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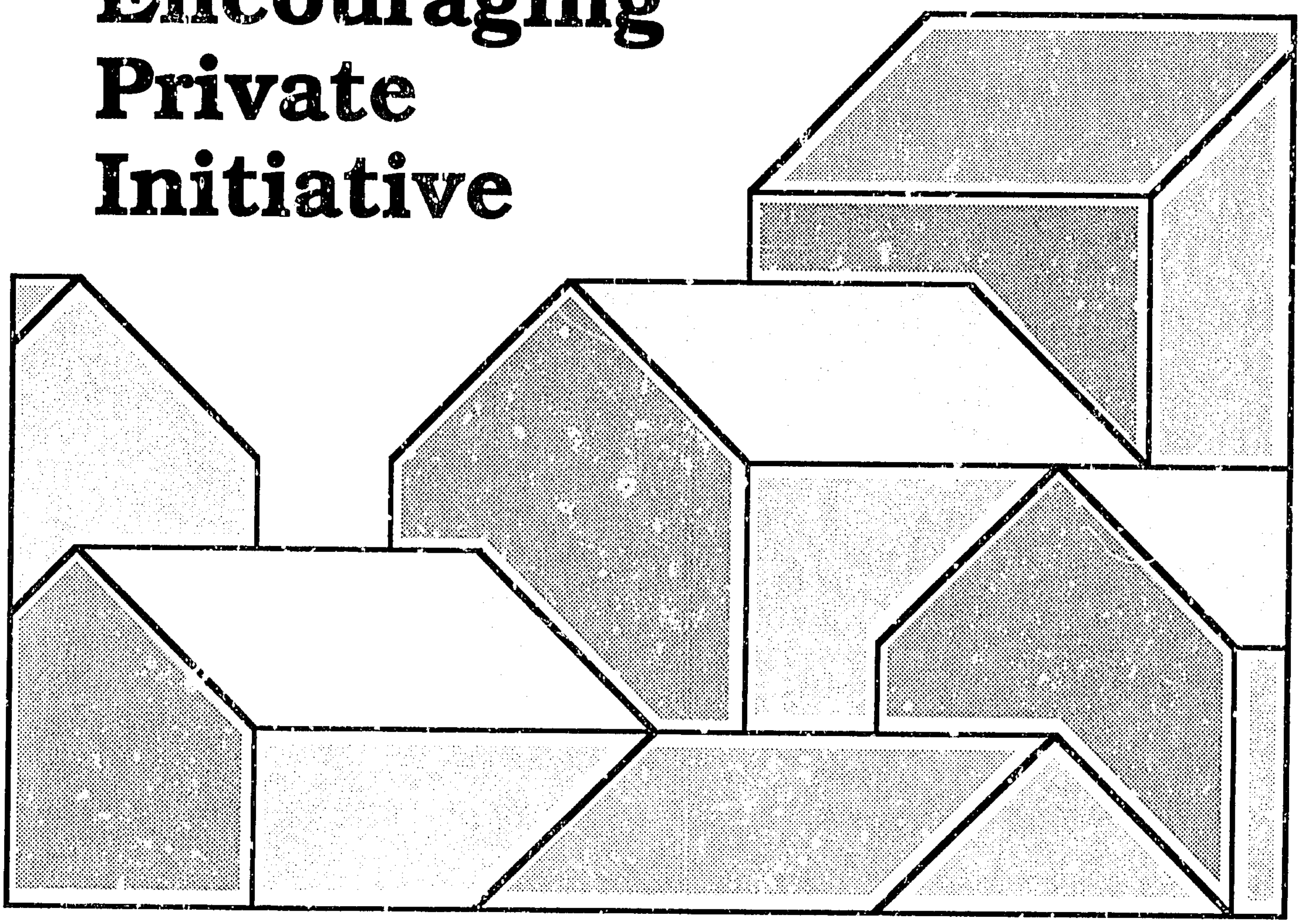
Encouraging Private Initiative



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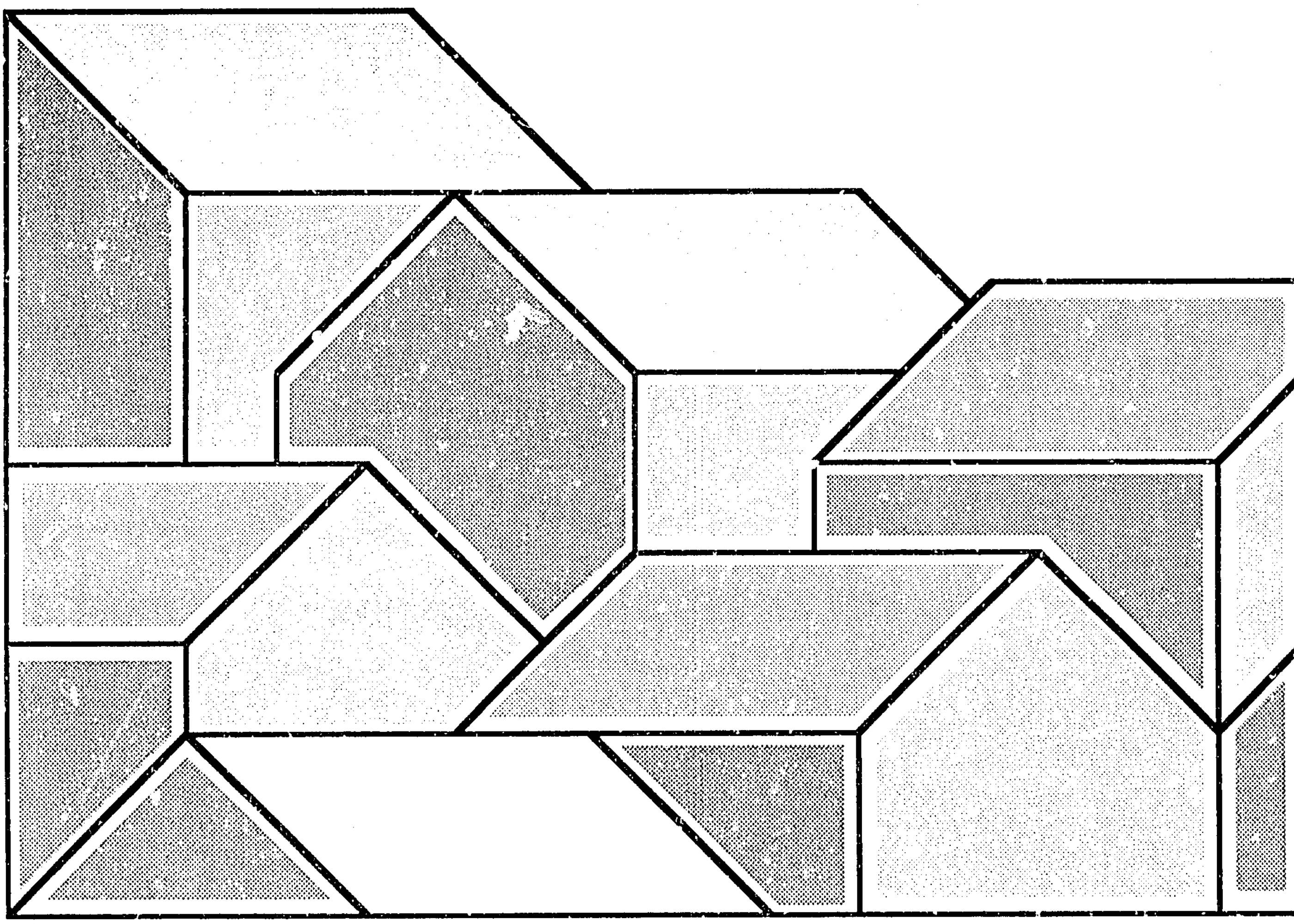

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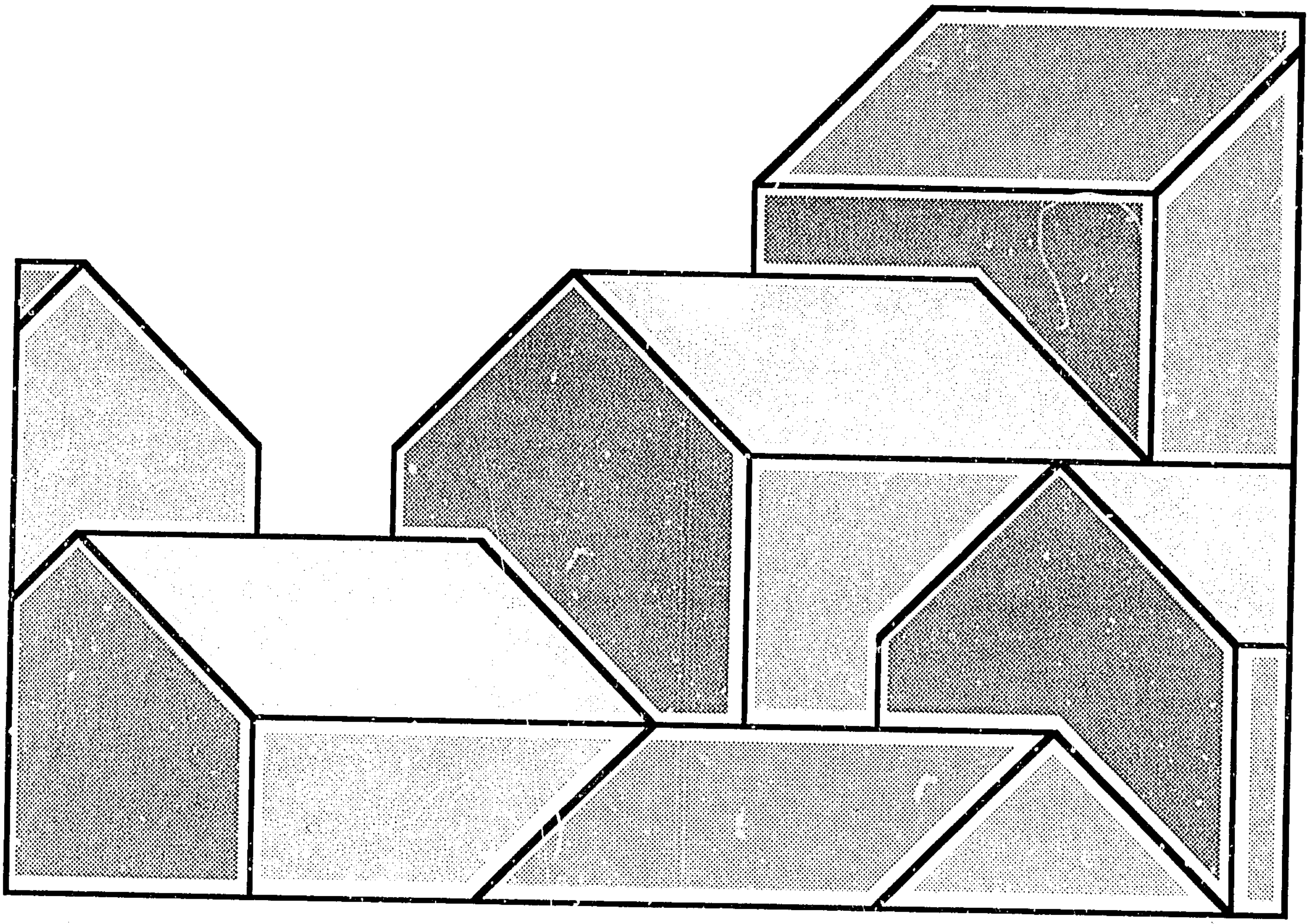

