.

INPREMA provided financing for 3,091 mortgage loans over the period 1980-86 for a total of Lps. 85.6 million. In our discussions with INPREMA we inquired as to how much leeway INPREMA had in structuring its portfolio to maximize its return. We were told that, among other things, the INPREMA board was very sensitive to the housing needs of its members; more so than INJUPEMP. If INPREMA were to scale back its housing activities it would risk a strike by its members. However, it is difficult to see how developing Lps. 50,000 housing units in Tegucigalpa and San Pedro Sula is responsive to the bulk of its membership given teacher salary levels.

The government and INPREMA are now engaged in a financing dispute that may foreshadow future restrictions on the use of pension funds. The government budget for 1989 provides for the GOH to make its entire contribution to INPREMA in 10-year, 10 percent bonds, which cannot be discounted or sold. This year's contribution is estimated at Lps. 35 million. According to INPREMA, its actuarial studies show it has a current deficit of Lps. 300 million, given its projected pension and health benefit commitments. Forcing it to accept government bonds for this year's government contribution will in effect force INPREMA to use all new investible funds to help cover the GOH fiscal deficit at below-market rates.

This dispute follows recommendations by the Budget Committee of Congress concerning INPREMA's operations which call on INPREMA to raise the interest rate on its mortgage loans to members to meet the requirements of its constitution, which require that investments yield a minimum of 10 percent. INPREMA's auditors have also recommended raising mortgage interest rates.

INPREMA's view is that raising loan rates from 9.5 percent to 10 percent would inflict hardship on its members. It wants the government's contribution reinstated to cash or alternatively to five-year variable rate bonds pegged to market with guaranteed repurchase at par.



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**Instituto de la Vivienda (INVA)**

Established in 1957, the Instituto de la Vivienda (INVA) operates under a broad charter as Honduras's national housing authority. Although considered a semi-autonomous agency, in fact INVA is supported by the GOH through a combination of subsidized loans and grants, and its Board of Directors consists of representatives from government ministries and Presidential appointees.

INVA serves as a financial intermediary for new construction and home improvement financing in both urban and rural areas. In addition, INVA operates a small savings and loan association.

Between 1986 and 1988, INVA financed a total of 5,470 new construction loans for a total value of Lps. 38.7 million, and a total of 15,070 home improvement loans valued at Lps. 16.4 million. As the table indicates, INVA's emphasis has been in urban areas, where it has accounted for Lps. 38.12 million in loans over the last three years, or nearly 70 percent of its lending. New construction loans in Tegucigalpa, San Pedro Sula and La Ceiba totaled Lps. 29.96 million, compared to Lps. 8.16 million of lending in rural areas. Lending for home improvements in rural areas only slightly exceeded urban lending, at Lps. 8.27 million and Lps. 8.16 million, respectively. Rural lending has actually been on the decline, falling from 5,957 home improvement loans in 1987 to 3,261 loans in 1988, and from 810 to 622 new construction loans for the same years. Urban lending has similarly declined, though the average loan size for new construction jumped sharply between 1987 and 1988, from Lps. 7,069 to Lps. 28,055, suggesting that INVA has begun to serve a higher income group.

**INVA's Housing Finance Activities, 1986-1988**

| | |
|---|---|
| Total urban new construction: | 3,079 loans |
| Total value: | Lps. 29.96 million |
| Total rural new construction: | 2,391 loans |
| Total value: | Lps. 8.71 million |
| Total urban home improvements: | 1,300 loans |
| Total value: | Lps. 8.16 million |
| Total rural home improvements: | 13,770 loans |
| Total value: | Lps. 8.27 million |



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INVA's new construction activities are typically turnkey units, with INVA overseeing their construction from the design stage through completion. In general, INVA requires a 5 or 10 percent downpayment, with loans amortized over 15 to 20 years. Interest rates range between 12 percent and 14 percent, with the lower rates attached to financing for the lowest cost units. Loan repayments can not exceed 25 percent of a borrower's income. Typical low-cost INVA units, purchase prices and affordability estimates are:

✦Cores on a serviced lot sell for Lps. 3,000 to Lps. 5,000 with 12 percent financing. Affordability: monthly income of Lps. 200.

✦A 25-square meter basic unit sells for Lps. 11,000 with 13 percent financing. Affordability: monthly income of Lps. 464.

✦A 38-square meter one-bedroom unit sells for Lps. 14,000 to Lps. 16,000 with 14 percent financing. Affordability: monthly income of Lps. 716.

✦A 45-square meter two-bedroom unit sells for Lps. 18,000, with 14 percent financing. Affordability: monthly income of Lps. 806.

Although these are the units promoted by INVA for lower income families, INVA is also developing higher cost units.

INVA's rural housing programs have been financed almost exclusively with USAID assistance. The GOH has made funds available to INVA at no cost. INVA in turn on-lends these funds at 5 percent to private voluntary organizations (PVOs) to finance rural home improvements, and to a limited extent new construction. The interest earned covers INVA's operating expenses for the program. In turn, PVOs on-lend the funds to individual borrowers, generally in the form of building materials loans. Currently, 24 PVOs are participating in the program. On-lending rates vary, but in many instances they exceed a 30 percent effective rate of return. To date, this program has financed over 22,000 home improvements and nearly 900 new construction loans.

Despite this impressive level of activity, the rural home improvement program suffers from a high delinquency rate of about 20 percent. Moreover, INVA's loans to the PVOs are unsecured, with repayment based only on the willingness of the PVOs to comply with the terms of their loan agreements. Overall, INVA's poor collection record is even more serious. At year-end 1987, INVA reported that its total delinquent accounts amounted to nearly 70 percent of its loan portfolio, and over 51 percent of all loans were delinquent by more than 12 months.

In spite of the fact that the delinquency problem has existed for years, INVA only recently took steps to try to resolve the problem by formulating a loan collection plan. However, this plan has not yet been tested, and it is questionable if INVA has the political will or leverage to take effective action on overdue loans. In the last two years, INVA has sent out 1,500 delinquent notices, but it does not appear prepared to initiate foreclosure proceedings. INVA has not allocated reserve funds in the past to cover bad debts, based on the assumption that all loans were secured by real estate and thus eventually collectible. Not only was this an erroneous assumption, since full loan recovery is generally not realized through distressed collateral, but it also underscores INVA's basic reluctance to manage its loan programs on a sound fiscal basis.

A 1985 organizational audit of INVA identified a number of operational and management areas for improvement, but the recommendations of this report have not been addressed. According to this audit, INVA lacks a clear policy agenda or framework; among other issues, INVA has never established a policy for how to determine appropriate on-lending rates. Additionally, INVA does not analyze the impact of new borrowings on its financial position. The audit recommended a substantial reduction in staff at INVA, but this proposal was never implemented in the face of stiff employee opposition. In fact, INVA has the same number of employees today as it did in 1985, and personnel expenses were largely responsible for a 12.4 percent increase in noninterest expenses in 1987.

INVA has also not proven itself to be a particularly efficient producer of low-cost housing. Other PVOs operating in Tegucigalpa have been able to produce better housing on larger lots than INVA, at a much lower cost per square meter of built-up area (see PVO discussion later in this report). INVA acts as its own housing developer, but the 1985 audit pointed out that it poorly plans and supervises its projects. The 1,100-unit El Sitio project is a



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case in point, where poor engineering and design have resulted in many of the families being relocated to other sites.

INVA's management and fiscal record put into question what its role should be, given its apparent inability to correct its own deficiencies.

Within the shelter sector, there is a need to coordinate land assembly, provision of urban services and other activities related to project development. Currently, every housing developer must work with each agency separately to register title, secure approvals for service connections and obtain other needed approvals. This lack of coordination causes long production delays and increases housing costs. Assuming INVA could play a coordinating role in expediting land assembly and development approvals, it would facilitate production. It has already begun to move in this direction (see below).

Honduras does not have a national housing policy, and there has been some discussion of creating a Ministry of Housing to take charge of policy execution and development. INVA has attempted to play such a policymaking role, but generally has not received strong support in this endeavor from other agencies such as SECPLAN, FOVI or the PVOs. While INVA should be a participant in any dialogue on shelter policy, it makes little sense to give INVA the lead responsibility in formulating a national shelter policy given the fact that it has failed to develop for itself a clear policy agenda or objectives, nor has it has demonstrated true leadership ability in the housing sector.

INVA has proposed an innovative approach to the land tenure problem in Honduras's cities. Known as PROLOTE, this program is designed to transfer title to over 16,000 households illegally occupying private or dominio pleno land. Under PROLOTE, INVA would act as an intermediary between landowners and squatters to negotiate a sale of the property. INVA would finance land purchase through five-year bonds which would be given to the landowners in lieu of a lump sum payment. The bonds would be redeemable on a quarterly basis. Separately, INVA would enter into land purchase contracts with each family, requiring monthly payments. INVA would hold onto the land title as "interim administrator"



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until the contract was fully repaid, at which time title would transfer to the beneficiaries. PROLOTE families would also have access to INVA's home improvement financing.

The land tenure problem in Honduras is enormous, with an estimated 33 percent of all households in Tegucigalpa and San Pedro Sula classified as squatters, and approximately 14 percent of all households in other urban areas illegally occupying land. Thus, the problem of land tenure needs to be addressed, and INVA should play a role in this process.

Despite efforts to make housing affordable to all families, undoubtedly there will still be households which can not afford even the most basic shelter. These families will continue to require some element of subsidy if they are to be adequately housed. INVA's current programs incorporate indirect or hidden subsidies through below market interest rates, loan losses and subsidized operating expenses. However, these forms of subsidies in general tend to be inefficient, causing distortions in the both the housing and finance sectors, and often they do not reach the intended beneficiaries. These indirect subsidies should be replaced by direct, transparent and targeted assistance to the neediest families. INVA could play a role in the definition and implementation of such subsidized housing programs.

In general, the roles and responsibilities of a public sector housing authority should be limited to those activities which the private sector or the beneficiaries can not do for themselves. Both INVA's role as a banker through its savings and loan association, and as a housing developer, are inappropriate since these are functions better performed by the private sector. INVA has not proven to be an efficient financial intermediary, especially when judged in terms of its delinquency rates. Funds currently channeled through INVA to PVOs could probably be more effectively managed through another institutional arrangement.

# CHAPTER THREE

# NONCONVENTIONAL HOUSING FINANCE INSTITUTIONS

## NONCONVENTIONAL HOUSING FINANCE INSTITUTIONS

According to the estimates of SECPLAN, for the ten-year period ending in 1984, public and private formal sector institutions accounted for only 13 percent of the increase in Honduras' urban and rural housing stock. In urban areas alone, the rate was somewhat higher, estimated at between 33 percent and 39 percent. The balance of new construction, as well as the majority of home improvement financing, was accounted for by informal financing mechanisms.

Similar to other developing countries, Honduras' informal sector is vast, diverse, and includes the majority of lower income households, many of which do not have secure tenure. In Tegucigalpa and San Pedro Sula, in 1986 nearly one-third of all households were classified as squatters, with 14 percent of households similarly classified in other urban areas. Renters accounted for another one-third of all urban households, and many of these renters live in overcrowded, impoverished conditions, and the units they occupy may not be legally tenured. No rural households are classified as squatters, yet the USAID-funded Small Farmers Titling Project is in the process of securing title for households which are illegally occupying national agrarian lands, thus indicating that in fact rural squatters do exist.

The majority of lower income or informal sector households do not have access to formal financing for new construction or home improvements, with the exception of funds available through INVA's programs and through FOVI for housing cooperatives. Risk-aversion, lack of collateral and low incomes deter commercial banks from addressing informal sector housing needs, and the involvement of savings and loan associations in lower income housing is largely in response to donor requirements and not to internal marketing decisions. Most informal sector households must rely on personal savings to finance shelter needs, or access financing available through nonconventional[1] sources such as credit unions, cooperatives and private voluntary organizations (PVOs).

Nonconventional finance institutions (NCFIs) themselves are legally incorporated and/or supervised under government regulations; thus, they are not informal sector organizations per se. However, typically their members or beneficiaries are informal sector households, the majority of which fall below median income. The diverse nature of the NCFIs enables them to respond to the



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multidimensional nature of the informal sector through appropriately designed housing programs, including new construction, home improvements, and scattered site as well as multi-unit projects.

Opportunities exist for greater involvement of NCFIs in Honduras' housing sector, thus expanding the number of institutions actively involved in shelter production and finance. Any program designed to strengthen and expand NCFI activities, however, would need to take into consideration their various organizational affiliations and particular beneficiary groups.

This section of the report describes the principal Honduran NCFIs; namely, PVOs, housing cooperatives and credit unions. Each type of organization is discussed in terms of its organization, capacity and sources of funding, with particular reference to their shelter programs. Following these descriptions, strategies are suggested for bringing about greater NCFI involvement in low-cost housing solutions.

## Private Voluntary Organizations

Reportedly, there are over 200 private voluntary organizations operating in Honduras. PVOs range from church-affiliated organizations, such as the Catholic church's Caritas, to international relief programs, such as Save the Children Federation, and they work in both urban and rural lower income communities. Their activities encompass emergency relief, technical assistance, institutional and business development, credit, housing, education, health programs, and provision of basic services. A partial listing of 85 PVOs indicates that fifteen undertake housing activities and seventeen manage credit programs. INVA has 23 borrowers under its rural home improvement program, most of which can be classified as PVOs.

For the most part, PVO funds are derived from external sources or contributions and not from member savings. Clearly, however, the potential exists for introducing savings schemes and linking savings to access to credit or services, a practice which is common among PVOs in other countries. The PVOs' housing activities are largely confined to rural areas, primarily since available funds through INVA's home improvement program are earmarked for activities outside of Tegucigalpa, San Pedro Sula and La Ceiba.

Thirty-three PVOs belong to a national federation, the Federacion de Organizaciones Privadas de Desarrollo de Honduras (FOPRIDEH).[2] Headquartered in Tegucigalpa, FOPRIDEH was first organized in 1980 and chartered in 1982, with its initial funding coming from both USAID and the GOH. Member organizations pay a nominal fee of Lps. 200 annually, but FOPRIDEH charges for many of its services. FOPRIDEH currently is in the process of finalizing a $1 million loan from the Inter-American Development Bank (BID) which, if the conditions precedent are met, will be on-lent to support income generating projects, and FOPRIDEH's administrative costs will be covered by an interest-rate spread. FOPRIDEH already has loan requests totaling $465,000 for such PVO-operated enterprises as a cheese factory, glove factory, and cattle and swine operation.

FOPRIDEH does not limit its services to only member PVOs, but will provide services at a higher cost to nonmembers; for instance, a recent fund-raising seminar cost members Lps. 100 and nonmembers Lps. 150. As another example of member versus nonmember services, FOPRIDEH will not aid in the legal defense of a nonmember PVO unless the case has ramifications for PVOs in general.

FOPRIDEH fosters community development through a "bottom-up" approach, emphasizing projects that are designed locally and ultimately lead to the empowerment of the people. FOPRIDEH itself does not undertake projects, but serves as a catalyst for development through assistance in financing, training and operations. The sectors in which it operates include housing, credit, business development, education and health. For funding purposes, FOPRIDEH analyzes projects in terms of their viability and management. Since its start-up, FOPRIDEH has grant-funded 48 projects throughout Honduras in excess of Lps. 6 million.

Fourteen of FOPRIDEH's members operate housing programs, and FOPRIDEH reports that another five nonmember PVOs work in the shelter sector. In the last four years, PVOs have financed some 22,000 housing "solutions," almost entirely through INVA's rural home improvement program. Most loans are made in the form of building materials which PVOs buy in bulk, and then finance the sale of these materials to borrowers at or below market prices.

Frequently, a profit margin is built into the sales price to recover part of the program's operating expenses.

Similar activities are not carried out in urban areas due to lack of funding. In the cities, INVA typically constructs multi-unit projects, and any funds INVA has available for home improvement loans are made to its own project residents. A number of PVOs would be prepared to enter the urban housing field if funds were available, and they would be able to manage scattered site construction or improvements which INVA is not geared to carry out.

PVOs are further constrained by their lack of access to FOVI's mortgage rediscounting facilities. Only one PVO, the Federacion Hondurena de Cooperativas de Viviendas (FEHCOVIL), has been approved for FOVI financing. Other PVOs must work through FEHCOVIL or a savings and loan intermediary to access FOVI resources, in turn adding to financing costs. Currently, most PVO housing activities are financed through loan repayments, but FOPRIDEH estimates that PVOs could expand their shelter-related activities by as much as 100 percent if adequate funding were available.