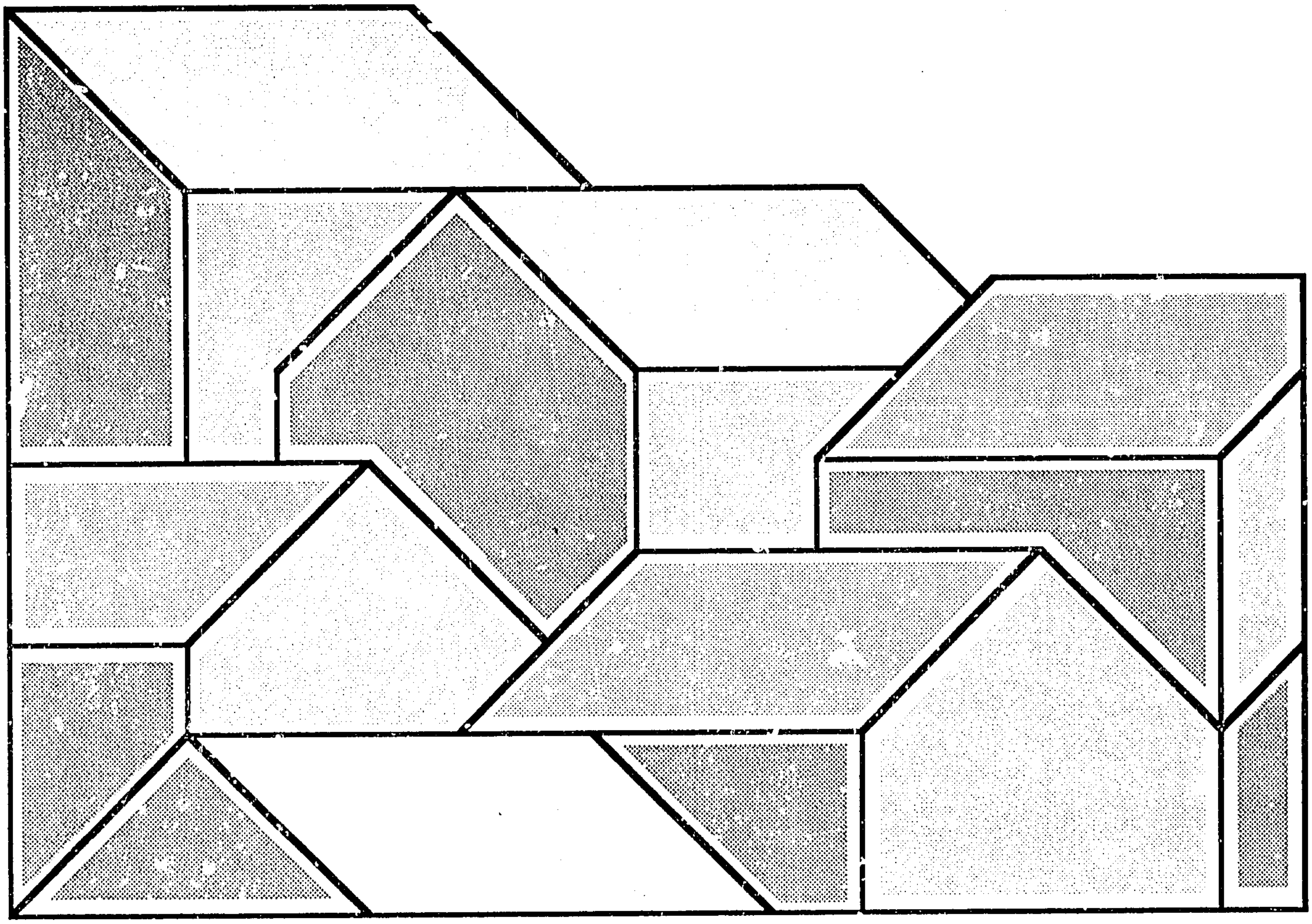

Foreword

The need for decent shelter in developing countries is enormous, and high rates of population growth and urbanization will continue to put pressure on the shelter sector through the end of this century and into the next. The US Agency for International Development has been working with developing countries to help them establish effective policies for meeting this need for 25 years.

Our experience has led us to an inexorable conclusion: The resources and the basic knowledge are now available to provide at least minimal shelter to all of the poor in developing countries in our lifetimes. What we need are effective policies and the political will to implement them. Governments should refrain from the costly and inefficient activity of building housing. The right government posture is to act as a facilitator. It should create the environment in which action by the formal private sector, the informal sector and individuals can be mobilized to address the problem. This conclusion is widely shared by the major donor countries and multinational organizations that work in the sector.

Our goal in preparing this monograph for the International Year of Shelter for the Homeless was to present ideas for how governments can encourage and support private sector efforts to provide housing for the poor. The monograph explains many specific actions governments in developing countries can take. It analyzes alternatives for private sector action through every aspect of shelter from land development and infrastructure provision to house construction and financing. It also presents concrete ideas for public policy development and implementation to increase the private sector's role.

Hundreds of millions of people will be born over the coming decades, and we will have to find ways to house them. But governments cannot take the lead role. This monograph explains how private sector resources can be mobilized and deployed to help meet the challenge. We think this is the most important message of IYSH. The Housing Guaranty Program of the US Agency for International Development, through which we have assisted 41 countries with over US $2 billion, is an excellent programmatic tool for helping to achieve our shelter goals. We welcome the opportunity to work with countries through this mechanisms to assist them to formulate and implement shelter policies that rely on private initiative.

Peter Kimm

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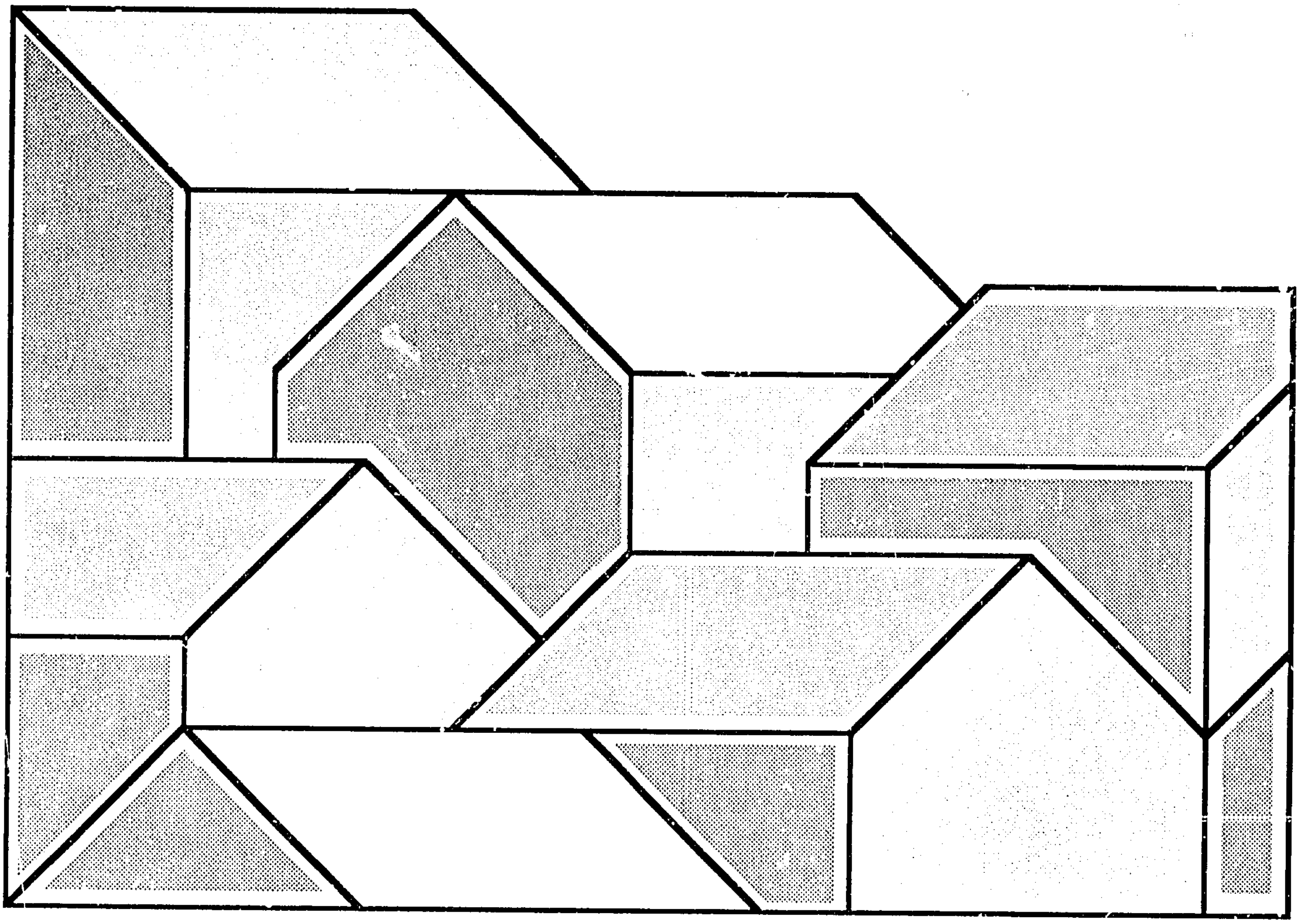


Executive Summary

The United Nations, in designating 1987 as the UN Year of Shelter for the Homeless, focused attention on a critical problem affecting hundreds of millions of people in the world today - the lack of decent shelter. High birth rates and massive rural to urban migration have overwhelmed the capacity of many developing countries to provide housing, potable water and adequate sanitation. As a result, the already large number of people living in severely overcrowded and unhealthy conditions is increasing rapidly. Shantytowns ring most urban areas in the developing world and provide the only shelter available to nearly half its urban households.

Providing shelter and stimulating a shelter industry are important national priorities in the developing world, for both have profound impacts on national economic growth, on the settlement of vast areas of productive land, and on social and political stability. Providing adequate housing, however, including division of land, installation of necessary infrastructure (particularly water, sanitation and roads), construction of housing units, and creation of an appropriate set of financing institutions, cannot be accomplished by shifting more resources from national treasuries to municipal budgets. The job simply outstrips the resources that most developing country governments - even with maximum donor assistance - could provide.

Bold, new approaches are needed. One approach begins with the premise that governments must learn to harness the creativity, energy, and personal sacrifice most individuals will apply in order to provide themselves a decent home. Harnessing these resources requires governments to facilitate individual initiative by creating policies and programs that encourage the private sector to produce shelter.

This monograph discusses the relative significance of the private sector in providing shelter, and the importance of a strong shelter industry to national economic development. In order to promote a healthy shelter industry, the paper suggests potential new roles for both the public and private sectors in meeting shelter

USAID Housing Guaranty Program

The Office of Housing and Urban Programs of the Agency for International Development has been providing capital and technical assistance for shelter and urban programs for 25 years. The principal source of capital assistance has been its Housing Guaranty (HG) program, under which AID guarantees long-term loans from private US banks, insurance companies, pension funds and savings and loan associations to LDCs for financing of basic shelter and infrastructure for lower-income families.

The central office in Washington is supported by seven Regional Housing and Urban Development Offices (RHUDOs) that are responsible for identifying and designing shelter projects in their respective regions. They are located in Tegucigalpa, Kingston, Panama, Tunis, Nairobi, Abidjan and Bangkok. The Washington office provides oversight and support through its Operations Division and leadership in policy and program development through its Policy and Urban Programs Division.

The HG program was enacted in the US Foreign Assistance Act of 1961. The fundamental goal of the program is to help achieve comprehensive, rational strategies for meeting the shelter needs of the poorer half of LDC populations. The HG Program works with LDC leaders in designing and implementing policies that create the climate that will permit individual initiative and encourage the private sector to produce the needed housing. To date, 41 countries have received assistance under the HG program in developing their own housing finance institutions and in mobilizing savings to help meet the housing needs of their populations.

needs, examines various approaches to encouraging private sector initiative, and illustrates models for expanded private sector contribution by drawing upon actual experiences of projects supported by the Office of Housing and Urban Programs of the US Agency for International Development in a wide variety of developing countries. Separate sections of the monograph address the principal components of a shelter program: appropriate mechanisms for distribution of housing and housing assistance; access to land; provision of infrastructure and urban services; production of building materials; and the construction and finance of housing units. Overall strategies for encouraging private initiative are also elaborated, and ways of evaluating the appropriateness of individual approaches suggested.

In order to understand the role and importance of the private sector in shelter production, it is first critical to recognize the relative contribution made by that sector to the overall shelter sector. In virtually every nation, the private sector, whether through formal institutions such as banks, construction companies and land developers, or through informal enterprises and individual labor, provides the overwhelming majority of occupied dwelling units. The task of producing adequate housing exceeds the public sector's ability to provide it, both in terms of capital resources available and in administrative and organization capacity. When allowed to function fairly freely, the private sector creates many forms of shelter, affordable by a wide range of income groups. While the lowest income groups may not be served by this system and may consequently require assistance from the public sector, a large proportion of the population will be reasonably well housed without expenditure of scarce public funds.

In many developing countries, the formal private sector has vastly more financial and human resources that can be directed to the production of housing than does the public sector and the potential for generating investment capital for shelter from individual and institutional savings far exceeds that available from public funds. At the same time, private sector managers are subject to the pressures of the marketplace to perform and are continually judged by an unequivocal 'bottom line.' To the extent that government-owned enterprises are run like privately-owned ones, no clear distinction may exist with respect to efficiency of operation or cost of doing business. However, most government-owned enterprises are not required to compete in the marketplace and be judged on their profit results. Unless government policy protects a private firm from the forces of the marketplace (for example, by granting a monopoly position), the formal private sector can usually perform a particular task more efficiently and at lower cost than a public agency.

While the formal private sector may have greater resources which could be applied to shelter and may arguably offer more efficiency in its production, it, like the public sector, has failed to meet the need for decent housing for lower-income families in most countries. Unlike governments, the private sector is primarily motivated by profit and is not obligated to respond to public expectations or social need. Persuading the private sector to expand its services to address the needs of a broader market usually requires both a relatively freely functioning marketplace and government policy aimed at creating incentives and reducing risk. Thus, in order to achieve significant improvements in shelter conditions, the public sector and the private sector must cooperate as neither can be expected to succeed in isolation.

Emphasis on the potential contribution of the private sector is consistent with the current thinking among economists and international aid agencies that private sector involvement is important to achieving significant economic development. It has become apparent that the relative neglect of markets and of private enterprise, which took place during the 1970s as a consequence of the then prevalent strategy for achieving accelerated development through direct public sector controls, was costly in terms of missed opportunities. While excessive government intervention in investment, production and distribution functions is now recognized as deleterious to economic development, this does not imply a proposed return to the laissez-faire policies of the 1950s

Private Sector: Formal and Informal Participants

The private sector encompasses both 'formal' institutions and organizations which are owned by private citizens and 'informal' activities which include individuals and small scale enterprises that are not formally registered, do not keep proper accounts, and employ labor mostly on a casual basis. In industrialized countries, the informal sector plays a very small role in the production and finance of housing. In virtually every developing country, however, the informal sector is responsible for the vast majority of new housing production. A UN study (Ramachandran, 1984) notes that in the Philippines, 86% of the increase in housing stock was produced through 'informal means,' in Brazil, 82%; in Venezuela, 77%; in Colombia, 77%; and in Chile, 44%. The contribution by the informal private sector can be expected to continue for the foreseeable future, particularly for the lowest income groups. If conditions are to be improved for large numbers of people, governments must recognize this reality and adjust their policies and programs accordingly.

and early 1960s. The development lessons of that era include a healthy skepticism of the motivations which drive private sector enterprises, particularly monopolies and very large transnational corporations.

Still, government officials must realize that providing adequate shelter is beyond the resources of the public sector. The resources of both the formal and informal private sectors are substantially greater than those of the public sector. Given appropriate encouragement, these private sector resources can be directed toward the task of providing adequate shelter for most segments of the housing market.

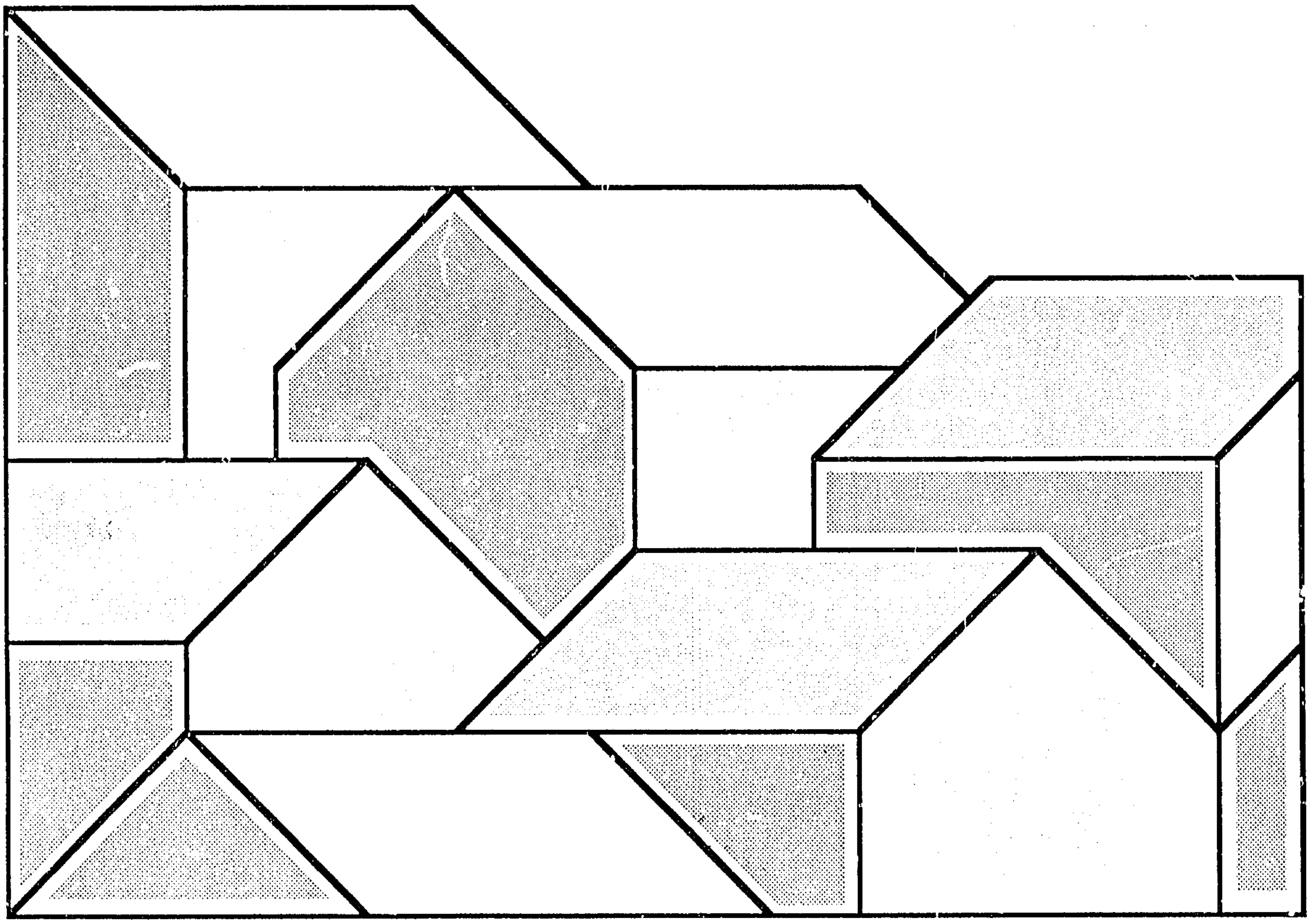
The motivation for government to encourage a vastly expanded private housing sector goes well beyond the obvious and important benefit of improved housing conditions: an active shelter industry creates long-term employment, and is an important component in a successful economic development strategy. Housing's contribution to overall economic growth is often undervalued in the debate over allocation of scarce resources. Housing is not, as if often thought, merely a social good; instead, it is an investment alternative which has an income multiplier of about two in developing countries. It also stimulates savings and investment by individuals normally considered unable to participate in such activities, and stimulates a wide variety of domestic industries.