A more detailed look at the housing activities of two PVOs is provided below.

Caritas de Danli

Caritas de Danli is a church-affiliated PVO, with the local church council serving as Caritas' Board of Directors. Caritas manages both new construction and home improvement loan programs which are funded through INVA's rural housing program and its own loan repayments. In addition to Danli, Caritas works in 140 nearby communities, generally ranging in size of 300 to 2,000 residents. While Caritas itself only has a 14-person staff, it relies on volunteers in each community where it works to carry out its programs.

Over the last five years, Caritas has financed 5,898 home improvements and 331 new construction loans. Both types of loans are made in building materials, and the actual improvements or construction are carried out through self-help. Caritas requires that all borrowers already have title to their land, which in this case refers to dominio util on ejido land since Caritas reports that private landholdings are rare in the areas where it works.



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For home improvement loans, Caritas purchases building materials in bulk, and finances their purchase by borrowers with a 20 percent mark-up over cost. Borrowers are also required to make a 20 percent down payment on the materials purchase. Thus, if Caritas buys bricks for Lps. 1,000, it on-lends these bricks for Lps. 1,200 and requires borrowers to pay Lps. 240 in advance, resulting in a loan balance of Lps. 960. No interest is charged on the loan balance which must be repaid within 12 months. Repayments can be made monthly, or in the case of farmers, in a lump sum at the time of harvest. Minimum and maximum loans amounts are Lps. 200 and Lps. 2,000, respectively.

New construction financing operates in a similar fashion. Caritas finances the purchase of building materials, in this case with a 12 percent mark-up in addition to which borrowers are charged interest of 12 percent annually. Loans must be repaid within four years, either on a monthly basis or in a series of annual lump sum payments. Minimum and maximum loan amounts are Lps. 1,600 and Lps. 5,000, respectively. Most new construction loans are sufficient to enable the borrower to build a 35 to 40 square meter house.

In 1989, Caritas anticipates making between 800 to 1,200 home improvement loans, for a total value between Lps. 750,000 and Lps. 800,000. At an average loan amount of Lps. 775, this results in a monthly repayment of Lps. 65. Caritas also expects to make 150 new construction loans totaling Lps. 600,000, for an average loan amount of Lps. 4,000 resulting in a monthly payment of Lps. 105 based on a four-year amortization.

The demand for shelter financing far exceeds Caritas' availability of funds. Currently, Caritas has requests for 3,000 home improvement loans and 450 new construction loans, or about three times its projected 1989 level of activity. Initially, Caritas' loans were primarily financed through INVA's rural housing program, but now most of its lending is financed through repayments since funds from INVA have diminished.[3]

Initially, Caritas' housing loans experienced a 27 percent delinquency rate which it reports resulted from poor loan decisions and inadequate follow-up. Improvements in its procedures have lowered the delinquency rate to 17 percent. Caritas secures its loans with a borrower's property, but it is adverse to proceed to the point of foreclosure. If a loan is delinquent, Caritas attempts to collect on it by meeting with the borrower and sending a series of demand letters. It has only foreclosed on one piece of property which was resolved by Caritas' selling off a borrower's cow to repay the loan.

Through its housing loans, Caritas is reaching very low income households. Caritas estimates that most of its beneficiaries have monthly household incomes below Lps. 200. Most of the loans are used to support scattered site development, enabling families to improve or build housing on their land rather than relocating to multi-unit projects.

Asociación San Jose Obrero

Situated in Choluteca, Asociación San Jose Obrero is another church-affiliated PVO with programs in health, employment and low-cost housing. With a staff of 190, San Jose Obrero carries out activities in Choluteca and nearby rural communities. Fourteen staff people are assigned to housing, and San Jose Obrero devotes 25 percent of its resources to shelter activities. Funding for San Jose Obrero's various programs comes from USAID, the Cooperative Housing Foundation (CHF), INVA and church contributions.

San Jose Obrero began its housing programs in 1980 with the construction of 60 units in Colonia Monsenor Marcelo. Two years later, San Jose Obrero initiated its self-help housing program at Namasigue with the substantial rehabilitation of 40 units. In 1986, another 50 units were built in Colonia Las Colinas which are not yet occupied due to delays in electrical connections. San Jose Obrero anticipates that electricity will be provided to the project within a few weeks. Finally, in Colonia El Gualiqueme, San Jose Obrero has rebuilt 50 units to assist families whose homes were destroyed last year by Hurricane Gilbert. All of San Jose Obrero's housing projects have been built on ejido land with dominio util title, since private landholdings with dominio pleno title are also rare in the Choluteca area.

Housing costs have varied, depending on whether the project has involved self-help construction, substantial rehabilitation or new construction. In the Colonia Monsenor Marcelo project, the per unit sales price was around Lps. 9,000, with four especially large houses costing Lps. 11,700. Since that time, San Jose Obrero reports that it has been able to reduce substantially per unit costs, plus it has diversified its housing portfolio to include both new construction and home improvements. For example, Lps. 1,000 rehabilitation loans were made to the victims of Hurricane Gilbert.

San Jose Obrero is also participating in INVA's rural housing program. Through year-end 1988, San Jose Obrero had made approximately Lps. 2.1 million in a combination of new construction and home improvement loans. In 1988 alone, it made 341 building materials loans for a total value of Lps. 964,789, or an average loan amount of just over Lps. 2,800.

San Jose Obrero has an approved line of credit from INVA for Lps. 300,000, and its higher volume of lending is made through loan repayments. San Jose Obrero borrows from INVA at 5 percent, and on-lends at 12 percent with a four-year repayment period and a maximum loan amount of Lps. 5,000. Based on the average loan size for 1988, monthly payments over a four-year amortization period amount to Lps. 70. Like Caritas, San Jose Obrero's home improvement financing is extended in the form of building materials.

San Jose Obrero reports a current loan delinquency rate between 5 and 8 percent.[4] (It also has been unable to s[illegible] one housing project.) Initially, it experienced a higher rate of arrears, which it attributes to cultural biases reinforced by local politics, past indiscriminate lending by development banks without good monitoring systems or repayment incentives, and the grant-taking mentally encouraged by government and church programs. San Jose Obrero has attempted to overcome these problems by declaring a loan to be delinquent if a payment is late by 15 days, visiting the borrower, exerting peer pressure on the borrower, naming delinquent borrowers on the radio, and ultimately retaining an attorney.

San Jose Obrero operates a small credit union through which it provides consumer loans. Other members of San Jose Obrero's target population belong to other Choluteca-based credit unions, including La Chorotega and La Guadalupe with 2,636 and 1,302 members, respectively. As of September, 1988, these two larger credit unions had mobilized savings in excess of Lps. 2.5 million. Locally, credit unions pay 9 percent on savings compared to the commercial bank rate of 8 percent.

**Federación Hondurena de Cooperativas de Viviendas, Ltda.**

The Federación Hondurena de Cooperativas de Viviendas (FEHCOVIL) is a federation of Honduras' housing cooperatives, and a PVO. Since its establishment in 1963, FEHCOVIL has financed the construction or improvement of approximately 19,400 houses in some 30 project sites. Most of FEHCOVIL's shelter activities involve new construction in urban areas, with a concentration to date in Tegucigalpa, but it has also undertaken home improvement projects and assisted rural cooperatives.

FEHCOVIL operates with a staff of 67 persons, including fully-staffed offices in Tegucigalpa, Olancho and Choluteca. In addition, it has one-person offices in San Pedro Sula and La Ceiba which it is planning to expand to better address housing needs in the north.

FEHCOVIL is a full-service cooperative, providing assistance in cooperative development, project design, preparation of bid and contract documents, and construction supervision. Training services are provided in cooperative law, member responsibilities, and basic accounting and financial management. FEHCOVIL continues to provide post-construction assistance to cooperatives which remain dues-paying affiliates; however, cooperatives are not required to remain members of FEHCOVIL, and currently it has a membership roster of 16 cooperatives.

Funding for FEHCOVIL comes from a variety of sources, including membership fees, FOVI and CHF. FOVI has provided both construction and long-term financing. On a limited basis, FEHCOVIL has borrowed from INVA, and in the past it accessed CABEI's resources.

The financing arrangements between FEHCOVIL and the cooperatives are flexible, reflecting both its source of funds and the arrangement negotiated with each cooperative. FEHCOVIL on-lends borrowed funds, covering its cost of operations with an interest rate spread of around 2 percent. The cooperative can pass these funds on to individual members at the same rate of interest and charge separate fees to cover its own costs, or it can on-lend at a higher interest rate to cover its own operating expenses with the resulting spread. Additionally, in some instances FEHCOVIL has charged an extra 1 percent interest to create a loan loss reserve fund, and in other cases it charges for its services in addition to the income realized through its on-lending.



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FEHCOVIL finances only basic housing units and some home improvements, but it does not develop wet cores or serviced sites. Construction is managed by an in-house unit which serves as a general contractor, with laborers and tradespeople (e.g., electricians and plumbers) hired on a project-by-process basis.

Cooperative members range from lower income informal sector households, with monthly incomes as low as Lps. 400, to moderate income professionals. FEHCOVIL-developed houses sell in the general range of Lps. 4,000 to Lps. 41,000. FEHCOVIL endeavors to target its assistance to lower income households, partly in response to FOVI's eligibility requirements, but it does not reject proposals from higher income groups.

Beneficiaries are required to make a 10 percent down payment, and loans are amortized monthly over a 15- or 20-year period. Currently, FEHCOVIL has near completion a housing project in Tegucigalpa with a selling price of Lps. 12,000. At 14 percent interest, with a 10 percent down payment and 20-year amortization, these units are affordable to families with monthly incomes of Lps. 537, assuming that loan repayments are limited to 25 percent of household income.

As of June, 1988, FEHCOVIL reported an overall delinquency rate of only 2.28 percent, rising to 3 percent by year-end. In general, arrears stay in the range of 2 to 3 percent. A number of factors account for this low delinquency rate. When members join a cooperative, they enter into a contract agreeing to abide by its rules, including the cooperative's right to evict them if they miss three monthly payments. Title to the properties is retained by the cooperative until the loan is fully repaid; thus, the cooperative can circumvent the regular foreclosure process in the event of default. Delinquent borrowers are first contacted by the cooperative, and if the account is not brought current, a special meeting is held by the Board of Directors to discuss eviction or other remedies. At any point, a borrower can bring his/her account current and remain in the premises; however, interest accrues on late payments, serving as a financial incentive to repay on time. If a member refuses to comply with an eviction order, the cooperative forcibly evicts the borrower with assistance from the police. Typically, this eviction process takes about six months as compared to a court-ordered foreclosure which can take two years or longer.

If a member is evicted, the cooperative resells the unit, reimbursing the member for his/her down payment, the amount paid on principal, the assessed value of home improvements, and one-half the appreciated value of the property. As a penalty, the member loses one-half of the value of the property's appreciation. If a member voluntarily leaves, the cooperative has the first right to purchase and resell the property, and the owner realizes the full value of the property's appreciation.

In the last few years, FEHCOVIL's production level has been somewhat erratic, though recently it has risen sharply. Between 1968 and 1986, FEHCOVIL financed on the average 124 units per year. In 1985 and 1986, production amounted to a total of only 96 units which FEHCOVIL reports was caused by financing difficulties encountered with CABEI. In 1987 and 1988, production has risen dramatically, to over 630 houses annually, in large part due to financing becoming available through FOVI and CHF. In the last year, FEHCOVIL financed 515 urban units for an average loan size of Lps. 25,781 and 122 rural units for an average loan size of Lps. 5,200.

FEHCOVIL's level of housing production in the last couple of years has made it a major player in the shelter sector. According to SECPLAN, formal public and private sector institutions constructed 25,500 new urban housing units between 1974 and 1985, or an annual average of 2,550 units. Assuming production levels have stayed relatively constant, FEHCOVIL's 515 new urban units in 1988 represents over 20 percent of total annual production. Of SECPLAN's ten-year estimate for total urban housing construction, the private sector accounted for 13,300 new units or 1,330 annually. Of this amount, FEHCOVIL's 1988 production totals nearly 40 percent of annual new construction.

Demand for cooperative housing exceeds FEHCOVIL's current level of effort, and FEHCOVIL believes that it could easily double or triple its present level of housing activity. However, it is constrained by the lack of available financing. Other constraints include the perennial water shortage in Tegucigalpa, making it difficult to secure water connections from SANAA, and general bureaucratic delays in processing building permits, service requests and title transfers.

Below, three of FEHCOVIL's projects in Tegucigalpa are described.

Sosa Traversia

Sosa Traversia is a scattered site cooperative located in one of Tegucigalpa's marginal or lower income neighborhoods. It is located beyond paved roads, but near enough to water and electrical connections to make these services accessible. As a scattered site cooperative, it is an experimental venture for FEHCOVIL which typically builds multi-unit projects on the same plot. However, the success of Sosa Traversia has encouraged FEHCOVIL to identify other opportunities for this type of development.

The Sosa Traversia cooperative was organized two years ago with assistance from FEHCOVIL. There are thirty members, and over half of the units are completed and occupied. Houses are constructed simply with brick walls and sloping tin roofs. Each unit has 2 bedrooms, kitchen, lavatory, and combination living and dining area. The units are single-family detached, with a built-up area of 42 square meters on 150 square meter plots.

For the Sosa Traversia project, FEHCOVIL's prerequisites for qualifying for financing are: beneficiaries must join the cooperative; members must already own a plot of land; and the member's monthly household income can not exceed Lps. 900.

The housing units alone are sold for Lps. 5,411. In addition, members are required to pay separately for electrical and water connections, costing approximately Lps. 600. The land cost adds approximately Lps. 3,000 to the cost, resulting in a total per unit cost of just over Lps. 9,000. The sales price is financed fully over 15 years at 14 percent interest, resulting in a monthly payment of Lps. 72. FEHCOVIL has borrowed funds for the Sosa Traversia project from CHF which it on-lends at 11 percent to the cooperative, which in turn on-lends to individual households at 14 percent. Each household is responsible for paying taxes and utilities.

Three or four members of the cooperative are already late in making loan payments, one by as many as four months, and the Board of Directors is in the process of reviewing this delinquency problem. The cooperative's president explains that the problem stems from the fact that members have never had to pay for housing on a regular basis.

Miraflores

The Miraflores project is a moderate income project adjacent to another cooperative, Miraflores Sur. The second Miraflores project consists of 157 nearly completed units, 83 of which are already occupied. All of the units have been presold to members, which is typical of FEHCOVIL's projects. FOVI has provided 85 percent of construction financing, with the balance coming from the members' deposits.

The Miraflores units are 72 square meters on 160 square meter plots, and each contains three bedrooms. The selling price is Lps. 41,000 per unit, including the cost of land, services, construction, and graded roads and drainage ditches. FEHCOVIL requires a 10 percent down payment, but some members have paid down as much as 25 percent. With only a 10 percent down payment, affordability would be limited to families earning over Lps. 2,000 per month.

Empleados Panificadora Roma, Ltda.

The Empleados Panificadora Roma project is another lower income project, but in this case, the members are employed by the formal sector as opposed to the marginal families assisted by the Sosa Traversia cooperative. In this project, all of the members are employed by the Panificadora Roma bakery.

The total project consists of 63 units, many of which are completed and occupied. The 36 square meter houses are built as duplexes with one adjoining wall. Each unit sells for Lps. 12,000, including land, service connections, construction, and graded roads with drainage ditches. A minimum 5 percent down payment is required with the loan balance repaid in five years. This short repayment period has been required by CHF, the funding source for this project. Beneficiary income can not exceed Lps. 900 monthly.

In addition to financing the purchase of these units, CHF is also offering home improvement loans of up to Lps. 6,000. In some cases, these funds are being used by beneficiaries prior to occupancy in order to add porches or extra bedrooms. The fact that beneficiary incomes can not exceed Lps. 900 suggests that many of these families have been able to make sizable down payments in order to afford both new construction and home improvement financing.

**Federacion de Asociaciónes Cooperativas de Ahorro y Credito de Honduras**

The Federacion de Asociaciones Cooperativas de Ahorro y Credito de Honduras (FACACH) is an association of credit unions from throughout Honduras. Currently, 83 credit unions belong to FACACH, with a total membership of over 55,000. Credit unions range in size from 80 to over 2,600 members, and about half are located in Tegucigalpa and San Pedro Sula. Of FACACH's 83 members, 50 are "open," meaning that anyone can join the credit union, while the rest are "closed" with membership limited to special groups (e.g., a company's employees).