These benefits are best realized in countries which rely heavily on the market system to create products and allocate resources. The profit motive combines with individual initiative to improve the efficiency of production, and to stimulate individual effort that does not generally accompany government programs.

While governments are not generally efficient in the actual production of housing, the public sector has an extremely important role in nurturing the formal and informal elements of the private sector. This role includes accepting the growth of a shelter industry as an important element of national economic development policy, creating a regulatory climate which pe.mits the marketplace to function relatively freely, and formulating a policy environment which promotes the growth of a private sector shelter industry. Specifically, government actions can facilitate or curtail access to credit; increase or decrease the cost of housing by influencing the cost of credit, materials, labor or land; and encourage or discourage investment in shelter by both the private formal and informal sectors. The effects of government actions can be complex and difficult to predict. Policies, programs and regulations should be carefully considered to ascertain their effects on housing, and on economic development in general.

There is also no question that some shelter needs must be met with government assistance. For those individuals with little or no current cash income, and with minimal prospect of participating in the nation's economy, publicly subsidized housing may be the only equitable solution. In order to increase the funds available to meet these essential needs, governments must nurture private sector capacity and provide incentives to produce a broader range of shelter while conducting its 'last resort' shelter programs in as efficient a manner as possible.

Part One of this monograph examines the components of shelter programs, and suggests ways to promote private initiative in those components. Part Two suggests a series of public policy options which may be adopted to promote the private sector shelter industry and improve the shelter investment strategies of the public sector.



Part One:

Public and Private Sector Roles in Providing Low-Cost Shelter

Improving Access to Housing and Housing Assistance

Delivering Land, Infrastructure and Urban Services

Expanding the Production of Housing

Mobilizing Funds

Providing Loans

Improving Access to Housing and Housing Assistance

Public Sector Distribution

The primary difference between a largely private sector housing market and a public one is the manner in which plots of land and/or housing units are distributed to individual families. In the private sector, the market is the primary mechanism for allocation. A buyer who wants to purchase or rent a home negotiates a price with a seller or landlord. The objective of the seller or landlord is to obtain an amount sufficient to cover the costs of the investment, including adequate compensation for undertaking the risk of producing and maintaining the investment in shelter. Buyers or tenants seek to obtain housing that meets their needs at an affordable price. A market-based housing distribution system works well where a diversity of products exists at prices which are affordable to potential buyers and tenants.

In developing countries, serious housing and land shortages often exist. Neither the public nor the private sector is producing sufficient quantities of affordable housing, particularly for low-income households. In the face of insufficient supply and the mismatch of what is available and what is affordable, governments often assume a role in the allocation process which results in distribution of the limited housing stock on the basis of social need or political influence and in so doing, both distorts the market and reduces the private sector's capacity and incentive to meet certain housing needs.

Government interventions in the allocation process can be either direct or indirect. Methods of direct intervention include setting criteria for who is eligible to occupy government-owned housing and who will be allowed to purchase units produced by the government. For example, when governments set eligibility criteria for housing allocation which favor civil servants, housing is seen as a fringe benefit to supplement low government salaries. This may assist government in retaining qualified employees, particularly professionals and skilled technicians who could otherwise earn more in the private sector, but it also represents a hidden subsidy of ominous proportions. Low-income households may also be given priority because appropriate, affordable housing may not be available in the private market.

Whatever group is favored, the households which receive government-allocated housing generally retain the units for many years, whether purchased or rented, because the housing shortage makes the possibility of obtaining other housing remote. In effect, once allocation is made, it becomes virtually permanent, and turnover is minimal. As people's economic circumstances improve so that they could purchase housing in the private market, they are reluctant to do so. This is partially due to shortages, but also is a function of the fact that they are generally paying less than market value for the unit they occupy. Governments are equally reluctant to force relocation from government housing when occupants are no longer eligible as such actions are politically unpopular. This situation contributes to the long waiting lists for government allocated housing, and results in housing subsidies being provided to some families who have the capacity to obtain shelter without government assistance.

Impact of Government Intervention

Government allocation of housing need not disrupt the market system if it is used only as a means of distributing a scarce commodity. However, government involvement in the allocation of housing generally does involve distortions of the market, particularly through direct and indirect subsidies. The only subsidies that do not disrupt the market are those that are carefully targeted to households that could not otherwise purchase from the private market.

"The only subsidies that do not disrupt the market are those that are carefully targeted to households that could not otherwise purchase from the private market."

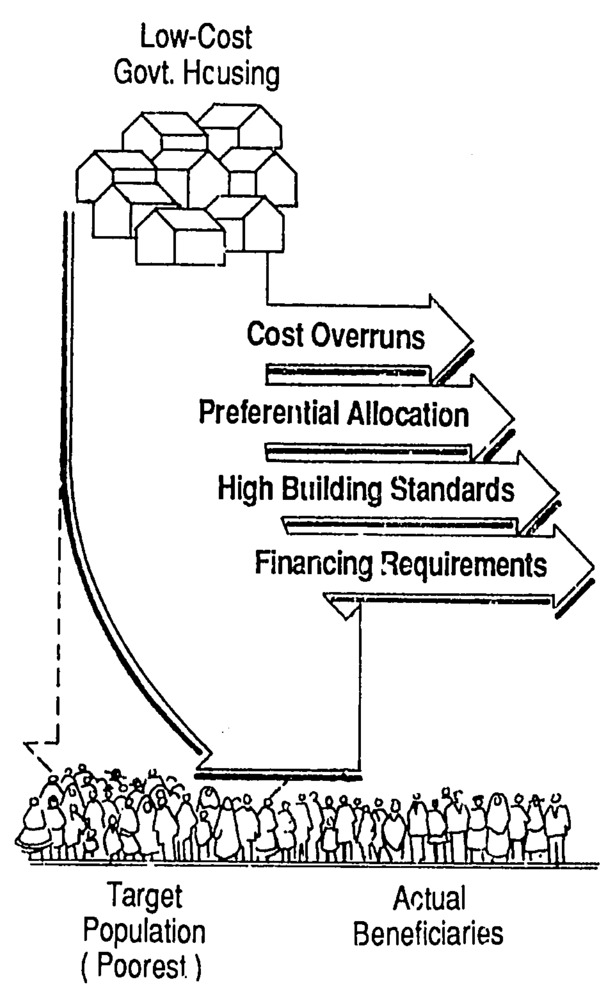
Examples of subsidies which do distort the market include selling units at prices below the market or below the rate needed to recover the cost of the unit or land. Because governments do not have to make a profit, have access to land at little or no direct cost, and are free to set prices without including administrative, financing or imputed interest costs, government-owned land or housing units are often sold at prices well below the cost of production in the private market.

When government sells land or housing units, it competes directly with private producers. If government housing or land is sold at below market prices, such as is possible when full cost recovery is not attempted, the private sector producers are less able to compete profitably and hence may not be willing to produce housing or make land available.

Rents which are subsidized by setting prices for government-owned units at levels lower than is needed to amortize the cost of construction, including financing, and provide adequate funds for maintenance also handicap the private sector. While such subsidies may be justified for the most needy, they are rarely applied so that only those who qualify actually receive them. Such subsidies are doubly counterproductive for not only can no LDC government afford to provide them to all who would be eligible, but typically, when government funds are scarce, maintenance is neglected and the housing stock deteriorates unless rents can be increased to cover maintenance requirements. Governments are usually reluctant to significantly increase rents and so the condition of the limited supply of rental housing stock declines.

Equally important, however, the existence of subsidized, government-owned rental housing adversely affects private sector willingness to provide rental housing, particularly for low-income households, because it cannot compete with subsidized government rents and still make a profit. As a result, fewer units are available and thus rents in the private sector may be even higher than they might otherwise be because of the small number of units available to meet demand. Low-income households who cannot obtain subsidized government housing will be the most severely affected.

Other examples of direct subsidies which restrict or reduce private initiatives are subsidized downpayments, or below market interest rates for certain groups. Even



when governments do not intervene directly by building and providing housing or by subsidizing housing loans or rents, they can affect the allocation process indirectly in a number of ways, all of which disrupt provision of housing by the private market. The imposition of rent and credit controls, and of unrealistic subdivision and building standards and the existence of cumbersome administrative processes can discourage the private sector from building or lending for housing, particularly to low-income households.

Both direct and indirect subsidies are put in place with admirable intentions, but are generally implemented with questionable results. Housing subsidies are often received by those who do not really need them while those in need are left out. When this occurs, the government is, in fact, undermining the private market, and the private sector either does not serve particular segments of the housing market or ceases to participate at all.