Although credit unions manage savings and loan activities, they are not regulated by the central bank but by the Instituto Hondureno de Cooperativas (IHC), a public agency. IHC is primarily responsible for reviewing all cooperatives' financial statements, but FACACH is free to establish its own lending policies.

As of September, 1988, FACACH's members reported savings in excess of Lps. 15.8 million and share capital of approximately Lps. 90 million. This imbalance between savings and share capital is partly explained by the fact that credit unions only began to mobilize savings in 1980. Members can withdraw their savings at any time, but share capital can only be withdrawn if the member quits the credit union. Members are not permitted to withdraw share capital in part, nor can share capital be withdrawn as long as the member still has an outstanding loan.

Credit unions are required to deposit 30 percent of their savings with FACACH, which in turn deposits 30 percent of its deposits with banks or other finance institutions. The balance of savings retained by FACACH is relent to credit unions to finance member borrowings. FACACH covers its own operating expenses through interest rate spreads and annual dues ranging from Lps. 300 to Lps. 1,500, depending on a credit union's size.

Individuals earn between 8 to 10 percent on their credit union savings, but only 4 to 8 percent on their share capital. Savings deposited with FACACH earn 8 percent on demand deposits, and between 8.5 percent and 10.75 percent for various time deposits. Credit unions are required to invest a portion of their share capital with FACACH, on which they earn only a 4 percent return. On loans made to the credit unions, FACACH charges between 11 percent and 14 percent interest.

As of September, 1988, credit unions reported over Lps. 97.9 million in loans outstanding to their members. Approximately 30 percent of all lending finances housing activities, with the demand being greater for home improvements than new construction.[5] Housing loans range in size from Lps. 2,000 to Lps. 50,000, repayable in up to five years. As a general rule, loans are limited to twice a member's share capital, but FACACH is considering adopting a higher loan-to-capital ratio to encourage more membership.

In general, the credit unions' repayment record has been poor. Delinquency rates vary widely, with a number of credit unions reporting arrears as high as 70 percent. Presently, FACACH reports a 20 percent delinquency rate on the loans due from its member credit unions.

Starting in the 1970s, FACACH began to experience financial difficulties brought about by a combination of bad investments and poor management decisions. To some extent, FACACH over-extended itself by beginning to directly own and operate rural enterprises; in particular, it lost considerable funds on three warehouse ventures. In addition, FACACH made loans to three credit unions for a total of Lps. 4 million for the purchase of fishing boats which were later confiscated when the boat owners ventured into a neighboring country's territorial waters. The boats were not insured, and FACACH took a loss on these investments.

In the last couple of years, FACACH has begun to correct some of these problems. As a general policy, it no longer takes an ownership position in business ventures, and loans to any one credit union are limited to 10 percent of FACACH's total portfolio to limit its risk exposure. Other corrective actions have been taken, including the replacement of mid-level staff with more qualified personnel.

FACACH is also benefiting from a USAID-sponsored project, the Fondo Desarrollo Financiero (FDF), which is aimed at strengthening the country's credit union movement. FDF is managed by a special unit created within FACACH, and while it is primarily intended to benefit rural, agricultural-based credit unions, its benefits are in fact more widespread. FDF's three core components are:

1. **Institutional development.** Under this activity, funds are made available to credit unions to address specific problems and provide developmental technical assistance. Credit unions are required to undergo an organizational assessment and



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problem identification process, resulting in the development of a multi-year business plan. To date, 15 credit unions have participated in this process. Previously, most credit unions did not demonstrate planning or cash management capabilities, and their efforts to secure funding were more consistent with proposal writing than business development. FDF's institutional development efforts are designed to instill a businesslike approach and result in an operating plan.

2. **Financial stabilization.** Financial stabilization involves an injection of capital into credit unions to improve their solvency and liquidity. Under this activity, credit unions can borrow funds at subsidized rates, with the precondition that the credit unions develop a multi-year recapitalization plan. As an example, in the past one farmers' credit cooperative made loans to members at 10 percent interest, but never charged separately for its commercial services (e.g., land preparation, packaging, marketing, etc.). The credit union also had a poor repayment record. Under financial stabilization, the credit union will borrow Lps. 500,000 at 4 percent interest, repayable in full at the end of each year. If the credit union meets its annual recapitalization target of Lps. 100,000, generated through fees on services, the credit union will be permitted to draw down again on its financial stabilization loan in each subsequent year, but for Lps. 100,000 less each year until the loan has been fully replaced by internally-generated sources.

3. **Credit.** FDF's last component is access to credit on closer to market rate terms. Loans are made in U.S. dollars at 12 percent, and they are intended to provide needed funds for imports (e.g., fertilizer and heavy equipment). Most loans will be repayable in one year, reflecting the primarily agricultural focus of FDF, but approximately one-third of these loans will be made for up to five years for such purchases as equipment.

FDF is intended to assist FACACH as well as the primary credit unions. FACACH has already undergone an extensive organizational assessment and prepared a five-year development plan through 1992. Over the next five years, FACACH will endeavor to strengthen its operations by nearly doubling credit union membership to 100,000 persons and capturing 10 percent of national household savings. Strategies for mobilizing this level of savings include promotional campaigns, raising the loan-to-savings ratio and improving the general image of the credit unions. In addition, FACACH plans to offer special theme-oriented savings programs, such as savings for Christmas, school or vacations. Finally, FACACH plans to study the feasibility of developing a deposit insurance program.

Credit unions have not played a major role in housing finance, and their loans tend to be targeted to home improvements and land purchase. The following case study, however, describes a housing project developed by Cooperativa Apaguiz[6] in Danli with assistance from FEHCOVIL.

Cooperativa Apaguiz

Cooperativa Apaguiz is a member credit union of FACACH. In conjunction with FEHCOVIL, it has recently built a 108-unit housing project on the outskirts of Danli, the largest housing project in the area. All of the units have been sold, and about half are occupied.

Cooperativa Apaguiz purchased the project site over 20 years ago, but the tract remained undeveloped until recently due to lack of funds. To secure financing, Cooperativa Apaguiz approached FEHCOVIL, which in turn accessed FOVI's resources for construction and long-term financing. In addition, FEHCOVIL has assisted in the project design and trained beneficiaries.

The houses are single-family detached units on 200 square meter lots with a 51 square meter built-up area. Site improvements include graded roads, drainage ditches, electrical connections, and its own water tower. Initially, the units themselves were expected to cost Lps. 13,000, not including site improvements. The buyers have also requested certain upgrades to the project design, such as better windows. As a result of these additions, the final sales price is expected to be Lps. 22,000, with the exact figure awaiting completion of the project's finishing touches. The buyers have been kept informed of these costs throughout the construction process, and according to Cooperativa Apaguiz the price increase has not posed any problems.

Beneficiaries are required to make a flat down payment of Lps. 2,000, with balance financed over 20 years at 14.75 percent. The interest rate reflects 11 percent financing from FOVI to FEHCOVIL, on-lent to Cooperativa Apaguiz at 13 percent, which is then on-lent to beneficiaries at 14.75 percent. To qualify for financing, beneficiaries must have a minimum monthly income of Lps. 800 but a maximum monthly income of Lps. 1,000. Monthly payments are expected to be approximately Lps. 260, or between 26 percent and 33 percent of household income.

Cooperativa Apaguiz has 989 members with average incomes of around Lps. 400 monthly. Thus, this initial project is reaching the credit union's higher income members. Some 300 other members have expressed interest in buying houses, and Cooperativa Apaguiz would like to



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undertake additional projects but it would probably require at least minimal assistance in developing a lower cost project. Also, while Cooperativa Apaguiz reports that it had a good working relationship with FEHCOVIL, it would like to be able to borrow from FOVI directly to lower the financing cost, thus being able to reach a lower income clientele.

## Expanding the Role of NCFIs in Housing Finance and Production

The foregoing descriptions of Honduras' nonconventional finance institutions has highlighted their involvement in low-cost shelter finance and production. These institutions play a significant role in the housing sector, especially in their ability to provide access to credit to the country's lowest income households. Moreover, their programs exercise an element of flexibility in design and approach which is lacking in many conventional and public sector finance programs.

NCFIs have a number of advantages over more traditional approaches to addressing low-cost housing needs. Of foremost importance, they are generally situated in low income communities, working alongside intended beneficiaries. As such, they are viewed with less skepticism or distrust than government-sponsored agencies, and more as advocates of the people. By utilizing existing community affiliations or alliances, or in the case of cooperatives by creating new alliances, they are better able to exert peer pressure to bring about loan recovery. While FACACH's credit unions suffer from high delinquency rates, other NCFIs, such as FEHCOVIL, Asociación San Jose Obrero and Caritas de Danli, appear to have reasonable repayment records, though this cannot be known for sure until better audits are conducted of these institutions. As a group, NCFIs also represent a multifaceted vehicle to approach the diverse housing problems and needs of the informal sector, and have lower production costs than INVA.[7]

The ability for NCFIs to expand their housing activities is largely constrained by a lack of resources. However, efforts or programs designed to expand significantly their work in informal sector housing should be based on a recognition of their absorptive capacity, and they should be accompanied by technical assistance efforts to improve their lending operations through more clearly defined policies and operations.

The following discussion suggest possible strategies and highlights key issues pertinent to expanding the role of NCFIs in the housing sector.

Fostering a FEHCOVIL/Credit Union Relationship

The Cooperativa Apaguiz project in Danli demonstrates the benefits of developing a working relationship between FEHCOVIL and FACACH's local credit unions. Typically, FEHCOVIL plays a role in organizing cooperatives, but by working through credit unions, a local organization already exists. In the case of Cooperativa Apaguiz, FEHCOVIL trained a group of members in cooperative principles and responsibilities, and served as a conduit for FOVI financing. Additionally, FEHCOVIL assisted in the project's design and studied its feasibility. The credit union itself provides on-site marketing and servicing functions, including the screening of beneficiaries. Since potential borrowers have a long-term relationship with Cooperativa Apaguiz, the credit union has a basis on which to judge a borrower's creditworthiness.

Through this partnership, each organization has contributed services based on their respective expertise. Additionally, FEHCOVIL can lower its own operating cost by being able to shift certain responsibilities to a local affiliate, rather than opening up a project office even on a temporary basis.

This relationship should be encouraged. A separate program may not be warranted, but consideration should be given to creating incentives within existing programs for FEHCOVIL to work closely with credit unions in housing finance and production. Options include establishing a special line of credit at FOVI to be channeled through FEHCOVIL to credit unions, or to providing resources directly to FEHCOVIL for on-lending to credit unions. The design of any such incentives should also consider what role, if any, FACACH should play in identifying or assisting credit unions to work with FEHCOVIL.

Savings Mobilization

With the exception of credit unions, Honduras' NCFIs are not involved in savings mobilization to a significant degree, unlike the situation found in many developing countries where NCFIs attempt to fill a gap in both access to credit as well as savings opportunities.[8] Rural households in particular often lack savings opportunities due to poor coverage by financial



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institutions, but even lower income urban households may hesitate to put their savings in conventional finance institutions for a number of reasons, including high transaction costs, distrust of banks, economic uncertainties or fear of government control.

National savings rates in Honduras have declined, falling from 12.7 percent of GDP in 1980 to 7.6 percent of GDP in 1985.[9] Over the same period, private savings alone fell from 9.7 percent to 5.8 percent of GDP.[10] Capital flight has contributed significantly to this declining savings rate; nevertheless, these figures suggest that an increase in savings is possible. Interviews in Honduras offer a mixed response as to whether or not lower income households deposit their savings in banks or savings and loan institutions. However, since most lower income or informal sector households do not have access to overseas investment opportunities, greater emphasis should be given to mobilizing their household savings.

As of September, 1988, FACACH's credit unions report savings in excess of Lps. 105.8 million, or an average of over Lps. 1,920 per member. The majority of these savings is held in the form of share capital earning below market-rate interest, suggesting that access to credit is a major factor in determining where a member saves. Share capital averages over Lps. 1,630 per member, and it can not be withdrawn unless a member wants to terminate his/her membership in the credit union. While it is not within the scope of this report to analyze savings potential, these figures indicate that lower income households do have a savings potential, and that reciprocity (that is, access to credit) is key to mobilizing savings.

As a strategy for mobilizing savings for housing finance through NCFIs, priority for new construction or home improvement financing could be linked to savings. Unlike a <u>contractual</u> savings scheme in which savers are guaranteed a loan after a certain period of time, a <u>priority</u> savings and loan program eliminates the risk of emerging liabilities by offering loans only if the NCFI has sufficient funds. A simple formula can be devised to establish a borrower's priority based on savings amounts, period of savings, and loan-to-savings ratio.

To encourage longer term savings, NCFIs would need to offer market rates on deposits, thus providing savings opportunities in addition to potential access to credit. Even so, an NCFI providing new construction financing runs the greatest risk of having savings withdrawn once a



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loan is approved, especially if the savings will be used for a down payment. If home improvement financing is offered as well, there will be a greater incentive for maintaining a savings balance. Credit unions offering loans for a variety of purposes are in the best position to attract and retain loan-linked savings.

Management of savings by NCFIs has been successful in other countries, and should pose no great problems in Honduras as well. Consideration needs to be given to the actual handling of funds, and maintaining and updating account records. Idle funds could be deposited in interest-bearing accounts at conventional finance institutions, and through proper cash management, NCFIs should be able to offset a large part of the interest they pay to savers.

NCFI Absorptive Capacity

Any strategy designed to expand the NCFIs' involvement in housing finance would need to reflect their absorptive capacities. NCFIs report a greater demand for housing finance than they can currently provide based largely on funding limitations. A brief summary of 1988 activities for some NCFIs provides a basis on which to estimate total NCFI on-lending capacities:

**FEHCOVIL.** In 1988, FEHCOVIL provided a total of Lps. 13.9 million in urban and rural housing loans. FEHCOVIL estimates that it could easily double or triple this output.

**PVOs.** In 1989, Caritas de Danli expects to make 1,000 home improvement loans at an average of Lps. 775 each, or Lps. 775,000 total. In addition, it anticipates making 150 construction loans at Lps. 4,000 each, or Lps. 600,000 total. Caritas reports that demand is three times this level of activity. In 1988, San Juan Obrero made 341 home improvement loans for Lps. 2,800 each. For the two organizations, the average home improvement loan size is approximately Lps. 1,800.

**Cooperativa Apaguiz.** Cooperativa Apaguiz is currently completing a 108-unit project, and reports a demand for 300 more houses by families with household incomes of around Lps. 400 monthly. Based on its current lending terms, these families could afford mortgages of Lps. 10,270.

Using these activity, cost and demand levels as a basis, it can be roughly, and perhaps even conservatively, estimated that NCFIs could support an initial lending activity of Lps. 52.795 million, calculated as follows:



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**FEHCOVIL.** Lps. 27.8 million, assuming FEHCOVIL doubles its present level of activity.

**Rural PVOs.** Lps. 15 million, assuming 10 PVOs each make 500 home improvement loans for Lps. 1,800 each and 150 construction loans for Lps. 4,000 each.

**Urban PVOs.** Lps. 4.86 million, assuming 3 PVOs each make 500 home improvement loans at Lps. 1,800 each and 100 construction loans at Lps. 7,200 each. (The construction loan average is based on 80 percent of FEHCOVIL's Sosa Traversia project which has produced a housing unit at Lps. 9,000, including land purchase and service connections.)

**Credit unions.** Lps. 5.135 million, assuming 10 credit unions each finance 50 mortgages at Lps. 10,270 each.

NCFI Access to FOVI

A major deterrent to housing finance is the potential mismatch between assets and liabilities; that is, mobilizing short-term resources (e.g:, savings) to make long-term loans (e.g., mortgages). In Honduras, FOVI's rediscount facilities enables eligible lenders to refinance their housing loans through FOVI on a long-term basis, thus minimizing the term risk and providing needed liquidity to the housing finance system.

Eligible participants in FOVI's rediscount program include savings and loan associations, commercial banks and INVA. Among NCFIs, three organizations--FEHCOVIL, San Juan Basco and FACACH--have now been approved for direct access to FOVI. Other NCFIs have only indirect access to FOVI by working out an on-lending arrangement with another eligible participant, such as Cooperativa Apaguiz's arrangement to borrow FOVI funds using FEHCOVIL as an intermediary. FOVI's recent approval of FACACH as an on-lending institution represents a new willingness to deal directly with other than traditional lenders. FOVI is now preparing a program for further broadening access to its credit.

FOVI plays a pivotal role in the housing finance system's liquidity and potential for expansion, but extending eligibility to NCFIs should be approached cautiously. The overriding concern should be FOVI's viability, and introducing unnecessary risk in its portfolio could



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threaten both its soundness and public image. For these reasons, only NCFIs which meet certain standards should be permitted direct access to FOVI's rediscount program.

As NCFIs demonstrate the soundness of their programs, including meeting certain qualifying standards, they should become eligible for FOVI financing. In general, qualifying standards should include:

1. Operating experience. NCFIs should be required to operate housing finance programs on a sound fiscal basis for at least three consecutive years.

2. Loan delinquencies and defaults. NCFIs should be required to meet reasonable standards of delinquency and default rates for at least two consecutive years. NCFIs should have clear definitions of what constitutes a delinquent or defaulted loan, and established procedures for addressing each event.

3. Interest rate coverage. NCFIs should be required to make housing loans at interest rates which cover, at a minimum, the cost of funds, administrative costs and loan loss rates. Interest rate coverage should be one basis on which the fiscal soundness of an NCFI is measured.

In Honduras, few NCFIs rigorously pursue delinquent loans, in large part because such action should ultimately lead to foreclosure proceedings if the delinquency is not cured. In turn, foreclosure is time-consuming and costly, and in many instances runs contrary to the NCFIs' nature.[11] However, for NCFIs to assume a more important role in housing finance, the problems of delinquencies and defaults needs to be addressed, especially if they anticipate accessing FOVI's resources. In particular, delinquent loans should not be held on the books indefinitely which currently is common practice, but declared in default and written off after a certain period of time has elapsed.

Loan losses are an inherent part of all lending, but standards used to measure the performance of conventional lenders can not be applied in their entirety to NCFIs. In the U.S., regulators classify commercial lenders as 'problems' if their default rates exceed 3 percent, but loan loss rates tend to be higher among community-based lenders.[12] A survey of over 100 U.S. revolving loan funds reports a default rate of 22 percent between 1982 and 1986.[13] In general, U.S. community-based, lower income lenders aim to achieve a default rate of 15 percent or less.



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Obviously, higher loan loss rates threaten a lender's viability, and the aim should be to reduce losses. At the same time, the impact of these losses can be mitigated in part by higher on-lending rates. In Honduras, a reasonable target for NCFI loan loss rates is 10 percent, provided that these losses are reflected in interest rates and covered by reserves.

## Legalizing Land Tenure

In Honduras' cities, the problems associated with insecure land tenure are particularly acute. An estimated 27 percent of all households in Tegucigalpa and San Pedro Sula are squatters, and approximately 14 percent are squatters in other urban areas. Insecure tenure and illegal occupancy of land have implications in terms of both housing standards and the ability to access financing for home improvements or construction.

Many lenders in general are reluctant to extend credit to lower income families, and squatter families have virtually no access to formal sources of credit. Similarly, urban services are not extended to squatter communities, and often the households are forced to illegally tap into water and electrical services. Over time, these services may be upgraded by the service providers which begin to charge user fees, but these actions do not convey land title and the households remain in a tenuous legal status. The need to legalize land tenure thus becomes a necessary precondition to upgrading housing for many of the urban poor.

The growth of squatter or marginal communities in Honduras is not a gradual process, whereby a few households at a time press the outer limits of urban areas. Rather, in many instances, land invasions are organized, with several dozen families illegally taking possession of land at one time. Assisted by 'professional invaders,' the families stake out a tract of land, run up a flag, and immediately construct temporary shelter. Unless the authorities are able to forcefully remove the squatters, their removal becomes a legal matter. Since the legal process is lengthy, and Honduras does not displace squatters as a matter of policy, their ability to occupy the land is ensured for at least several years. Semi-permanent housing is constructed and gradually improved, but most housing remains substandard since the families are disinclined to invest in housing without secure tenure.

An example of one invasion will serve to describe the general process involved. In 1980, a group of 25 men, 100 women and scores of children invaded land on the outskirts of Tegucigalpa. The squatters placed stones around the perimeter of the land they intended to occupy, raised a flag, and began to build temporary shelter with cardboard and brush. The landowner and his foremen arrived shortly thereafter, demanding that they leave the land. A scuffle broke out, and the landowner shot dead the president of the group's patronato. The landowner fled, and the police arrested the men. Other families joined the remaining women, and a collection was taken up to secure the release of the men from jail.

The squatters stayed on the land, and in the ensuing months their houses were burned twice. At night, houses would be shot at, so the families dug trenches in their earthen floors in which to sleep so as to avoid the bullets coming through the walls. The families began to contribute funds into a bank account in hopes of purchasing the land, but the opportunity to do so was never extended. Eventually, Lps. 250,000 were collected, but Lps. 30,000 were withdrawn to pay for the installation of 14 standpipes and another Lps. 90,000 were withdrawn to bring electrical service to the neighborhood.

Currently, 1,500 families occupy the site, living in self-constructed wooden houses. Residents state that they would like to buy the land because they want to improve their homes, replacing wooden structures with brick, but without land title they are unwilling to make further improvements. Although the squatters arranged for basic urban services, they remain inadequate, as evidenced by the fact that there is only one standpipe for each 107 families.

Similar situations have occurred throughout Tegucigalpa and other cities, underscoring the need to tackle the land tenure problem as part of an integrated approach to addressing lower income housing needs. In recognition of this problem, INVA has proposed a tenure legalization program, known as PROLOTE, which is designed to transfer title to over 16,000 households illegally occupying private or <u>dominio pleno</u> land. Under PROLOTE, INVA would act as an intermediary between landowners and squatters to negotiate a sale of the property. INVA would finance land purchase through five-year bonds which would be given to the landowners in lieu of a lump sum payment. The bonds would be redeemable on a quarterly basis. Separately, INVA would enter into land purchase contracts with each family, requiring monthly payments. INVA would hold onto the land title as 'interim administrator' until the contract was fully repaid, at which time title would transfer to the beneficiaries. PROLOTE families would also have access to INVA's home improvement financing.

PROLOTE itself is still in the design stages, with variations on its basic components under discussion. For instance, INVA has not yet determined an appropriate repayment period for the land purchase, and recently suggested that beneficiaries should be required to pay for the land within six months. Apparently the landowners themselves have not been consulted in the project's design, and their particular concerns will need to be addressed. Undoubtedly, many landowners will see PROLOTE as a means to recover payment for their properties, but they may be more inclined to do so through a lump sum payment than bond financing. One advantage of a lump sum payment might be to lower the land's purchase price. While the program's specific features still need to be developed, PROLOTE's overall approach has merit, and the project deserves further attention.

As proposed, PROLOTE would address only the tenure problems faced by squatters on privately-owned or dominio pleno land, but in fact many illegal settlements are on ejido or municipal land.[14] This suggests that a parallel program could be developed for other squatter communities. Indeed, the land tenure problem is so enormous that it is unlikely that INVA can adequately address the issue entirely on its own. In fact, PVOs may be better positioned to perform this function, since they are working more closely with marginal families, and they are not regarded with the same distrust associated with government-sponsored agencies. Moreover, INVA itself has experienced management problems, and it is questionable as to whether it has the capability to manage PROLOTE at the envisioned level of activity.

Clearly, the legalization of land tenure in Honduras' urban areas should be given priority in any housing sector initiatives. Implementation of a tenure legalization project need not be confined to any one organization, and in fact it may be preferable to address the problem through a number of institutions, including INVA, FOPRIDEH and the PVOs. In designing a PROLOTE-type project, issues which will need to be addressed include:

✦Financing the land purchase, and the source of funds if the purchase is to be made through a lump sum payment;

✦Assessing the fair market value of the land;

✦Ensuring that the land purchase terms are affordable to the project beneficiaries;

✦Involving all households on a given tract in the land purchase scheme, and deciding what action should be taken if a few households refuse to participate in the program and/or become delinquent in their loan payments; and

✦Supplementing the land purchase scheme with home improvement or new construction financing.

Notes, chapter 3

1. A distinction should be made between the terms "nonconventional" and "nontraditional," the latter often being used to describe nonbank finance institutions. In fact, the operations of credit unions, cooperatives and PVOs are commonly based on indigenous group associations or affiliations, and as such are much more "traditional" in nature than conventional banks and sa ·ings and loan associations. For this reason, the term "nonconventional" is used in this report as a more apt description of these organizations.

2. FOP makes the distinction between PVOs and PDOs, or private development organizations. According to FOP, PDOs are neither voluntary nor charitable, but organizations which are committed to local community development, and only PDOs are members of the federation. While the nuances of this distinction are recognized, in this report these organizations will be referred to as PVOs since this terminology is more widely used. However, it should be noted that the discussion of PVOs in this report refers to private organizations which give priority to developmental activities and not charitable programs.

3. Caritas reports that it originally borrowed funds from INVA with interest-only payments during the first 10 years. However, INVA recently informed Caritas that it could only draw down new funds if it repaid a portion of the principal currently outstanding. Also, Caritas reports that INVA has allocated its funds by region, making inadequate resources available for the Danli area.

4. In Honduras, loan delinquency rates commonly refer to only the overdue portion of a loan, and not the entire loan which may be delinquent. From available information, it appears that the delinquency rate reported by San Jose Obrero is based only on the amount overdue, whereas the 17 percent delinquency rate reported by Caritas is consistent with the U.S. definition of delinquencies.

5. In rural areas, the demand for loans by use or sector in diminishing order of priority is: farming, business, housing and consumer. In urban areas, the demand for loans by use or sector in diminishing order of priority is: business, housing and consumer.

6. In Honduras, credit unions are also referred to as cooperatives, with the distinction being that they are credit cooperatives as compared to housing or other cooperatives.

7. As an example, INVA sells a one-bedroom, 38-square meter rowhouse for approximately Lps. 15,000, or Lps. 395 per built-up square meter. By comparison, FEHCOVIL's Sosa Traversia project has developed a 42-square meter house costing approximately Lps. 9,000, or 214 per built-up square meter; and its Empleados Panificadora Roma project is offering 36-square meter duplexes for Lps. 12,000, or Lps. 333 per built-up



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square meter. Both of FEHCOVIL's projects are on larger lots or at least have space around each unit, whereas INVA's rowhouses are attached on two sides.

8. As one case study, see Smith, Timothy J. August 1988. "Indonesia: Mobilization of Small-Scale Savings for Housing Finance." Office of the State Minister for Housing and the World Bank.

9. "Honduras Country Economic Memorandum." April 17, 1987. World Bank Report No. 6332-HO, p. 2.

10. Ibid.

11. Most NCFIs have only a general or vague understanding of the foreclosure process, and even INVA and other conventional lenders are hesitant to pursue foreclosure beyond writing threatening letters to delinquent borrowers. This suggests that the foreclosure process is indeed cumbersome and costly. Foreclosure is one area for further analysis and technical assistance, with the aim of streamlining the process to make it a realistic recourse for lenders. The high delinquency rates reported by both the private and public sectors alike indicate that borrowers are aware that they have little to fear if they do not repay their loans, thus increasing a lender's real risk and preventing the development of a fully operational and sound housing finance system.

12. Nathanson, Neal W. n.d. "The Sustainability of Economic Development Investment Funds." National Rural Development and Finance Corporation.

13. Kwass, Peter, Beth Siegel, and Laura Henze. 1987. "The Design and Management of State and Local Revolving Loan Funds: A Handbook." Mt. Auburn Associates, prepared for the U.S. Department of Commerce, p. 13.

14. In general, land title in Honduras is classified as either dominio pleno, conveying clear title to private landowners, and Dominio util, conveying the right of occupancy but not clear title. Squatter settlements are further classified by the authorities to connote their current administrative status. Such classifications include "clandestine" (built without approvals), "recuperadas" (located on ejido land), "intervenidas" (land seized by the municipality), etc. These secondary classifications serve administrative purposes, but generally they do not alter the fact they they are dominio pleno or util lands. However, these administrative classifications would need to be taken into consideration in designing a PROLOTE-type program, as they would have some significance in identifying priority settlements for assistance.



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# HONDURAS
# SHELTER AND URBAN DEVELOPMENT
# SECTOR ASSESSMENT

## APPENDIX II
## URBAN DEVELOPMENT AND DECENTRALIZATION

Prepared for USAID/Honduras
The Urban Institute
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George Peterson, Team Leader
Donald Gardner, Housing Finance
Timothy Smith, Housing Finance
Duke Banks, III, Urban Development
David Jickling, Urban Development
Jeffrey Telgarsky, Urban Development

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Authors' Note

The principal authors of this Appendix are Duke Banks, III, David Jickling, and Jeffrey Telgarsky. The volume was edited by George Peterson.

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# CHAPTER ONE

# REGIONAL AND URBAN DEVELOPMENT TRENDS

## INTRODUCTION

In general terms, Honduras can be divided into five regions: Center (departments of Comayagua, Francisco Morazan, and La Paz); North (Atlantida, Cortes, and Yoro); South (Choluteca and Valle); East (Colon, El Paraiso, Gracias a Dios, and Olancho); and West (Copán, Intibuca, Lempira, Ocotepeque, and Santa Barbara). Historically, the North has been the region with the highest concentration of economic activity, being the center of the banana trade, industry, and shipping. With the selection of Tegucigalpa as the seat of government, growth, investment, and economic development have been highly concentrated along a north-south axis running from San Pedro Sula to the capital. As we shall see below, more recently growth has spread into the eastern region.

### Demographic Trends and Urbanization

The population of Honduras reached 4.377 million in 1988 and the country continues to record high levels of population growth. The 1988 census indicates an average annual growth rate of 3.6 percent for the period 1974-88 (up from an average of 2.8 annually during 1950-74). (These growth rates are consistently higher than those estimated by the UN in their population projections. However, the UN also estimates the 1988 Honduran population at 4.8 million--implying under-counting by the census of approximately 400,000 persons. U.S. Department of Commerce estimates also imply a similar magnitude of under-counting by the Honduran census. However, for the remainder of this report, we use population and housing figures as provided from the national census.)

Since 1961, the average annual population growth rate of urban areas has exceeded 5.0 percent. The level of urbanization in the country has risen from 23.1 percent in 1961 to 31.4 percent in 1974 to 38.3 percent in 1988. In absolute terms, the number of persons residing in urban areas has increased fourfold, from 435,000 in 1961 to 1.75 million in 1988. Population growth in rural areas, which fell to 1.8 percent in 1961-74, has increased during the recent census period to 2.6 percent.

**Table 1**

**Regional Population Distribution 1974-88**
**('000s)**

| | 1974 | | 1988 | | Avg. Annual Growth (%) | | |
|---|---|---|---|---|---|---|---|
| Region | Total | Percent Urban | Total | Percent Urban | Total | Urban | Rural |
| Center | 656.3 | 51.6 | 1,124.4 | 59.9 | 4.0 | 5.2 | 2.6 |
| North | 726.1 | 43.0 | 1,233.4 | 50.3 | 3.9 | 5.0 | 2.9 |
| South | 285.2 | 18.7 | 413.1 | 32.7 | 2.7 | 4.4 | 2.2 |
| East | 390.7 | 14.1 | 717.8 | 19.1 | 4.4 | 6.7 | 4.0 |
| West | 598.6 | 11.2 | 870.1 | 15.4 | 2.7 | 5.0 | 2.4 |
| TOTAL | 2,656.9 | 31.1 | 4,376.8 | 38.3 | 3.6 | 5.2 | 2.8 |

This urban growth can be broken down into three components: (1) the natural rate of increase of the urban population; (2) migration from rural areas; and (3) redefinition of settlements from rural (less than 2,000 residents) to urban (2,000 or more residents). Unfortunately, there is very little data available to construct an accurate breakdown of these components of growth.

Information from the 1988 census indicates about 14 percent of the increase in the urban population was due to the reclassification of settlements from rural to urban, both because of individual settlement growth and because of expansion of major urban areas to include them. If we assume the natural rate of increase for the urban population was the same as the national average (3.6 percent), then 62 percent of urban growth is from natural increase and 24 percent of urban growth is due to migration. If, as is likely, the natural rate of increase in urban areas is higher than the national average (for example, due to better access to medical care and younger population), then the implicit portion of urban growth due to migration from rural areas is correspondingly smaller. The relatively low levels of migration, compared to population growth, appear reasonable in comparison with the fragmentary data available. For example, SECPLAN (1988)[1] reports that the net contribution of migration to growth in the Center region--one of the main destinations for migrants--during 1974-86 was 33.4 percent.