Policies and Programs that Strengthen Market Forces in the Allocation of Housing

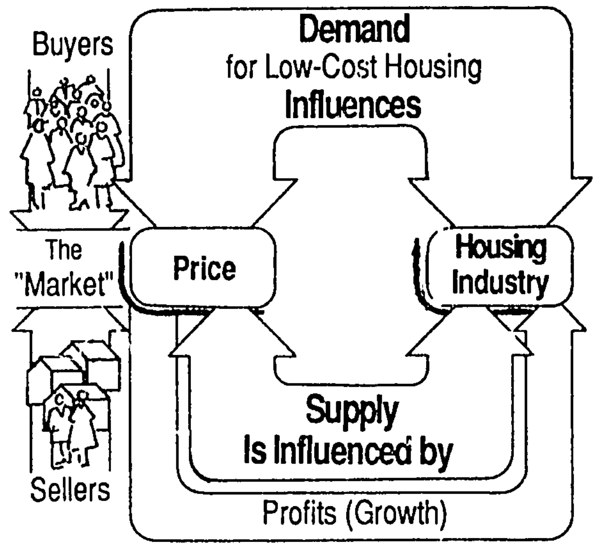
Government can encourage greater private sector participation in producing and financing housing by reducing its direct role through privatizing government-owned housing and land and by refocusing its efforts based on a careful reevaluation of the need for subsidies and preferential allocation.

Privatization of government-owned housing and land

One way government can encourage private sector participation in the shelter delivery system is to sell undeveloped land to private builders and existing rental housing units to the tenants who occupy them or to other eligible households. The objective is to reduce the presence of the government in the general housing market and to refocus assistance on those households for which the private sector cannot provide shelter. Owners generally take better care of their houses than renters and are willing to make additional investment in upgrading or enlarging their housing units. This means that the government can reduce its housing expenditure while the households affected by the program can obtain improved housing through their own investment. Not only does the government thus reduce recurrent expenditure associated with maintenance of rental housing units, but the funds obtained from these sales can be used to assist other families obtain housing, to build additional units, and to provide needed infrastructure or services, or they can be invested elsewhere in the economy.

If government sells land and units at market prices, the private market will not be disrupted. If current tenants cannot afford to buy units they occupy at market prices, government may consider reducing sales prices or providing loan subsidies, but such an approach should be limited to a one-time action intended to remove the government from direct participation in the housing market. To continue below market sales would disrupt the functioning of the market. With the knowledge that government sales will not continue, private builders and private financial institutions may be encouraged to provide housing resources.

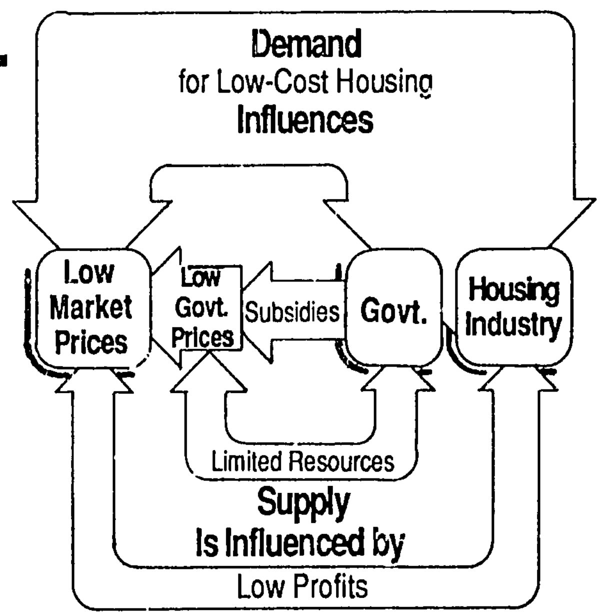
Market System
(Allocation by Affordability)



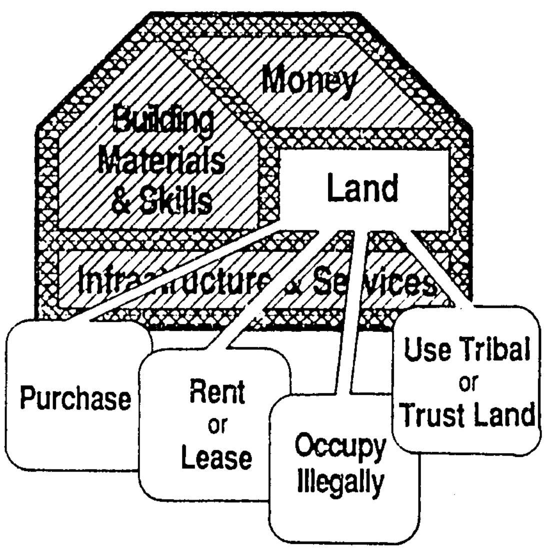
Reevaluation of the need for subsidies and preferential allocation

By carefully rethinking the need for subsidies and improving administration of them, government will be able to use its resources more effectively. This can remove government from direct competition with the private sector and thus encourage private builders and financial institutions to invest in housing which is affordable. By facilitating the allocation of subsidies or subsidized units to those most in need, government can conserve scarce resources and avoid unnecessary expenditure. This may entail some hard decisions with respect to which households need assistance and may require that previous practices which benefited other groups be curtailed. While such actions may be politically unpopular in the short run, the benefits to be derived from conserving resources and encouraging private sector participation can result in long-term improvement in housing conditions for the general population as investment in housing is accelerated.

Public and Private Sector Housing Industries
(Allocation by Affordability and Government Policy)



Delivering Land, Infrastructure and Urban Services for Housing



Providing Access to Land

The most basic requirement in providing shelter is access to land. In some countries, land is bought and sold as a commodity in the marketplace. Its price is determined by its location, its allowable uses, and the degree to which the infrastructure necessary for actual development is in place. In general, the desirability and price of the land for development is established by competing demands for a particular parcel. At the opposite end of the spectrum are countries where all land is owned by the state with government controlling access to its use. These include traditional tribal societies where land is owned by the people in common as well as those where state ownership of land was instituted to redress the inequities of feudal or colonial systems. In this system, price is set by the government in order to meet a variety of social and economic goals.

Irrespective of how land ownership is initially held, access to land for purposes of housing construction is by one of several means: outright purchase; leasing or renting; using tribal or trust land; or illegal occupation. Illegal land occupation has resulted in unauthorized shantytowns in and near most large and medium-sized cities throughout the developing world. Most of these areas have been invaded by squatters who have built temporary shelter on land they neither own, rent nor have the right to use.

Illegal occupation and subdivision of land owned either by government or private individuals is an indication that the land distribution method, whatever its nature, is not functioning properly. The lack of secure land tenure is a major factor inhibiting investment in permanent shelter within squatter settlements and, together with the lack of advance planning and a program for incremental investments in public infrastructure and services, effectively prevents transition from slum areas to stable urban neighborhoods. The conditions in most shantytowns can be dramatically improved by simply extending to residents an opportunity to purchase or rent occupied land on terms which provide relatively secure tenure.

In order to minimize expansion of squatter settlements, an adequate supply of building sites for new housing must be made available. This is also essential to maintaining moderate land costs. In addition to encouraging unauthorized settlements, a shortage of affordable building sites leads to inflation of land prices.

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Land assembly or land banking

In areas where land is owned by many individuals or entities, assembly of sufficiently large parcels to pian an economically viable residential development may require considerable effort. Some governments have established land development agencies or land banking programs to facilitate the provision of land for shelter. Some of these land agencies engage in actual development and sale of land. Others simply control the supply of land, either by making available or withholding land which they control. A land development agency may be used to assemble and make available land for private use whether land ownership is dominated by government or by the private sector.

Land banking is a technique for assuring an adequate supply of land by acquiring moderate cost, privately-owned land in advance of actual need and then releasing land for development as needed. Short of actually purchasing privately-owned land, governments may assist with private land assemblies or use their powers of taxation to encourage private owners either to withhold land from development or to make it available at a particular time.

Land subdivision

Whether undertaken by a public agency or by the private sector, the process of surveying and subdividing land into plots suitable for development into residential apartments, rowhouses or single family houses is an essential function. During the subdivision process, a plan is prepared and submitted for approval to the responsible public authority. Appropriate rights-of-way are designated for roads and utilities. Land may also be set aside for schools, clinics or other public facilities. During the subdivision process, public authorities have great latitude in determining appropriate uses of the land and the density of development which will be allowed or required on the site.

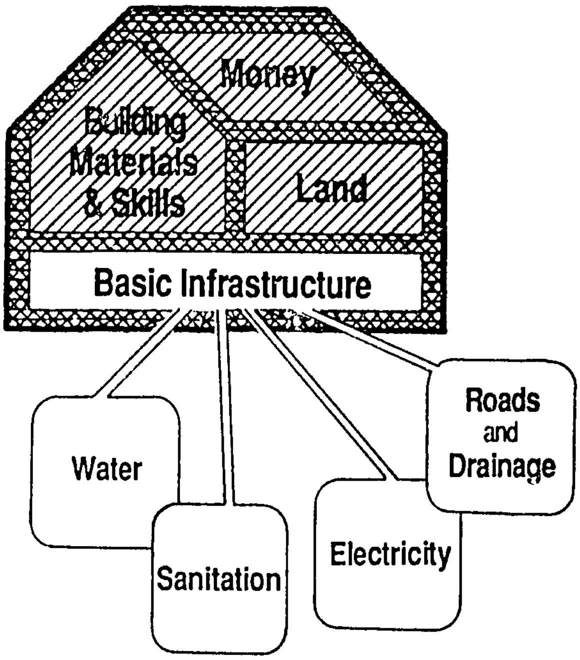
The subdivision standards applied at this stage have a significant impact on the ultimate cost of shelter as land costs are a major element of the cost of housing. Excessive lot size requirements can limit the affordability of land and shelter. For example, a subdivision which allocates 30% of the land area to roads and 20% to public facilities and open space must recover the cost of the land from the sale of only 50% of the land area. A subdivision with more modest road reserves and fewer sites for public buildings will be more affordable in that the cost per lot will be lower and there will be more plots to sell. Care must be taken to see that public health and safety are adequately protected, but public officials must also realize that the consequence of imposing arbitrary or unrealistically high subdivision standards may be the growth of unauthorized squatter settlements. For example, in areas where developable land is in short supply and demand is high, the cost of land (whether privately or publicly-owned) may dictate how the land will be developed. Large lots for single family houses are often not feasible and higher density solutions must be devised if the supply of affordable new units is to keep up with demand.