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SECPLAN also estimates 43 percent of Tegucigalpa's residents arrived as migrants from outside the city; GITEC (1988) reports 45 percent of San Pedro Sula's inhabitants are migrants.[2]

On a regional basis, population growth has been strongest in the Center, North, and East; all of these regions have growth rates above the national average (see table 1). In the Center and North, population growth is led by urban populations which make up over half the total population and are growing at more than 5 percent annually. Within the urban sector, rates of population growth are the highest among cities with more than 20,000 inhabitants located along the Tegucigalpa-San Pedro Sula axis. Table 2 shows these cities (Tegucigalpa, Comayagua, Siguatepeque, El Progreso, Choloma, and San Pedro Sula) all grew at average annual rates of more than 5.0 percent during 1974-88.

In the East, both urban and rural populations are growing faster than the national averages--both because of development in the Aguan River valley and the flow of migrants across the border from Nicaragua. Smaller cities, such as Juticalpa and Catacamas in Olancho and Tocoa in Colon, have been growing at more than 4.5 percent annually. Both Danlí and El Paraiso in El Paraiso show high rates of population increase, but this is strongly influenced by the flow of refugees from the Nicaraguan border area.

The South and West regions show rates of population growth in both urban and rural sectors that are well below the national average; it is likely these areas are experiencing net out-migration to other regions with more dynamic economic prospects. Only Choluteca in the South region shows substantial growth, averaging 5.3 percent annually during 1974-88.

## The Pattern of Economic Development

It is difficult to describe with any degree of precision the regional differences in Honduran economic development. Output measures are not available at regional or departmental levels--thus, we must rely on other indicators such as urbanization, employment, and income (as given in Ministry of Planning (1987/1988)[3] for conclusions on regional

Table 2

**Major City Growth 1974-1988**
**(population in thousands, average annual growth in percent)**

| City | Department | Urban Population 1974 | 1988 | Growth |
|---|---|---|---|---|
| Tegucigalpa, DC | Frans Morz | 273.9 | 551.6 | 5.1 |
| San Pedro Sula | Cortes | 151.0 | 279.4 | 4.5[a] |
| La Ceiba | Atlantida | 38.8 | 68.3 | 4.1 |
| El Progreso | Yoro | 28.1 | 55.5 | 5.0 |
| Choluteca | Choluteca | 26.2 | 53.8 | 5.3 |
| Choloma | Cortes | 9.2 | 38.3 | 10.8 |
| Comayagua | Comayagua | 15.9 | 36.4 | 6.1 |
| Puerto Cortes | Cortes | 25.8 | 31.4 | 1.4 |
| Danlí | El Paraiso | 10.8 | 28.1 | 7.0 |
| La Lima[b] | Cortes | n.a | 27.7 | n.a |
| Siguatepeque | Comayagua | 12.5 | 27.2 | 5.7 |
| Tela | Atlantida | 19.1 | 23.3 | 1.5 |
| Juticalpa | Olancho | 10.1 | 20.0 | 5.0 |
| Santa Rosa de Copán | Copán | 12.4 | 19.2 | 3.2 |
| Catacamas | Olancho | 9.1 | 17.4 | 4.7 |
| San Lorenzo | Valle | 9.5 | 15.3 | 3.5 |
| Tocóa | Colon | 2.8 | 13.8 | 12.1 |
| Olanchito | Yoro | 7.4 | 13.6 | 4.4 |
| El Paraiso | El Paraiso | 6.7 | 13.0 | 4.8 |
| Villaneuva | Cortes | 6.3 | 12.0 | 4.6 |
| La Paz | La Paz | 6.8 | 11.0 | 3.5 |

[a]Excludes La Lima in 1988; growth including La Lima is 5.2 percent.
[b]Made independent from San Pedro Sula in 1981.



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development. In general, the Center and North regions present the highest level of development, with the East, South, and West regions (in that order) showing lower levels of development. Conversations with planners at SECPLAN indicate that while the Tegucigalpa-San Pedro Sula axis will continue to have the strongest concentrations of economic activity, the highest rates of economic growth will be found outside this area. The Aguan Valley in the East region and areas in the interior of Olancho are expected to be the primary focal point of growth over the coming decade, followed by increasing activity along the eastern part of the north coast.

The Center and North regions, dominated by Tegucigalpa and San Pedro Sula, are the most highly urbanized with 60 percent and 50 percent, respectively, of their populations living in urban areas. The three other regions all show 1988 urbanization levels below 25 percent.

Employment patterns across the regions point to a similar division of functions between the regions. Urban employment in the Center is concentrated in the service sector, especially government. In the North, employment in industry is much higher than elsewhere, though the share of the labor force working in industry has declined during the 1980s because of weak aggregate growth. The three other regions show higher levels of employment related to agriculture and natural resources. As well, employment in the East, South, and West is also much more likely to be with small firms and be nonsalaried (both indicators of lower levels of economic development).

Finally, average urban incomes in 1986 were highest in the Center at Lps. 867 per month. Urban incomes in the North averaged 87 percent of those in the Center; in the East, South, and West incomes averaged 64 percent, 50 percent, and 62 percent, respectively. The Center region showed 53 percent of its urban households with incomes of less than Lps. 600 per month (the poverty line for an average urban household is Lps. 594 per month), while in the North poverty affected 59 percent of urban households. In the remaining regions, poverty levels were significantly higher, approximately 70 percent of urban households in the West and in the South.

We now look at each of the regions in more detail.[4]

Tegucigalpa and the Center Region

The Center Region is dominated by Tegucigalpa, the national capital and largest city in Honduras. Practically all central offices of the public sector (including autonomous and semi-autonomous organizations) are located in the city. The 1986 urban work force survey[5] indicates the central region contains 45 percent of urban employment; Tegucigalpa accounts for 41 percent of the national urban work force. Being dominated by the national government, not surprisingly, the city's service sector is the largest source of employment, accounting for 76 percent of total employment.

However, Tegucigalpa only accounts for 21 percent of national industrial output. This proportionally low share of secondary sector activity is explained mainly by the city's poor surface transportation links with the rest of the country, remoteness from major areas of agricultural production, and lack of level terrain for development. The industries which do locate in Tegucigalpa produce primarily for the local and regional market, not for national consumption. The industrial sector provides 23 percent of all employment in the city.

Other urban centers in the region (El Progreso, Comayagua, and Siguatepeque) serve as service and agro-processing centers for surrounding agricultural producers.

San Pedro Sula and the North Region

The North contains the core of the country's industrial and agricultural sectors. The region is endowed with good access to transport (land, sea, and air) and extensive areas of good quality agricultural land. Plentiful subterranean water supplies support both urban and agricultural demands. However, growth has not been evenly distributed throughout the region. While San Pedro Sula and it environs and areas in the Aguan Valley have grown rapidly, the coastal areas and seaports (Puerto Cortes, Tela, and La Ceiba) have not.

San Pedro Sula has the largest concentration of industrial production in Honduras: the city accounts for 52 percent of all industrial establishments and 62 percent of national industrial production. Twenty-eight percent of the city's work force is employed in the secondary sector; this industrial work force represents 32 percent of the national total. Manufacturing activities are centered on consumer goods (foods, beverages, clothing/footwear, wood and building products) for the national market. As the second city of Honduras, San Pedro Sula also contains numerous branch offices of public sector organizations.

The coastal towns are reliant on key industries which have not shown much dynamism in recent years. Economic activity in Puerto Cortes is based on shipping (through Empresa Nacional Portuaria (ENP), an oil refinery, and the United Fruit Company) and rail transport inland. In addition, a Free Zone has been established in Puerto Cortes for export assembly operations. Economic activity in La Ceiba is perhaps even more concentrated. The main economic activity is agro-processing; the Standard Fruit Company employs two-thirds of the workers in the industry. Standard Fruit has recently been cutting back its operations in the area and has discussed moving its central operations to Puerto Castilla in Colon Department. As yet, La Ceiba has not become strongly linked with development of the Aguan Valley, but the construction of new roads linking the two offer potential for such a linkage.

Choluteca and the South Region

Economic activity in the South region is based primarily on agriculture, the port of San Lorenzo on the Pacific Coast, and the regional center of Choluteca. Major agricultural products of the region have traditionally included cattle, cotton, cereals, and sugarcane. However, cattle production is currently experiencing a downswing and traditional crops are being replaced by more lucrative export crops such as melons and cashew nuts, which will be enhanced by irrigation.[6] A shrimp industry operates out of the coastal areas; exports in 1989 are estimated by AID to generate US$25 million in net earnings for the region.

The city of Choluteca acts as a regional service center. Commercial and agricultural activities employ 36 percent of the urban work force in the department. The proportion of workers employed in industry and services is below the national average. While the southern region displays the lowest level of total population growth (mainly because its rural population has been growing slowly, Choluteca's growth has remained strong at 5.3 percent per year during 1974-88.



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## The East Region

This area is rich in good agricultural land (mainly in the Aguan Valley and the interior of Olancho department) and is seen by Honduran planners as having strong economic potential, particularly for increasing output of nontraditional export crops. Highway construction is under way to link the Aguan Valley with the ports at La Ceiba and Puerto Castillo. It is also speculated that port facilities at Trujillo will need to be developed.

In the interior of Olancho, agricultural land is being brought into production; the department has the highest rural population growth rate in the country (4.3 percent annually during 1974-88). Construction of highways linking Tegucigalpa with the East region and northeastern coast through Juticalpa and Catacamas should also help maintain the high levels of population growth in the department.

## The West Region

This region is predominantly rural and focused on small-scale agricultural activities. Urban areas made up only 15 percent of the population in 1988; the largest city in the region, Santa Rosa de Copán, has only 19,200 inhabitants. Activities in these centers are geared mainly towards agriculture and services. Only 19 percent of the urban labor force works in industry. The region is the home of El Mochito mine (recently closed and reopened) which produces zinc, lead, and silver.

**Footnotes**

1. SECPLAN, Secretaría de Planificación, Coordinación, y Presupuesto (1988). Sintesis Diagnostico Socio-economico de la Región Central (Tegucigalpa: SECPLAN).

2. GITEC Consult GMBH, Programa Integral de Mejoramiento Habitacional Urbano--RPRIMHUR (2 vols.), report prepared for INVA (1988).

3. Dirección General de Estadistica y Censos, Encuesta Continua Sobre Fuerza de Trabajo (2 vols.) Ministerio de Planificación, Coordinación, y Presupuesto (1987 and 1988).

4. These descriptions draw on Annex 5 of GITEC (1988).

5. The survey covered 16 cities possessing 89 percent of the national population.

6. Japan International Cooperation Agency, Field Note of Preliminary Survey Mission of Choluteca River Project (1987).

# CHAPTER TWO

# BUDGET PREPARATION FOR HONDURAN MUNICIPALITIES

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## THE BUDGET CYCLE

Municipalities now are involved only in the first stage of their own budget preparation. They are required to prepare, by November 15th of each year, a draft budget (Anteproyecto de Presupuesto) for the next fiscal year beginning January 1. The draft budget is submitted to the Dirección General de Asesoría y Asistencia Técnica Municipal (DGAATM) of the Ministerio de Gobernación for review.

The draft budget contains revenue and expenditure projections, and must by law be balanced (i.e., projected revenues must equal or exceed projected expenditures). Once approved by the municipal authorities, the revenue-raising plan contained in the budget, with its schedule of tax rates, fees, and charges, also is known as a Plan de Arbitrios.

In projecting revenues, the municipal government must use several forms provided by the DGAATM. Principal among these are the form to project property tax revenues, the form to project revenues from the residency tax (impuesto vecinal), and the form to project revenues from business taxes, fees, and charges. The latter form alone contains 78 line items corresponding to the different rates of charges imposed on different business activities by the current Municipal Law.

In each case, revenues are projected by applying the legally established tax rate or fee level to the legally inscribed tax base. Thus the revenue side of the budget is really a calculation of the amount of payments legally due the municipality, given the cadastral coverage that the municipality has achieved. No adjustment is made in budget preparation for past experience in actual revenue collection or anticipating delinquent accounts. As a result, in the eight municipal budgets that we examined in detail, <u>actual</u> revenues on current account fell far short of budget projections, ranging between 35 and 55 percent of the revenue levels projected in the budget.

For expenditure projections, the DGAATM merely provides municipalities with sheets on which individual expenditures are to be listed in line item fashion. Even though the Ministerio de Hacienda has prepared a detailed Program Budget Manual, which by law is supposed to be used throughout the public sector, only seven of the 289 municipalities submit a "program" budget. These municipalities are: Distrito Central, San Pedro Sula, La Ceiba, Tela, La Linea, Villanueva, and El Progreso. However, these are "program" budgets only in the sense that different operating units are identified and line-item expenditures listed for them separately. Very little program detail is provided, and no goals or objectives are stated for the organizational unit. For the other municipalities, the expenditure budget is simply an undifferentiated listing of individual spending items.

**Budget Review**

After submission to the DGAATM, the Budget is reviewed by that office. The main criteria used in this review are:

✦Debt Service and Earmarking. Determine that these are budgeted correctly. Typically, municipalities ignore these items or drastically underbudget the required amounts.

✦Budget Balance. If projected expenditures exceed projected revenues (and the revenue calculations have been made correctly), the expenditure side of the budget is reduced by DGAATM.

✦Salary Ratio. DGAATM reviews the budget to determine if salaries exceed 45 percent of total projected expenditures. If they do, salary line items are reduced.

✦Comparison with Previous Year Budget. On both the expenditure and revenue side, municipalities are supposed to show on their forms how projections for the next budget year compare with figures incorporated in the current-year budget. When there is a large discrepancy, DGAATM may change the next year budget figures to eliminate it.

✦Computational Accuracy. The addition, subtraction, and multiplication in the budget tables is checked.

The DGAATM indicated that the salary line items were the most controversial, since these often call for increases in staff as well as for salary increases. However, very little or no



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analysis is performed to determine whether the staffing and salary adjustments proposed by a municipality are justified.

Several features of this central-government review deserve emphasis. First, there typically is no discussion with the municipality to determine how revisions to the budget proposal should be made. No attempts are made by DGAATM, for example, to ascertain local program priorities when expenditure items must be cut. The central government office simply substitutes its numbers for the ones the municipality has submitted. Second, although the central review compares line items in the new budget with the figures for similar line items in the current budget, no comparison is made with actual spending or actual revenue collection, nor is there any attempt to bring revenue projections into line with realistic expectations. Thus, the greatly exaggerated revenue projections survive central review. In our sample of eight municipalities, the revenue projections in the approved budgets proved, on average, to be more than twice as large as actual revenue collections.

The entire budget process also involves a series of confusing distinctions between the "operating" budget and the "capital" budget. Revenues for the capital budget include loans, projected capital grants from the national government or external donors, and collections of past-due operating revenues from previous budget years. There is also supposed to be an operating budget surplus which is applied to the capital account. On the expenditure side, interest on indebtedness as well as debt amortization, and past-due obligations for unpaid contractor or supplier bills, unpaid wages, and unpaid obligatory earmarkings all are treated as capital expenditures, along with new capital investment. Since most municipalities vastly overestimate their loan and grant proceeds, they also greatly exaggerate the capital budget they can finance. In the period 1985-86, for example, the Distrito Central received only about 20 percent of the capital funds it had projected.

On the expenditure side of the capital budget, municipalities tend to list projects that will generate income as part of the capital budget, but often place nonrevenue-generating capital projects (e.g., building a municipal plaza) under the operating budget, regardless of the magnitude of the outlay or the means of financing. To further complicate matters, many municipalities do not prepare a separate capital budget, leaving this task to BANMA when they apply for a capital loan.

Once the budget review has been completed by the DGAATM, the revised budget is sent to the Consejo Departamental for its approval. Normally, the Consejo Departamental approves the budget as revised by DGAATM, although there can be significant delay in doing so. After this approval, the budget is sent back to the municipality and becomes "final."

Article 206 of the current Municipal Law states that once municipal budgets are approved by the Consejo Departamental, municipalities cannot give further salary increases. This article has been interpreted, as well, to mean that municipalities cannot implement any unbudgeted personnel cutbacks.