Land tenure and titling

Land tenure and titling procedures vary widely in form and complexity. In some cases, several distinct systems coexist making land assembly and transfer of title extremely difficult. The most widespread cause of titling problems is the lack of a cadastre (an official register of real estate ownership and boundaries) and incomplete or inadequate land registration. The lack of a proper cadastral survey makes property boundaries difficult to determine, leaving many areas in dispute. An incomplete land registry makes it impossible to trace the history of the transfer of property rights on a parcel and thus difficult to determine who owns the parcel. Disputes are common with several parties claiming ownership on the basis of conflicting legal codes or inheritance rights that have been in force at various times. For example, Islamic law establishes inheritance rights which are often at odds with civil law, yet both sets of laws may be recognized in a particular country. Royal charters, land grants and other vestiges of a period of colonial rule may establish individual claims to property in direct conflict with tribal claims to land that has been held in common and used for generations. Such conflicts must be resolved if a reasonable system of granting long-term tenure rights are to be put in place.

Providing Infrastructure

A major factor affecting the cost of land for housing development is the level of infrastructure and services. Where land is distributed through market mechanisms, government generally assesses property taxes to cover much of the cost of providing and maintaining urban infrastructure and services with the remainder provided by certain user fees and allocations from general tax revenues. Where land ownership remains with the government, land rent fees usually replace the property taxes as a source of revenue.



Standards may vary from those appropriate to areas receiving new urban emigrants to those being developed as affluent subdivisions or high density urban neighborhoods. In a least-cost approach to land development, roadways may be graded to demark rights-of-way and to accommodate surface water drainage; communal water fountains may be installed; and house plots staked out. In such areas, infrastructure can be upgraded incrementally as income levels rise. More affluent subdivisions will include paved roads, individual water connections and perhaps sanitary sewer hookups. Higher density urban areas will most likely require curbs and gutters, paved roads and sanitary sewers, as well as piped water. They will also require fire protection and more frequent trash collection.

Off-site and on-site

Off-site infrastructure is usually provided by publicly-regulated utility companies or governmental agencies. The costs of such infrastructure are typically financed with general revenues rather than user fees or direct charges to specific beneficiaries.

Major road and surface drainage projects may be built by public agencies using direct hire labor or by private contractors usually selected through competitive bidding. Maintenance of existing roads is most commonly handled by direct hire labor but may also be contracted, particularly when significant upgrading or resurfacing is required. The cost of primary and secondary road construction is virtually always recovered through general taxation rather than directly from beneficiaries.

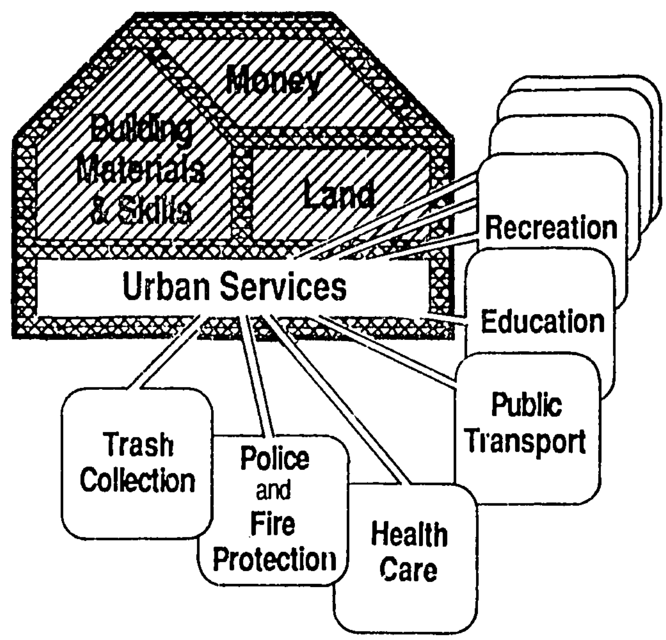
Reservoirs, pumping stations, purfication plants, trunk lines and water mains are generally built by the responsible public agency or utility company itself or by private contractors under their supervision. Maintenance is usually done by the utility company's own staff. The costs of such installations are amortized over forty or fifty years and recovered in the rates charged to users. The initial funds for construction are typically obtained from low-interest loans from governments or international agencies or from bonds sold primarily to institutional investors such as pension funds and insurance companies.

The extent of off-site sanitation works varies considerably from location to location. In some cases, none exists. In others, simple collector sewers discharge directly into a river or lead to an off-shore outfall line. In other cases, settling ponds and other sewerage treatment facilities are required to avoid environmental contamination which can affect public health. Sanitation works are installed either under contract or using direct labor hired by the responsible public agency or utility company. The costs of off-site sanitation works are usually recovered from general government revenues but may be at least partially recovered through rates of utility companies responsible for both water and sanitation.

On-site infrastructure is most often financed by the public or private developer of the land and the cost is passed through directly to the beneficiaries in the purchase price or rents collected. The costs of road and surface drainage work are usually recovered in the price of the land or the sale or rental price of the residential units while water and sanitation costs are recovered either in the land price or in hookup charges. In cases where soil conditions permit and where no off-site sanitation network exists, individual septic systems are often used. Such systems are paid for directly by the owner of the plot. When soil conditions or cost preclude on-site leaching fields, individual septic systems become little more than holding tanks which require regular service to remove the waste. In such cases, what is normally infrastructure becomes, at least partially, an on-going urban service as well. Pumping and cleaning septic tanks can be contracted by private companies for a fee or provided by a governmental agency, such as a public health department, as part of the general services provided by the municipality. The costs are recovered through property taxes or general revenue or directly through fees charged for the service.

Urban Services

Governmental departments are often responsible for providing a range of urban services including trash collection, fire protection, health care, education, public transportation, and the maintenance and operation of other community facilities. Most commonly, such services are provided at the local government level, although one or more may be the responsibility of a central government agency. Where government provides the services, they are usually paid for from property taxes or general revenue. In some situations, private organizations offer alternative services such as schools or health care on a user fee basis. Community-based fire departments run by volunteers may be organized where adequate protection is not otherwise available. Trash collection and public transportation are now often provided by companies where government supported services are not available or are not adequate to meet the demand. Private trash collection is paid for either by service charges or by sale of the materials collected. In order for waste materials to have a market value, a recycling industry must exist to sort and process the collected materials. Where such an industry exists or can be developed, private trash collection may be the least costly alternative.



Policies and Programs which Encourage Private Initiative in the Delivery of Land, Infrastructure and Urban Services for Housing

In order to develop an effective program for stimulating private sector participation in land and infrastructure development, a number of governmental initiatives deserve emphasis. These include:

Strengthening local government capacity to work with the private sector in meeting land development needs

Enabling the private sector to participate in land development requires clear identification of both the constraints and opportunities. Measures must then be taken to remove disincentives and capitalize on opportunities. Although some measures require national action, e.g., reform of national laws, regulations and policies, and streamlining of certain administrative procedures, each urban area will have its own set of constraints and opportunities that call for local initiatives and solutions.

Local constraints may occur in many different forms: inadequate and uncertain planning framework to guide land and infrastructure development; excessively high land development standards; unresponsive local administrative procedures for subdivision approval; absence of qualified municipal staff to guide proper subdivision development and to review and approve subdivision requests; lack of recognition by political leaders of the social problems and future costs associated with illegal, spontaneous settlement; a difficult physical setting that requires innovative approaches to land and infrastructure development; or simply an incomplete understanding of land ownership.

Opportunities may be found in well-located, municipally-owned land that could be developed by the private sector for low-income housing sites or the presence of small landowners who, if assisted, could open sizeable amounts of land either individually, with neighboring landowners, or as cooperatives. There may be the possibility of adopting simple methods of guiding spontaneous development to produce buildable lots at

Kenya
Local Government Capacity

Many developing country governments have struggled with the problems of implementing a nationwide shelter program in the absence of effective local government agencies. In 1983, the Government of Kenya, with assistance from USAID, initiated a program aimed specifically at improving local government capacity to plan and deliver housing and urban services and to implement central government development policies and programs throughout the country. A key element of the program was training local officials in a variety of areas including the evaluation of projects, project planning, budgeting, financial management and cost recovery techniques. The program was organized to support the district focus efforts of central government.

A local development planning process and reporting system known as the Local Authority Development Programme (LADP) was established as a first step. The Ministry of Local Government prepared and distributed to all local authorities a simple reporting form and a set of guidelines for completing the form, along with an indication that the LADP was essential to preparation of Kenya's overall National Development Plan and that the LADP process would be used to identify and evaluate local projects to be financed by central government.

The first round of LADPs received were quite impressive evidence that given a clear set of guidelines, even the least sophisticated local authority can prepare a reasonable development program. As the program continues, manuals are being prepared to assist with preparing feasibility studies, managing projects, and preparing annual development budget estimates (T.S.S., 1982).