<u>Monitoring and Auditing</u>

On a monthly basis, the municipalities are supposed to prepare a year to date report of revenues and expenditures and submit this to the DGAATM. The central agency provides special color-coded forms for this reporting. There are more than 200 different revenue line items and more than 450 expenditure line items that are supposed to be reported, each with its own code.

Actual reporting under this system is sporadic, although almost all municipalities do end up reporting their line item expenditures and revenues. The DGAATM places great importance on the reporting function as the basis of its control over local government spending, and makes very significant efforts to enforce local reporting. Ironically, once the data are collected by DGAATM, no use is made of them. They are merely transcribed by hand onto thirty column sheets in a central ledger. No comparison of actual spending with budgeted spending is conducted. No totals of spending by purpose for the local government sector are computed. No investigation is made of the accuracy of the data reported. The revenue and spending data collected by DGAATM can be used only by inspecting the line item summaries entered into the central ledger for an individual municipality.

The only auditing of municipal accounts is performed by the Contraloria de la Republica, which audits a very limited number of municipal governments on a sporadic basis with considerable delay.

**Earmarking**

Current laws call for a number of earmarked spending items, which are supposed to appear in the municipal budget. The earmarks include:

✦Mandatory purchase of BANMA shares. Each municipal government is supposed to purchase annually BANMA shares in an amount equal to 5 percent of its combined operating and capital income (excluding loans). In fact, very few municipalities ever do this. No municipality is current with its mandatory purchases, and only San Pedro Sula has purchased shares that even begin to approximate its legal obligations.

✦A mandatory annual contribution equal to 0.5 percent of operating revenues is supposed to be made to the Asociación Municipal de Honduras (AMHON). Virtually no municipality in fact makes this payment. As a result, AMHON is totally without funds and nonfunctional.

✦At least 8 percent of operating revenues, by law, are to be spent on public education. None of the smaller municipalities that we interviewed makes a computation of this kind to see if it is in compliance with the law, and none has a program for using the public budget in support of local education.

✦A mandatory contribution equal to 1 percent of monthly salary payments is supposed to be made to the Instituto Nacional de Formación Profesional. In practice, this payment, too, is rarely made.

Municipal governments are also supposed to include in their budgets payments for all of their outstanding debts, including interest and amortization payments to BANMA and commercial banks, late salary payments, unpaid mandatory contributions, overdue commercial bills, etc. In reality, because of the overly optimistic revenue projections, these debts are usually not paid or are underpaid, even though they were initially budgeted.

**Financial Information**

While the financial figures are maintained in a raw format, there is no readily available information, either at the local level or in DGAATM, to determine the actual financial situation of a municipality, its financial reserves, or its cumulative debt situation. With the existing financial information, it is almost impossible to calculate these critical figures.

## SUMMARY

The current system of budgeting for municipalities gives the impression of having many controls. It involves three layers of government: the municipality itself, the central government, and the departmental government. Some 25 staff positions are filled (and more are authorized) at the central level alone for budget review and provision of forms to the municipalities.

In reality, however, there is no budget or integrated financial information system. There is no attempt, at either the local level or the central level, to relate planned expenditures to the local service functions that will be performed. The revenues that appear in the budget are never realized; therefore, the entire budget rests on an illusory base. Although salary expenditures nominally are limited to 45 percent of the approved budget, since the budgeted revenues do not materialize and personnel are not cut, the personnel budget ends up being a far greater percentage of the actual total. Capital outlays, debt repayments, and other forms of spending are eliminated to bring the budget into a cash balance. The mandatory earmarking of muncipal budgets, prescribed in the Municipal Law, is almost universally ignored.

As a result of this "system," neither public authorities at the local level nor those at the central level, know how municipalities spend their revenues, or the status of their financial situation. There is almost no programmatic control over budget priorities. San Pedro Sula alone is a partial exception to this generalization.



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# CHAPTER THREE

## CADASTRAL SYSTEMS
## AND LOCAL REVENUE GENERATION

## BACKGROUND

Cadastral systems are the backbone of local land management and local revenue collection. The development of cadastral records is a relatively new activity in Honduras. The first attempt was made in 1972 with aerial photography, delineation and mapping of approximately 6,000 sq. kms. in the Departments of De Valle and Choluteca. The following year the San Pedro Sula area was done using the services of Clapp and Mayne. In that effort 95 percent of the San Pedro Sula property on the Property Register was incorporated into the cadastral rolls.

In the mid- to late 1970s the Municipal Bank, BANMA, and the Ministerio de Gobernación became involved in cadastral studies. Later, in 1980, the cadastral pilot project unit was incorporated into the Central Government as the Dirección Ejecutivo de Catastro (DEC).

For the country as a whole, 111 municipalities representing 38 percent of the country's municipalities have some type of cadastral office. Of the remaining 178 municipalities that do not have a cadastral office, 176 are small municipalities which presently generate less than Lps. 100,000 in revenues annually.

## CADASTRAL RESPONSIBILITIES IN HONDURAS

There are presently three organizations that are involved with cadastral work in Honduras. They are the DEC under the SECPLAN Ministry, the Desarrollo Municipal unit of BANMA, and the cadastral unit of the Dirección General de Asesoría y Asistencia Técnica Municipal (DGAATM) of the Ministerio de Gobernación. Following is a brief description of their accomplishments and capabilities.

### Dirección Ejecutivo de Catastro Nacional

This is the largest and most professional of the cadastral units in Honduras. Using primarily international funds they have managed to produce state of the art cadastral maps and



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records for approximately 31 percent of the land area of Honduras, primarily in rural areas (which is also the most difficult to map because of the inaccessibility of certain areas of the country). DEC is regarded as possessing some of the most advanced facilities in Latin America.[1]

Using various AID funding mechanisms, the unit has done work in the following departments:

| | |
|---|---|
| Comayagua | Cortes |
| Fransisco Morazón | Atlantida |
| Olancho | El Rosario |
| Santa Barbara | Copán |
| Yoro | La Paz |
| El Paraiso | De Valle |
| Choluteca | |

The major present effort of the unit has been in assisting the Instituto Nacional Agraria (INA) in its land-titling program for small farmers. Through this program, DEC has identified boundaries and recorded ownership for over 2 million hectares of land in the rural areas of the above-mentioned departments using a staff of approximately 100 field workers.

Donor assistance has had the effect of steering DEC's priorities toward rural areas, while many of the urban areas in the above-mentioned departments remain unmapped. Where possible, DEC has used their own funds for urban mapping. Although there are several municipalities that have been partially mapped, there are only two municipalities that DEC has completely surveyed, and for which it has prepared cadastral rolls. These are Villa de San Antonio and Puerto Cortes. In the case of Puerto Cortes, the municipality contracted with DEC to perform the cadastral work for the city.

In the future, DEC intends to direct more of its effort toward cadastral work at the municipal level. This includes carrying out cadastral studies in 23 predetermined municipalities using IDB funding under the new BANMA project. With AID rural development funds, they will also be doing work in 19 municipalities in the Comayagua Department, plus the municipalities of Florida in the Copán Department, Macolizo in the Santa Barbara Department, and Comayagua in the Comayagua Department. The Comayagua



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effort will also include the opening of a regional office to assist DEC in maintaining cadastral files for the region.

In the area of maintenance, if additional funding can be found, DEC would like to open regional offices in the Departments of Cortes, Copán, and Santa Barbara.

## Desarrollo Municipal Unit of BANMA

The Desarrollo Municipal unit of BANMA is responsible for establishing cadastral maps and records for municipalities. During the 1970s BANMA gave this area top priority, and established the cadastral rolls of several municipalities, including Puerto Cortes, Choloma, El Progreso, Tela, La Ceiba, Choluteca, Siquatepeque, El Paraiso, and Juticalpa.

The work done by BANMA lacks the degree of sophistication that the DEC unit possesses because it is not as reliant on expensive technology such as sophisticated aerial photography techniques. Consequently, their costs are lower. BANMA also charges the municipalities for the cadastral work it performs. The project cost becomes, in many instances, a municipal debt to BANMA.

During the 1980s cadastral work has not been given a high priority by BANMA. While some municipalities have been provided with cadastral assistance (i.e., Esparta, Santa Rita de Copán, Danlí, Ojojona, among others), the unit has suffered greatly because of the reduction in force during the summer of 1988. Today, there are only two professionals available to assist municipalities in this area. They are presently not doing any significant cadastral work since they are part of the intervention team in the cities of Juticalpa and Catacamas.

In discussion with BANMA, we found that the major concern expressed was the high level of personnel turnover at municipal cadastral offices, the lack of attention by municipalities to maintaining cadastral files, and the lax property tax collection efforts by municipalities. The high turnover rate means that, despite BANMA training, there are very few qualified people at the municipal level to maintain the cadastral files and initiate property tax collections.

**Dirección General de Asesoría y Asistencia Técnica Municipal del Ministerio de Gobernación**

This is the third unit that provides cadastral assistance to municipalities in Honduras. Its major emphasis is on the smaller cities and towns. As opposed to BANMA, it provides free services to municipalities that request them.

The services themselves are similar to those offered by BANMA. However, several officials commented on the lack of professionalism of the well-intentioned, but unqualified staff. Of the eight people in the cadastral unit, none are professionals (have a college degree). There is a widespread feeling among municipal officials that of the three units, the DGAATM offers the weakest technical assistance. Its efforts have been limited, as well, by budgetary constraints, in that while there is staff, there is no budget for per diems and travel, so that the staff are limited in their field visits.

The DGAATM has organized cadastral offices in several cities and towns during the 1980s. However, it does not generally provide follow-up assistance to the municipalities in maintaining the files or in collections.

## PROBLEMS OF OVERLAP

Historically, there has been very little institutional cooperation between the three units providing cadastral assistance. The DEC-BANMA joint venture for the IDB program is a positive step in trying to improve interinstitutional linkages.

On the technical side, DEC mentioned that when they have done cadastral work where either BANMA or DGAATM have done previous work, there was difficulty in using the previous effort as a base on which to build. The major problem has been establishing map coordinates and parcel numbers. As a consequence, DEC has discarded the existing system and begun anew with its own records. In the near future this problem will intensify, especially in the Comayagua area, where DEC plans to do cadastral work in 19 municipalities, several of which have previously participated in either BANMA or DGAATM programs.

## IMPACT ON PROPERTY TAX REVENUES OF CADASTRAL REFORM AND UPDATING

In order to determine the effect of cadastral reforms and updating on local property tax revenues, data were collected for municipalities where the three organizations had implemented mapping, property registration, and recording systems.

### DEC

At the municipal level DEC has completed two cadastral projects: at the Villa de San Antonio, and Puerto Cortes.

Villa de San Antonio[2]

Property Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1980 | 1,651.10 |
| 1981 | 1,519.05 |
| 1982 | 2,589.80 |
| 1983 | 3,732.79 |
| 1984 | 2,648.50 |
| 1985 | 4,511.31 |
| 1986 | 6,164.15 |
| 1987* | 14,098.68 |
| 1988 | 12,811.27 |

*Year cadastral project implemented.

As the collection information shows, with the implementation of the cadastral project in 1987, there was a dramatic 129 percent increase in property tax revenues. Yet, even in 1987, the municipality did not exploit the full potential of the property tax because delinquency accounts totaled Lps. 12,524.23, which represents 89 percent of the amount actually collected. While the 1988 collection figure declined slightly, the delinquency accounts rose to Lps. 16,083.65 and represents 125 percent of the amount collected. This shows that there is



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further revenue potential from more aggressive tax collection. However, the revenue potential from the property tax under current law remains limited because of the very low tax rates.

It was not possible to determine a cost/benefit ratio for the cadastral effort because DEC could not determine the actual cost of carrying out the Villa de San Antonio program. A good part of the work was done with resources provided by the USAID rural titling program, which could not readily be allocated specifically to the municipality of Villa de San Antonio.

Puerto Cortes[3]

The case of Puerto Cortes is unique because the municipality, recognizing the value of having an up-to-date cadastral system, approached DEC to modernize their cadastral records which were originally developed by BANMA in the mid-1970s. The cost to Puerto Cortes for the project was Lps. 389,266.51. The municipality used funds made available to it from the sharing of port revenues to pay the contract cost.

Property Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1980 | 63,912.91 |
| 1981 | 74,711.43 |
| 1982 | 56,204.73 |
| 1983 | 90,960.18 |
| 1984 | 67,147.43 |
| 1985 | 77,885.39 |
| 1986 | 84,685.58 |
| 1987* | 93,129.58 |
| 1988* | 152,184.79 |

*Cadastral work completed end of 1987 and impacts 1988.

In this case there was an increase of 63 percent in property tax collection, most of which can be attributed to the cadastral project. An additional Lps. 92,828.40 was collected on past due accounts in 1988 resulting in a total property tax collection of Lps. 245,013.18 for the year.

If one uses only the increase in regular property tax collection figures to compute the return to investment, the cost of the cadastral project could be amortized over approximately 6.5 years by dedicating the additional revenues generated toward project costs. This is a marginally viable investment in today's interest-rate environment.

The time required to amortize could be reduced further by using more aggressive collection methods, or if the municipality were free to impose higher local tax rates, as contemplated under the proposed new municipal law. Even while property tax receipts were increasing, so were delinquent accounts. The 1986 delinquent account total of Lps. 72,357.22 increased to Lps. 89,512.12 in 1987 for an increase of 16.8 percent. The ultimate payback to the DEC project will depend on whether the system is maintained in the future, and whether new building projects are integrated into it efficiently.

**BANMA**

BANMA provided examples of cadastral work for three cities where work was done in the mid-1970s: Tela, Juticalpa, and Comayagua.[4]

Tela

Property Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1973 | 15,750 |
| 1974 | 18,116 |
| 1975* | 22,513 |
| 1976 | 44,439 |
| 1977 | 42,234 |
| 1978 | 73,341 |
| 1979 | 75,802 |
| 1980 | 77,570 |
| 1981 | 87,155 |
| 1982 | 79,853 |
| 1983 | Could not determine |
| 1984 | 66,641 |
| 1985 | 98,303 |
| 1986 | 108,261 |

*Year cadastral project implemented.

The cost for the cadastral project in 1975 was Lps. 100,604, with revenue impact reflected in subsequent years.

Between 1975 and 1976, property tax revenue increased 97 percent, largely because of the establishment of the cadastral office. After taking a slight dip in 1977, property tax collections increased year by year until 1982. The jump in revenue generated in 1976 would have amortized project costs in 4.5 years.

The record of property tax receipts also reveals tne impact of political changes. The installation of a new mayor dedicated to raising local revenues was behind the 50 percent increase in property tax revenues between 1984 and 1985.

Juticalpa

Property Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1973 | 15,476 |
| 1974 | 20,895 |
| 1975 | 29,313 |
| 1976* | 32,686 |
| 1977 | 39,826 |
| 1978 | 35,303 |
| 1979 | 45,055 |
| 1980 | 56,012 |
| 1981 | 49,100 |
| 1982 | 56,622 |
| 1983 | Could not determine |
| 1984 | 68,911 |
| 1985 | 71,783 |
| 1986 | 73,495 |

*Year cadastral project implemented.

In the case of Juticalpa, there was no dramatic rise in property tax revenue as in the other cities. Between 1976 and 1977 there was an increase of 22 percent, only slightly above the average increase in other years. The next year revenues from the property tax declined. The cost of the cadastral project was Lps. 41,211. If the additional revenue generated is used



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to amortize the cost, it would have taken approximately 5.5 years for Juticalpa to fully pay for the work.

Comayagua

Property Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1973 | 15,390 |
| 1974 | 15,295 |
| 1975 | 28,184 |
| 1976 | 32,366 |
| 1977* | 30,618 |
| 1978 | 52,869 |
| 1979 | 49,799 |
| 1980 | 52,713 |
| 1981 | 55,835 |
| 1982 | 100,709 |
| 1983 | 123,565 |
| 1984 | 170,762 |
| 1985 | 174,164 |
| 1986 | 112,126 |

*Year cadastral project implemented.

The cadastral project was carried out in 1977 for Comayagua at a cost of Lps. 92,821.50. The year following the implementation of the cadastral system, property tax revenues rose by 73 percent. As in several other municipalities, there was a modest decline in property tax revenues in the second year after cadastral reform.

If the additional revenue were used to amortize the cost of the project, it would have taken a little over four years to pay for the project.