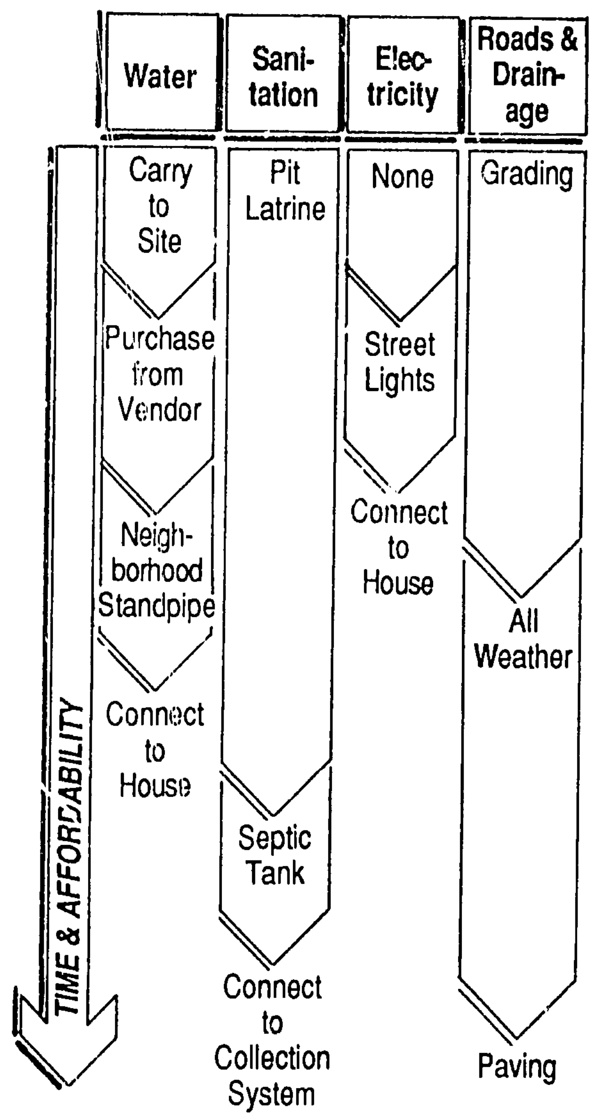
minimum standards within a legal subdivision framework. Another opportunity may be the development of an improved land information system that provides greater security of tenure for local residents.

If a land development program is to maximize private sector initiative, all levels of government must be able to shoulder their appropriate responsibilities. Although national level efforts may be required to stimulate change, it is municipalities that often must take the lead in working with the private sector to address land development opportunities and constraints. It is they, after all, who must carry the burdens of urban growth, who must address the needs of their low-income citizens, and who must bear the long-term financial consequences of spontaneous and illegal land development. Local governments best understand local land needs and conditions and, therefore, can best take the initiatives with the private sector to address them.

Shifting public sector shelter investment emphasis from the construction of housing to servicing land

In most developing countries, the lack of suitable land is a constraint on private sector housing development. If public resources currently being invested in shelter are shifted from constructing housing to servicing land, more citizens will benefit by building their own houses. To achieve this, government may choose to intervene by acquiring property and making it available, either as serviced or unserviced plots, to private developers who agree to build housing for certain prescribed markets.

While government intervention in the land market may be essential to provide secure tenure or speed housing production in some situations, unnecessary intervention should be avoided, particularly in land acquisition, as this will most likely inflate the cost of land and thus the cost of housing. But in countries with overlapping land tenure systems where title is difficult to establish, some form of government involvement may be essential in order to provide the mortgage security required by lenders.



In countries with a well-functioning land market, the private sector developer should most often be left to acquire the land. From the private land developer's perspective, there are always a number of equally suitable sites for development, whereas government usually identifies one particular parcel in one area, which limits flexibility and usually increases costs. In acquiring land for new projects, a private developer will simultaneously negotiate on many parcels of land, comparing the advantages of each against market factors and the willingness of the seller to complete a transaction. By looking at an entire region for potential development sites, private land buyers can most often acquire an appropriate site at the least cost.

Another method of land acquisition used by private developers is the purchase of options to buy a parcel at some future time. In order to make such a transaction attractive to the landowner, the future acquisition price is set significantly higher than the current value. The cost of acquiring the option is generally related to the landowner's carrying costs which may be quite low for undeveloped land. Thus, for a relatively low cost, the land buyers are able to control far more parcels than if they actually acquired the land. Since land markets are highly speculative, this approach also helps reduce the developer's risk by providing control of many parcels simultaneously. Since land values increase rapidly just prior to development, the cost of the unused options are offset by the rapid increase in the value of the site actually acquired (Kitay, 1984). Where land markets are functioning in this manner, the public sector would be well advised to leave land acquisition to the private sector and provide assistance in some other aspect of the process. In countries where no real land market exists, other solutions should be considered.

Korea
Land Adjustment

Land pooling or land adjustment is a concept which involves government acquisition, servicing, and resale of land, usually land held by a number of private owners. The Korean Land Development Agency has used this approach quite successfully. A development plan is prepared creating three categories of land within the project area: (1) public land for roads, schools, and other public facilities which will remain in public ownership, usually 15 to 25 percent of the total area; (2) private land that will be sold by the government at a public sale to recoup its out-of-pocket costs for servicing the entire area, usually 15 to 25 percent; and (3) private land that will be returned to the original owners in proportion to their original ownership shares, usually 50 to 70 percent of the total area (Kitay, 1985).

A public/private partnership approach to acquiring land for development known as 'land pooling' or 'land adjustment' may be effective in some cases. In this approach, the private sector, usually several landowners, contributes the land while the public sector provides the infrastructure which makes development possible.

Such an approach may be initiated either by the government or by the landowners. The chief advantage is minimal expense to government in contrast to direct land acquisition programs. Landowners benefit from the increased value in their remaining serviced land which far exceeds the value of the unserviced land they had when the project began. The legal procedures involved in implementing a land adjustment program, however, are complex and time consuming. Several prerequisites are needed when using this approach, including: cooperation from all levels of government; appropriate enabling legislation; a reasonably efficient cadastre or title registration system; well trained, objective appraisers of real property; and highly skilled negotiators and administrators. Consequently, the land adjustment or land pooling approach may be too cumbersome for many situations but could be given serious consideration in countries where most of the prerequisite conditions exist.

Developing land information and titling systems to promote private housing investment

Insecurity of tenure brought about by weak legal and administrative systems for establishing, recording and transferring title has significantly curtailed private land investment by slowing land transactions and discouraging lenders from extending credit. It has also impeded development of public land and infrastructure by rendering property taxation ineffective and hence cost recovery unachievable.

Any permanent solution entails overcoming the shortage of personnel trained in the specialized process of land transfers and in land valuation. A reliable system of identifying and recording title to land must be established that corresponds in sophistication with the evolving skill level of personnel. Development of personnel and improvements to land records systems may take many years to achieve but are vital steps in increasing the availability of legal land tenure for lower income people which is essential to promoting private housing investment.

Somalia
Land Titling and Transfer

Since 1984, USAID has provided assistance to the Government of Somalia, Municipality of Mogadishu, in its effort to improve a municipal land distribution program. Among the key activities in this effort is the reorganization of the land office, modification of its land titling and plot registration procedures, and training of its personnel to enable an expanded capacity to manage a comprehensive land distribution program. It is the objective of these activities to create an efficient and self-financing program of land development that will permit municipal servicing of new areas in Mogadishu and thereby meet a very high demand for plots with basic services.

Development of appropriate and affordable standards for land subdivision and infrastructure

Even when land itself is not a constraint, the availability or the cost of infrastructure and essential urban services may restrain private initiative. Often the constraint is related to costs and how they are to be recovered rather than who will actually do the installation. Where realistic standards exist and public utility lines are nearby, it is usually feasible for private developers to install on-site infrastructure and recover the costs directly from buyers as a part of the sales price.

In many countries, regulations specify standards for subdivision design and infrastructure which are so high as to render the cost of a serviced site unaffordable to the vast majority of the population. As a result, the public sector must assume responsibility for providing the infrastructure and attempting to recover the costs through property taxes over a long time period as private developers cannot recover such high costs directly from purchasers.

An incremental approach to the issue of standards has been adopted in some countries which may be useful in others. For example, in Malawi, various grades of residential areas are designated with each having different development standards. Low-income areas are planned on the basis of progressively upgradable standards. In these areas, house plots are marked only with corner stakes and road rights-of-way are graded. After this is completed, house plots can be sold. While the purchaser of such a plot gets little more than what is available in rural areas, the framework for future urbanization has been established. Subsequently, water lines can be added either to supply standpipes or individual connections. Eventually, the road right-of-way can be paved and other services added. This flexible approach to regulatory standards reduces the need for illegal squatter settlements by allowing private sector builders to provide shelter solutions affordable to all segments of the housing market.

Streamlining administrative procedures for land development

A significant constraint to private land development is the cost of excessive delays which are often experienced in securing subdivision approvals, waiting for public utility companies to provide service, or obtaining final loan disbursements. Much too often, administrative procedures associated with land development are so time consuming that private companies cannot carry the financing costs and other expenses associated with the delays without suffering losses. In such circumstances, private developers have no recourse but to abstain from the development of residential lands.

Encouragement of expanded private sector participation in the provision of urban services

In their efforts to meet the mounting deficit in urban services with very limited funds, some governments are finding that urban services do not necessarily all have to be delivered by government nor be paid for through taxes. Certain services, including garbage collection, markets, slaughterhouses, transportation and transit terminals such as airports or bus parks, have specific, identifiable users and lend themselves to full or partial private ownership or to private management. Many of these services can be provided more effectively and at less cost by private companies than by local government and need not be paid for collectively by taxes.

A variety of local factors will determine whether particular urban services can be provided by the private sector and how privatization can best be accomplished. These factors include: the political and economic environment of the country; the specific benefits which will accrue to the public and those which will accrue to the private operator; the availability of capable private sector managers; and the extent to which private ownership or management will displace public service jobs.