## DIRECCIÓN GENERAL DE ASESORÍA Y ASISTENCIA TÉCNICA MUNICIPAL

The DGAATM provided the following examples for this study: the municipalities of Marcala, Guaimaca, and Ojojona. All of these municipalities are small towns with populations under 10,000. The information provided by the DGAATM apparently refers to total revenue figures, not property tax revenues alone.

The DGAATM was not able to determine the cost of providing the service to the municipalities because of the assumption that salary expense is a "fixed" cost. Hence they are not prepared to identify the true project costs.

<u>Marcala</u>

Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1982 | 56,090 |
| 1983* | 76,488 |
| 1984 | 76,155 |
| 1985 | 97,350 |
| 1986 | 90,548 |
| 1987 | 96,385 |

*Year cadastral project implemented.

In 1983, the year that the cadastral office was established, there was an increase of 36 percent in tax revenues. The following year, 1984, revenues were practically identical to the prior year, then again jumped 28 percent in 1985, falling in the subsequent year.

<u>Guaimaca</u>

Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1983 | 53,570 |
| 1984* | 72,841 |
| 1985 | 83,424 |
| 1986 | 76,567 |
| 1987* | 85,040 |
| 1988 | 96,872 |

*The cadastral office was established in 1984, with maintenance efforts through 1985. In 1987 the office was reactivated.



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Upon the establishment of the cadastral office in 1984, tax revenues increased 36 percent, and continued to increase while the cadastral file was being maintained. For lack of maintenance, tax revenues dipped in 1986. With the reactivation of the office in 1987, tax revenue again increased, though modestly.

<u>Ojojona</u>

Tax Collection History

| Year | Amount Collected (Lps.) |
|---|---|
| 1984 | 31,464 |
| 1985* | 43,930 |
| 1986 | 53,462 |
| 1987 | 35,688 |
| 1988 | 41,921 |

*The cadastral office was created in 1985. Because of a change in political parties new, unqualified personnel were hired in 1987 with a corresponding drop in revenue. The office was recently closed, and it is anticipated that 1989 revenues will be lower than in prior years.

The case of Ojojona shows what happens when there is a change in the political leadership and the efforts to use the cadastral file are thwarted. After increasing revenues 40 percent between 1984 and 1985, there was a drop of 33 percent between 1986 and 1987 due to the changing political climate and the rotation of personnel. Because of this environment, it can be assumed that the delinquency account situation in Ojojona also has deteriorated since no aggressive collection procedures are being used.

## SUMMARY OF REVENUE IMPACT AFTER IMPLEMENTATION OF A CADASTRAL PROJECT

As the above examples show, a cadastral project has an immediate impact on revenue generation, regardless of the organizational unit that did the cadastral work. The increase in revenue flows ranged from 22 percent to 129 percent and are reflected in descending order in the following table:

**Increase in Property Tax Revenue after a Cadastral Project First Year Increase Only**

| Municipality | Implementing Unit | Increase* (percentage) |
|---|---|---|
| Villa de San Antonio | DEC | 129 |
| Tela | BANMA[a] | 97 |
| Comayagua | BANMA[a] | 73 |
| Puerto Cortes | DEC | 63 |
| Ojojona | DGAATM[b] | 40 |
| Marcala | DGAATM[b] | 36 |
| Guaimaca | DGAATM[b] | 36 |
| Juticalpa | BANMA[a] | 22 |

*Growth of revenue in year of implementation (does not control for other factors contributing to revenue increase)

[a]property tax plus residency tax
[b]total tax revenues

Whether cadastral projects represent good investments, strictly from a revenue-producing perspective, is less clear. Only about half of the projects would have paid for themselves if financed at market rates of interest. There are, of course, additional benefits to land management from having a good cadastral system. However, the financial return to a cadastral project will depend greatly upon a municipality's commitment to follow through with annual maintenance and more vigorous tax collection. The payoff to cadastral updating also would be greater at higher rates of taxation and fees, as municipalities would be empowered to impose under the new municipal law.

## THE NATURE OF ARREARS ACCOUNTS

In several discussions, and in the above analysis, the problem of arrears accounts (morosidad) was mentioned. It is a continual problem since one of the major reasons for the



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arrears that municipalities have with their debtors (e.g., BANMA) is the lack of payment by local citizens to the municipality for property taxes and user charges. Moreover, as detailed above, new cadastral projects typically increase delinquency as well as tax receipts.

The San Pedro Sula study analyzed the relationship between property tax increases and arrears accounts. The municipality introduced a massive revaluation in 1985 that added Lps. 635 million to the tax base. In the next year, property tax receipts jumped by almost 60 percent. As in other municipalities, however, in the second year, receipts declined modestly while arrears climbed steeply.

**Relationship between Increase in Property Tax and Arrears Accounts (index of yield with 1983 as base year)**

| | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|
| Property Tax | 100 | 137 | 143 | 225 | 218 |
| Arrears | 100 | 138 | 165 | 187 | 240 |

Source: UMVIDE and PADCO, Estudio para el Desarrollo de Tierras en San Pedro Sula (1988), with correction for typographical error.

Property taxes are not the only revenue source affected over time. The study also highlights the relationship of revenue increases to arrears for business taxes, public service charges, personal income tax charges, and paving assessments.[5] In all cases the arrears accounts showed higher percentage increases than the corresponding increases in tax collections.

The San Pedro Sula experience highlights two important lessons. First, there is much more revenue to be gained by increasing property valuations in line with market price increases than by expanding cadastral coverage to include presently unregistered properties. From the perspective of local revenue generation, the first priority should be an adequate system of regular revaluation. Second, without active efforts at maintaining property tax rolls and pursuing revenue collection, the benefits of cadastral reform will quickly erode.

## RECOMMENDATIONS

To strengthen cadastral administration in Honduras, the following recommendations are made:

### Policy

✦The GOH needs to provide legal authorities with stronger sanctions for the nonpayment of property tax and service charges to municipalities.

✦The GOH should create fiscal incentives that encourage local government officials to aggressively collect property taxes and user taxes in their municipalities.

✦The GOH should provide protection to trained municipal employees to curtail the excessive turnover in personnel that is one of the principal causes of poor financial management and poor revenue collection.

### Technical Assistance

Considering that 45 new municipalities will be provided with cadastral projects either through IDB or AID funding, as a result of projects already agreed to it is not necessary at this time to support additional cadastral coverage. Instead, the focus of the technical assistance should be to complement the IDB and AID activities, especially in the areas of property valuation, arrears account management, and cadastral maintenance, and revenue collection. These are the activities with greatest revenue payoff.

One organizational problem is whether three different governmental units should continue providing cadastral assistance to municipalities. Of the three organizations, only two (DEC and BANMA) have any track record in the major secondary municipalities. The DGAATM efforts have been mostly with the smaller sized municipalities where there is little revenue potential.

Under these circumstances, it is best for DEC and BANMA to lead the way in cadastral work as is presently contemplated with the IDB program. On a long-range basis, it is best that

DEC be recognized as the appropriate unit to provide cadastral assistance because of its multipurpose approach and its commitment to ongoing maintenance.

Given these circumstances, the following technical assistance recommendations are made:

✦Provide strong technical assistance in the area of arrears accounts management and collections. This would include collection reforms to closely follow implementation of each cadastral project.

✦Work with local community leaders of the municipalities to design positive public relation campaigns that link tax receipts to concrete community projects, so that the benefits of tax payment become visible.

✦Assist the maintenance efforts of the DEC cadastral program, by helping establish regional offices around the country. This may require providing the regional offices with personal computers or a computer terminal that would be tied to their mainframe in Tegucigalpa.

✦Provide municipalities with technical assistance to continue maintenance of their cadastral files once these have been updated by BANMA or DEC.

## Footnotes

1. See Grenville Barnes, "The Cadastre-Based Land Information System in Honduras." Madison, Wisconsin: Land Tenure Center, University of Wisconsin, December 1987, p. 10.

2. Information obtained from a draft report on the cadastral effort for the AID-funded rural small farmers titling program.

3. Information obtained from preliminary data DEC has prepared for a report on the rural titling program for USAID.

4. Information provided by BANMA did not specifically break out property tax figures. The Tributos Directos figures were used that include property tax and the neighborhood head tax or residency tax (impuesto vecinal).

5. See sections 7.2 through 7.5 of the San Pedro Sula Study for more detail.



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# CHAPTER FOUR

## THE ROLE OF
## DIRECCIÓN GENERAL DE ASESORÍA Y ASISTENCIA TÉCNICA MUNICIPAL

## DIRECCIÓN GENERAL DE ASESORÍA Y ASISTENCIA TÉCNICA MUNICIPAL (DGAATM)

The Dirección General de Asesoría y Asistencia Técnica Municipal (DGAATM) of the Ministerio de Gobernacíon is the central government unit responsible for liaison with and control over all of the municipalities of Honduras. The unit's primary responsibilities are to review municipal budgets, provide technical assistance to municipalities, and act on behalf of municipalities before the central government. Approximately 80 percent of its effort is directed to the small (less than 10,000 population) municipalities.

The DGAATM was established on May 18, 1960 through Decree 311. Article 2 of that decree spells out all of its duties and responsibilities which are outlined in 25 subsequent paragraphs.

While the title of the unit implies providing technical assistance to municipalities, its major role is to control the budget preparation process (see Chapter Two of this Appendix). As is described in the review of the budget process, the budget guidance provided by this unit is extremely weak. It provides virtually no technical assistance in assisting municipalities to prepare viable, realistic budgets.

The cadastral unit (see Chapter Three) provides assistance to the municipalities in establishing cadastral records. Usually, the DGAATM works with the smaller municipalities. Two or three representatives of the unit will spend one month on site working with a municipality to train those who are interested in learning about cadastral administration. They will typically train 10-12 people per community, and assist the municipality to develop its tax rolls and valuation mechanisms. At the end of the program, the DGAATM assists the municipality in identifying the best students so that these can be hired to administer the cadastral records. The DGAATM feels that by training an excess number of people, there will be someone in the community who knows about cadastral administration in the case of a change in political party at the municipal level with resultant personnel turnover. While this is an interesting method of addressing the issue of massive personnel changes, no information was provided to indicate that the other cadastral students were offered positions by the new municipal officials.

The training provided by cadastral personnel of the DGAATM does not include collection administration, but it does include property valuation techniques and how to provide continual maintenance of cadastral records.

Besides these two primary functions the DGAATM compiles statistical information about the municipalities (population, number of employees, kms. of streets, etc.). Financial information on the municipalities, however, is extremely weak.

In the area of technical assistance, the unit has organized several training workshops titled "Perfeccionamiento de los Empleados Municipales" since 1984. These have been provided mostly to municipal employees of small towns.

Staffing of DGAATM is 65, but approximately 28 employees are on "loan" to other organizational units in the Ministerio de Gobernación. A more realistic staffing figure, hence, is 37 which is divided as follows (including the number of professionals in each unit):

| Area | No. of Employees | No. of Professionals |
|---|---|---|
| Budgeting | 18 | 4 |
| Cadastral | 8 | 0 |
| Selling of forms to municipalities | 7 | 0 |
| Secretarial pool | 4 | 0 |
| Total | 37 | 4 |

As the figures indicate, the professional depth of the DGAATM is very limited.

## Capability of the DGAATM to Fulfill its Responsibilities

Article 2 of Decree 311 spells out the responsibilities of DGAATM towards the municipalities. In discussion with the Director of the DGAATM, an analysis was conducted of which of these functions DGAATM actually performs. A summary of these responsibilities, plus the degree of accomplishment, is provided at the end of this chapter.

A quick review of this table shows that relatively few of the responsibilities are presently being met in full. Of the 25 tasks only 12 are being done as required by the law. The others are done on a sporadic or partial basis, or not at all.

Several of the responsibilities not being performed are priority items for municipal development. Among these are the development of statistical data bases for municipal finance, and studies concerning local public services that can be provided by municipalities on an economic basis.

For the most part, the unit is absorbed with trying to maintain antiquated accounting books and ledgers concerning municipal finance. This, along with a management preoccupation with the legal/judicial aspects of municipal administration and control, has prevented the DGAATM from providing meaningful assistance to local governments, especially in the area of municipal finance and budget management.

Far from promoting municipal self-sufficiency, the DGAATM has opposed the formation of municipal associations at the departmental level, and has opposed any relaxation of central government control over municipal budgeting.

## RECOMMENDATIONS

Because of its weak institutional base the DGAATM is not a viable organization through which to channel either technical assistance or training programs to Honduran municipalities.

The only viable short term role for the DGAATM is for it to compile municipal financial information, and for it to perform limited review of municipal budgets.

Analysis of the Dirección General de Asesoría y Asistencia Técnica Municipal

An analysis of each function or responsibility as indicated in Article 2 of Decree 311. Each numbered item corresponds to the appropriate paragraph number in Article 2 of the Decree. The functional description is a summary translation of the description in the actual law.

| Function | Results |
| --- | --- |
| 1. Respond to requests from the municipalities for advice in matters concerning municipal adminstration. | Yes. Do respond, but with emphasis on the legal aspects as opposed to how to provide better municipal service. |
| 2. Organize the financial statistics and patrimony of the municipalities, making suggestions as to how to improve their financial situation. | Do receive financial information concerning actual expenditures and revenues from municipalities, but because of its manual operation, data are not used or available for use by others. No meaningful advice is provided concerning improvement in municipalities' financial situation. |
| 3. Prepare circulars and instructions for municipal budget preparation, for the purpose of maintaining uniformity of municipal budgets. | Do prepare a very elementary budget instruction guide. The process places emphasis on line-item detail rather than identifying program goals and objectives. There is a high degree of uniformity in reporting among municipalities (because of the need to use pre-established forms), but there is no meaningful compilation of statistical information. |
| 4. Advise the municipalities on the establishment of tariff schedules and budgeting; maintain the appropriate registers for statistical information. | Budgeting advice is extremely limited and of poor quality. No help provided in preparing tariff schedules. Meaningful statistical compilation is not prepared. |
| 5. Advise on revenue collection, taxing, and user service charge systems. | Do on occasion, but very weak in this area; of use only by the smallest towns. |
| 6. Provide municipalities the necessary forms to record tax and revenue | Provide the forms and oversee the process. |



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| | collections for the purpose of maintaining a uniform reporting mechanism concerning municipal revenue. | |
| 7. | Assist municipal authorities in implementing standards and methods to obtain an efficient and effective municipal adminstration. | Virtually nonexistent. |
| 8. | Coordinate local infrastructure programs with the general planning of the Central Government with the objective of obtaining optimal use of investments for irrigation, opening of new roads, and electrification. | This activity is not performed. |
| 9. | Coordinate the execution of public works that affect two or more municipalities with the objective of reducing costs and avoiding duplication of effort. | This activity is not performed. |
| 10. | Provide advice on the financing of profitable public services and other types of works that are in the public interest. | This activity is not performed. |
| 11. | Study the organization of the municipal treasury. | This activity is not performed. |
| 12. | Collaborate with local municipal authorities in preparing cadastral records. | This service is being provided on request. It is done primarily for small communities. |
| 13. | Register the administrative divisions of the State, and be aware of conflicts between municipalities and help resolve these through the corresponding Secretara de Estado. | This responsibility is being performed; quality of work is not known. |

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|---|---|
| 14. Organize the registers of the members of the Municipal Corporations with annotations concerning the functions that they exercise. | This is being done, however, the work has no application. |
| 15. Establish courses to improve the performance of municipal employees. | Since 1984 have provided a course titled "Perfeccionamiento de los Empleados Municipales." Quality not known. |
| 16. Promote municipal research. | No research has been carried out. |
| 17. Note and bring to the attention of the municipalities appropriate laws, regulations, and other dispositions that will affect municipalities. | This service is being performed. |
| 18. Provide advice to the municipalities for contracting with the Central Government, the private sector, and banking institutions, and keep a register of the respective contracts. | Almost no meaningful advice provided on this subject. |
| 19. Provide reports on concessions that are provided by municipalities. | Not being performed. |
| 20. Act as lobbyist for the municipalities before the respective Ministries concerning the elaboration and reform of municipal laws. | Virtually no performance; DGAATM has not served as a catalyst or lobbyist for new municipal law. |
| 21. Publish periodically an information bulletin concerning municipal administration with the objective of stimulating research in the problems facing local government. | While a yearly, four-page bulletin has been published in the last several years, its content is limited to recognizing the mayors of the smaller communities. Very little information is provided concerning municipal administration and no encouragement is given to study local government problems in Honduras. |



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| 22. Promote the preparation of operating manuals for local government officials. | The DGAATM claims it provides this service, but other than the budget preparation material, no other manuals were provided to the study team. |
| 23. Promote regional meetings of mayors where there exist administrative problems to resolve; help find technical solutions. | This has been done on a sporadic basis. However, DGAATM has resisted legal recognition of the Mayors' Association for Cortes Department, as well as other regional groupings. |
| 24. Represent the Ministerio de Gobernación y Justicia in Congresses and Assemblies that are municipal in nature. | This responsibility is performed as required. |
| 25. Prepare an annual report summarizing the activities of the DGAATM. | This responsibility is being performed. |

# CHAPTER FIVE

# THE BANCO MUNICIPAL AUTONOMO (BANMA)

## BACKGROUND

The Banco Municipal Autonomo (BANMA) is the principal source of capital finance for Honduran municipalities, and traditionally has been the principal vehicle for external donor support of local government. It thus occupies a critical place in the urban development sector.

BANMA was created through Decree No. 12 of the National Congress on November 4, 1961, and initiated operations on June 1, 1962. Its mandate is to provide local governments with economic and financial resources, as well as technical assistance which will allow the local governments to develop autonomously and meet the public service needs of their communities.

To achieve these goals the Law states that BANMA will be the sole depository of all funds, securities and assets of any kind of the cities, that it will be the financial organ for municipal works and services, and the coordinator of economic and financial activities of the cities in relation to the national government. Specifically, BANMA is designated as the sole receiver of all funds related to city expenses or for public works, services, and maintenance operations, or for any disbursements intended for localities from the national government or autonomous agencies. Municipalities are required to earmark 5 percent of their revenues each year to the purchase of capital shares in BANMA, in order to strengthen its capital base.

As can be seen, the law creating BANMA endows it with a dual role. The Bank clearly is intended to be an economic and financial resource serving local governments. At the same time, the law institutionalizes a situation where local governments can become the financial stepchildren of BANMA. Interpreted literally, the municipalities would be deprived of financial independence by the requirement that BANMA handle all of their finances.

### Current Financial Situation

Since its inception, BANMA has been plagued by a very high rate of delinquent accounts, both on its loans to municipalities and on the mandatory contributions to capital. The delinquencies are of such magnitude that for all intents and purposes, the Bank should be considered insolvent, as the following analysis will demonstrate. Its financial situation has prevented BANMA from making significant numbers of new loans or financing the capital development of Honduran local government, except as a pass-through agent for international financing programs. It also has led to permanent strains between BANMA and the local governments it is supposed to serve.

Between 1987 and 1988 BANMA's delinquent accounts from loans increased from Lps. 22.1 million to Lps. 29.4 million (this is the amount of loan payment actually overdue). Partly as a result, the Bank lost Lps. 2.5 million in 1988 resulting in an erosion of almost 7 percent of its nominal capital base.

In addition to delinquent loans, BANMA faces Lps. 1.7 million in delinquent payments on avales and Lps. 15.7 million in delinquent payments on fidecomisos. Avales are guarantees of payment provided by BANMA to third parties (usually private financial institutions) for municipalities' purchases of materials and supplies; fidecomisos are debt repayment obligations that BANMA assumes on behalf of the municipalities for advances made to the municipalities by the Central Bank. As can be seen from Table 3, virtually all of these latter delinquencies are owed by the Distrito Central. For example, the fidecomisos reflect solely repayment obligations to the Central Bank for advances used to fund Christmas Bonuses (aguinaldos) in the Distrito Central government.[1] Overall, the Distrito Central is responsible for more than 75 percent of BANMA's delinquent payments.

The total delinquent account figure exceeds the capital base of the Bank (Lps. 34.3 million) by Lps. 12.6 million. Even excluding the delinquencies for fidecomisos, which as explained in footnote 1 do not represent BANMA capital at risk, delinquencies account for 91 percent of BANMAS's nominal capital base. Since no payments at all are being made on many of the delinquent loans, outstanding unpaid amounts are rising very quickly (at a rate of 33 percent in 1988), and the ratio of total bad debt (including payments not yet due on loans that are delinquent) to capital is far in excess of 100 percent. On the basis of accounting principles used in the United States BANMA would be insolvent. The Bank has no reserves for bad loans.

**Table 3**

**BANMA Delinquent Accounts, As of 12/30/88**
**(Thousands of Lempiras)**

| Item | AMDC | Other Municipalities | Total |
|---|---|---|---|
| Project loans | 18,516 | 10,933 | 29,449 |
| Avales | 1,684 | 39 | 1,723 |
| Fidecomisos | 15,674 | 0 | 15,674 |
| Total | 35,874 | 10,972 | 46,846 |

In both 1987 and 1988, at the insistence of the World Bank, BANMA negotiated intensively with municipalities to reschedule existing indebtedness and bring the municipalities current in their rescheduled payments. This program was to serve as the basis for BANMA's revitalization as a credible financial intermediary.

BANMA itself has not monitored the repayment record under its refinancing program. However, a special analysis conducted for this study found that the Bank refinanced 11 project loans in eight municipalities in 1988. A comparison of repayment rates under the new terms with the previous repayment record revealed that only in two small cities (Choloma and Quimistán) was there any improvement. In five other cities the repayment record under the renegotiated terms was just as poor, or worse, than it had been before, including several cases in which no payments at all were made. (The revised schedule of payments for the eighth city did not call for payments to be made until 1989.) A similarly discouraging picture occurs for municipalities that were refinanced in 1987.

Because of the gravity of the delinquent accounts situation at the beginning of 1988, the Bank established a Recovery Plan for 1988 that set the objective of recovering at least 11.9 million lempiras in delinquent loans between April and December of 1988. Although the Bank was unable to provide information regarding actual collections under the Recovery Plan, in view of the large increase in total delinquencies in 1988, it is apparent that the Plan did not come close to meeting its targets.

Another factor in BANMA's capital depletion has been the failure of municipalities to make the capital contributions specified in the law. As Table 4 reveals, through December 31, 1988, municipalities had paid in only Lps. 13.2 million of the Lps. 35.8 million that they owed.

**Table 4**

**Municipal Paid in Capital to BANMA**
**(12/31/88, Thousands of Lempiras)**

| | Distrito Central | San Pedro Sula | La Ceiba | Puerto Cortes | All Others |
|---|---|---|---|---|---|
| Payments due | 12,213 | 8,322 | 1,443 | 900 | 12,970 |
| Capital paid in | 3,221 | 6,547 | 144 | 314 | 3,106 |
| Capital past due | 8,992 | 1,865 | 1,299 | 586 | 9,864 |
| (percent) | (73.6) | (22.4) | (90.0) | (65.1) | (76.1) |

As a practical matter, the consequence of low loan repayments and low municipal capital contributions, in the face of high and continuing operating expenses, is that BANMA becomes almost exclusively dependent upon foreign capital for financing local investment projects. Between 1980 and 1988, more than 89 percent of all BANMA loans were externally financed. In effect, there is no system for domestic financing of local government capital projects (although San Pedro Sula has begun to borrow for such purposes from commercial banks).

Origin of Delinquencies; Policy Options

Although there are many factors contributing to the delinquency record at BANMA, four deserve emphasis. Together, these considerations indicate just how difficult it will be for BANMA to act as a "bank," absent the most fundamental reforms in the organization's structure.

First, Honduran society at all levels resists paying debts, especially to public entitities. Other public organizations in the Shelter and Urban Development sector, such as INVA and SANAA, share in the same poor collection record. This general tendency is exacerbated by the fact that many local officials perceive that it is in their best interests to obtain the largest possible loans for local projects, in the expectation that the loans will not have to be repaid, or will be repaid only in part. In fact, on numerous occasions the national government has ended up forgiving local governments their indebtedness, either explicitly or implicitly by providing financial assistance to BANMA to compensate for the lack of repayment. In some cases, such as the advances for the Distrito Central's aguinaldos, the loan arrangements are only a thinly disguised transfer in the first place; this "loan" from the Central Bank carried no date of repayment and no specification of the interest rate to be paid. It is understandable, then, that all parties should treat BANMA loans as if they were in large part subsidies.

Second, BANMA's own efforts at loan collection have been highly erratic, depending upon the political direction that the Bank was taking. For several years, very few efforts at collection were made. Then, with a change of Bank leadership or as a result of the conditions of an external loan, loan repayment becomes a priority. BANMA's lack of a steady policy toward loan repayment has encouraged municipalities in their desire to avoid payment.

Third, the municipalities maintain that they have had very little voice in the most important local capital projects financed by BANMA loans. These projects were selected by BANMA, designed and located by BANMA or its agents, and built under the supervision of BANMA or other central-government organizations. When project revenues prove to be inadequate to repay the loan, or as in the case or the Choluteca bus station, when a project is never used at all, the municipalities feel no obligation to make up the repayment shortfall from general revenues.

Finally, as BANMA's financial condition becomes clearer, contributing to its capital base seems increasingly like throwing money away. In return for their capital contributions, municipal governments earn no financial return whatsoever. Even if the Bank were to be liquidated, its capital base, under the most optimistic assessment, is far less than the paid-in



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capital of the municipalities, and may well be negative. Moreover, the municipalities earn no policy voice in return for their "ownership" of the Bank. The President of the Bank is named by the central government. Local governments have only two representatives on the Board of Directors. (This representation in itself is a recent innovation.)

BANMA's policy options in dealing with delinquencies are limited. Its most effective short-run strategy has been to intervene in municipalities that are far behind in loan payments. BANMA then sets up a local office to collect payments directly from individual beneficiaries and use these to service its loan. However, in addition to diverting BANMA's professional staff from other duties, including technical assistance, this procedure perpetuates the dependency of local government. Many mayors, in fact, welcome BANMA's intervention, since it shifts from local government to BANMA the burden of revenue collection and the undesirable image of charging prices for public services.

## Technical Assistance Capability

Because of the deteriorating financial situation in 1988, BANMA imposed an austerity program that included a layoff that reduced overall personnel by approximately one-third, reducing staff from 300 to 200. Through this layoff, the Technical Assistance Unit, Desarrollo Municipal, was drastically reduced from 23 to 6, leaving only two professionals. These professionals are presently being used in ad hoc situations, as part of the "intervention teams" in Juticalpa, Catacamas, and El Progreso.

What is especially disappointing is that prior to the layoff, BANMA received technical assistance through a World Bank project that produced valuable manuals and other products in the areas of tax administration, finance administration, and planning of infrastructure projects. Consequently, BANMA has excellent material available for both technical assistance and training, but is presently incapable of providing these services to municipalities. Moreover, most of the personnel associated with the development of the manuals have left the Bank, with the result that these may never be used, even if new personnel are hired.

A new IDB program, signed in January 1989, will provide BANMA with new funds to finance investment projects in secondary cities. The agreement requires that BANMA add 10 professionals to the technical assistance unit to provide technical assistance and training, especially in cadastral systems. The agreement also calls for a new round of technical assistance to BANMA in internal project management, financial management, and computerization.

# CHAPTER SIX

## UNIVERSIDAD NACIONAL AUTONOMO DE HONDURAS: ITS ROLE IN MUNICIPAL TRAINING

## BACKGROUND

Article 229 of the proposed municipal law contemplates that the National University (UNAH) will create a municipal training and development institute using existing resources the university receives from the central government. It therefore is appropriate to examine the approach and philosophy of the existing public administration program at the university.

UNAH's public administration program was originally established as part of the Economics Department. Later the program was moved to the law school, principally because the curriculum was designed by lawyers. The present dean is of the opinion that the program does not belong in the law school, but in another department such as business administration.

The public administration program has been in existence for over 15 years. It presently has a faculty of 12 professors, six of whom are considered full time, and six of whom are considered part time. Its main activities take place in the late afternoon and evening, with little activity during the day. In fact, several of the "full time" faculty members also have other jobs, mostly in central government ministries.

The philosophy of the program is based on the legal/judicial aspects of public administration, as opposed to the management of public enterprises. Approximately 60 percent of the curriculum and lectures dwell on judicial matters, while 40 percent emphasize technical matters (which would include finance, budgeting, personnel administration, and organization and methods).

Very little of the actual program concerns municipal administration. There is one course on local government administration, which is given occasionally, with major emphasis on understanding the various laws that impact on municipalities (municipal law, BANMA law, and organic law of the Central District). A copy of the curriculum is provided at the end of the chapter. The program does not offer any courses on project management, municipal finance or budgeting, with the exception of generalities within the judicial framework.

Review of the course readings for the public administration and local government courses indicates a high level of dependency on legal works. The technical bibliography is a



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mixture of European, Mexican and Venezuelan works, many of questionable quality, which lack managerial focus.

The public administration program does not include field investigations or practical research (example: analysis of the functional organization of a municipality, or central government ministry). Students and faculty are not encouraged to do on-site field work as part of their educational or teaching experience.

The primary reasons cited for the lack of research and field work is the lack of funds for per diems, travel, etc., and difficulty in obtaining collaboration with public administration units to do research.

The university has elaborate training facilities in Tegucigalpa, and branch campuses in San Pedro Sula and La Ceiba. It also offers "Educación a Distancia" programs in Danlí Choluteca, Juticalpa, Siguatepeque, and Santa Rosa de Copán.

## Overall Capability

The value of the university in providing technical training to local government specialists is limited because of the legal/judicial inclination of the public administration program. The focus of a municipal administration program should be a management and results-oriented curriculum, particularly in the areas of finance administration and project management.

In terms of curriculum, the present program suffers from not providing incentives for students or faculty to do research on public administration issues that affect Honduras. Among the textbooks and documents used in the curriculum, only three concern Honduras (Budget Analysis of San Pedro Sula by Maria A. and Carolina Sabillon C., Administrative Procedures and Accounting for Honduran Municipalities by Clapp and Mayne, Inc., and Manual for Urban Property Valuation Procedures by Clapp and Mayne, Inc.). Considering that the public administration program has been in existence for over 15 years, it is unfortunate that there is virtually no textbook or research material concerning public administration in Honduras. Of the three texts cited above, the two by Clapp and Mayne were prepared using international donor funding, and do not represent local contributions to the subjects addressed.

Faculty and staff commitment is limited since the majority of the faculty view their job at the university as their "second job," which is very common in Latin America. However, because of the magnitude of training and technical assistance required in the municipal field, a commitment is required by an institution to provide full time staff for training programs.

Lastly, since the university is autonomous and financed by dedicated revenue sources, there is very little room for influencing the content of the curriculum, quality of staff, research and technical assistance orientation, or entrance criteria for students into a municipal program. Its autonomous nature means that the university can set its own priorities, and is unlikely to shift its basic orientation in response to a new municipal law.

## RECOMMENDATIONS

Because of the institutional weaknesses described above, the university should not be used as a principal source of training for Honduran local government officials.

The position of oficial mayor, authorized in the proposed municipal law, might eventually be filled by graduates of the regular public administration program. In the interest of strengthening that program, alternatives that could be considered would include:

✦Take the public administration program out of the law schocl, and create a separate department with its own dean.

✦Revamp the orientation and curriculum so that it emphasizes results-oriented management of public enterprises.

✦Incorporate research, field investigation, and technical assistance into the curriculum.

✦Require the faculty to conduct and publish research with a certain degree of regularity.



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For most of the above points, the university could receive technical assistance from the National Association of Schools of Public Affairs and Administration (NASPAA) which has had previous experience helping university programs in designing curriculums.

In-service training for existing municipal officials, however, should be the responsibility of an independent training institute, one which works closely with municipalities in the provision of technical assistance and performance of analytical studies. All of its efforts should be directed specifically to strengthening local government. A reasonable goal for a municipal training program would be to train all of the budget and financial officers, chief managers of local water and sewer systems, chief administrative officers, municipal engineers, capital project managers, and directors of land management for the 21 cities over 10,000 population.

The proposed municipal law does also indicate the need to train elected officials. In order to create a more viable training program, the training of all municipal candidates regardless of political party would be a desirable option. This would be similar to the training provided by state municipal leagues in the United States to candidates for city councils.

The institute should draw on the best course preparation already assembled by training organizations throughout Latin America, including the Brazilian Institute for Municipal Administration (IBAM), the International Union of Local Authorities (IULA), the Latin American Center for Training and Development of Local Governments (CELCADEL), and the Central American Institute for Business Administration (INCAE).



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