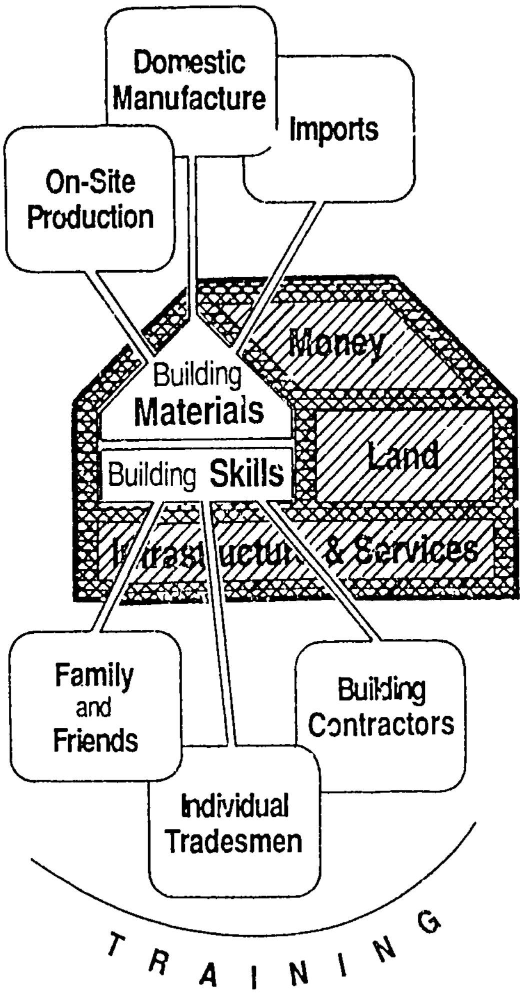
Tunisia
Procedural Reforms

Recognition of a growing deficit in supply of land for low-income housing and the resultant mushrooming of squatter settlements prompted a review of constraints facing private land developers. It was determined that delays brought about by cumbersome administrative procedures more than doubled the land development time frame. A project recently approved for AID financing would assist Tunisian municipalities and other land development-related public agencies improve the administrative environment in order to encourage participation of the private sector in land development.

The project will rely on the appropriate central ministry for land policy formulation and project coordination. The creation of a small 'land development assistance unit' has been proposed to provide technical assistance to municipalities and private developers. Selected municipalities will take the leadership in preparing land development strategies, in helping the private sector identify initial land development projects within their cities, and in carrying out reforms needed in local regulations, standards, and procedures. Construction financing for subdivision and infrastructure costs and beneficiary financing will be provided by a quasi-public finance institution, using AID loan funds. Private developers will be responsible for carrying out the land development activities.

A set of simple guidelines to assist other municipalities in preparing their own land development strategies is expected to grow from the field experiences in the selected municipalities.

Expanding the Production of Housing



Once suitable land and infrastructure are available, the production of housing units can begin. Building materials are an essential ingredient and skilled labor is required to construct all but the most basic forms of shelter. Housing production in most countries involves a mix of both public and private sector organizations providing a wide range of housing types. To understand the production phase of the shelter delivery process, two virtually separate systems need to be considered, one which functions within the informal sector and another within the formal sector.

Producing Housing in the Informal Sector

The vast majority of housing construction in the developing world is built by the owners themselves with assistance from family members or neighbors, with the occasional day laborers or tradesmen hired as needed to build a roof, add a kitchen or tile a floor. Construction is incremental and based on a family's ability to pay for additional shelter improvements. The process usually begins with a family buying or renting a lot in a subdivision or moving into an illegal or spontaneous settlement. The first phase of construction is generally a sanitary core and a one room, all-purpose structure. Additional rooms are added as family savings permit. In the illegal settlements, it is likely to be a temporary structure and, unless tenure can be assured, further investment is improbable. The provision of secure tenure in a neighborhood can transform it from a shantytown to an area of substantial dwellings with well maintained gardens and other amenities. When families buy a serviced lot in a subdivision, the period of time required to complete the incremental construction process may be as long as five years, but experience suggests that a substantial portion of the work will be done within two or three years.

Within the informal sector, the purchase of building materials may be the principal form of household savings. When sufficient materials have been purchased, the family may add a room to the house, pour a concrete floor to replace an earthen one, or perhaps the part of the concrete floor which was poured at an earlier stage. In order to facilitate this process, building materials suppliers sometimes provide short-term credit which allows a family to acquire all the supplies needed to complete an entire phase of construction, but paying for the material over several months.

Producing Housing in the Formal Sector

The formal housing construction sector includes governmental agencies and government-owned organizations, cooperative organizations which are partially funded by government but governed by boards with some degree of autonomy, and private sector builders. The tasks undertaken by each are similar, but the roles played by government or the private sector vary. The developer provides an overall management function: ascertaining the market, defining the product, arranging for land and finance, contracting for the construction, controlling the cost, and marketing. The developer function may be undertaken by either the public or the private sector. When it is a private sector activity, there is an element of financial risk involved which helps set the parameters of the project. When governments perform the developer function, other factors may intervene to offset market conditions resulting in projects which may or may not be economically sound.

The design functions required to build houses and multifamily units may be undertaken by staff architects, surveyors and engineers working directly for governmental agencies, housing corporations, or private developers, or they may be contracted to professionals in private practice. In either case, the key to a successful project is to match the design solutions to the target market, i.e. the solutions must be affordable and appeal to those who are expected to rent or purchase.

Similarly, actual construction may be handled directly by the staff of governmental agencies or private builder/developers, or may be contracted to privately-owned construction companies. Selection of construction contractors may be through competitive bidding or through negotiations.

Compensation to contractors may be on a fixed price basis, on a cost-plus-fixed-fee basis, or on a reimbursable time and materials basis. The advantage of contractor-built housing over individual house construction is one of speed and volume. The construction of contractor-built, single houses requires only a few months whereas the informal sector process may require two or more years. The formal sector is also capable of more complex projects such as multifamily units.

Unfortunately, the cost of housing built by the formal sector is usually not affordable by lower-income families due to unrealistic standards. Private sector developers are generally willing to build for households in the middle and upper-income bracket, but reluctant to reduce standards and lower cost to build for lower-income groups. In order to facilitate construction of low-cost shelter by the formal private sector, some government agencies build modest core units or provide serviced sites to private builders or individuals. In other situations, governments provide financial incentives to encourage private builder/developers to construct housing units for low-income families.

Producing Building Materials

The production of building materials is potentially a significant sector of any country's economy. Construction materials, whether the manufacturers are state-owned enterprises, worker-owned cooperatives or privately-owned companies, are needed for all types of buildings. While materials for construction of shelter may represent 25 to 50 percent of all construction materials used, they are generally the simplest to produce. Materials for shelter construction can often be produced on-site by the builder or from indigenous materials by a domestic manufacturing operation.

The cost of building materials is a significant part of the total cost of shelter. In countries where domestically produced materials are scarce, the foreign exchange element of imported materials may be a limiting factor in shelter production. Conversely, the construction of new housing may be used to stimulate and sustain domestic manufacturing or on-site production of building materials.

Governments exercise control over the flow of imports either directly or indirectly. In some instances, government itself is the sole legal source of imports; in others, control is exercised through licensing and quotas or indirectly by way of duties, foreign currency restrictions, or credit restrictions. The objective of import controls may be the protection of domestic industries or it may be strictly a matter of economic policy, e.g., controlling the outflow of scarce foreign currency reserves. Whether controls are directly or indirectly exercised by government, restrictions on the flow of imported building materials will affect the rate and/or cost of housing production when domestically-produced alternative materials are not available.

Policies and Programs Which Encourage Private Initiative in Housing Production

Private sector housing production can be stimulated through a variety of government actions. Public agencies can enter into joint venture agreements with private firms to develop, build and sell or rent housing. The public sector can undertake land assembly or installation of infrastructure for private developers. Government can promote incentives such as loans, guarantees, grants, or tax reductions. Equally critical are actions to remove obstacles and disincentives to private sector housing production, such as overly high building and planning standards and rent control. Another method is to promote development of domestic capacity to manufacture building materials when this can be accomplished in a cost efficient manner.

Assistance to the informal sector through providing serviced sites and small building loans

Government can play an important role in assisting the informal private sector to produce shelter. Experience in Kenya and Zimbabwe illustrates this point.

The Government of Kenya in 1977 initiated a program to provide serviced sites to low-income households in an area of Nairobi known as Dandora and loans to assist purchasers build their own houses. The program was not intended to replace, but to assist the informal approach to low-income housing production. Government loans made available under the program were quite small, approximately enough to purchase materials to build a two-room house. Labor was provided directly by the beneficiaries or paid for by them from savings or from loans obtained through traditional informal sector lending arrangements. Project experience in Dandora suggests that the combination of secure land tenure and small government loans can be effective in stimulating informal sector housing production. Within a period of six years, private investment in the Dandora area exceeded government funds. Ninety percent of the households had built more than the basic two-room units and the initial investments leveraged over twice again as much additional building. Experience with repayment of the government loans has been reasonably good, although delinquency rates have increased in recent years as general economic conditions have deteriorated.

The Kwekwe project in Zimbabwe provides potentially significant variations on the approach used in Kenya. The objective was largely the same: to provide support for informal sector house building activities. The basic difference was the use of formal private sector financial institutions to administer the loan funds with the additional objective of generating new sources of loans for housing. In the Kwekwe project, the funds came in approximately equal contributions from three sources, a USAID Housing Guaranty Loan, direct government allocations to the National Housing Funds, and the Beverly Building Society (BBS). The Ministry of Public Construction and National Housing (MPCNH) serviced the land, allocated the plots and provided construction finance to the households. Upon completion of the house, the BBS issued a mortgage which repaid MPCNH for the construction loan. The municipality was responsible for recovering the cost of infrastructure from the beneficiaries through taxes and user fees to repay MPCNH.

In formulating a successful program, the key is a clear understanding of how the informal sector actually works in a particular country and the real constraints which affect it. Often the constraints will be financial, in which case the approaches described may serve as useful models. To the extent constraints are excessive regulatory and administrative requirements or unrealistic standards, remedial regulatory action is necessary.

Use of public/private partnerships to produce housing in the formal sector

Direct contractual agreements between government and private sector enterprises aimed at increasing housing production have an advantage over less direct relationships in that precise numbers of units to be built are known. Such ventures may be of a limited nature where the government simply agrees to purchase completed units at a set price, referred to as turnkey projects, or of a broader nature where specific roles are defined for each participant and the finished units are sold or rented with the parties sharing profits or losses on a predetermined basis. While ventures of this type are usually effective in terms of increasing production, US experience with the turnkey housing program suggests the need for caution as unit costs actually increased above the cost of units built either directly by the public sector or by the private sector alone (Nenno, 1968). The apparent reason was the removal of market mechanisms by negotiating a purchase price rather than setting a price based on what individual buyers were willing to pay. Even bidding did not cut costs as the builder/developers found working with the additional government regulations and reporting requirements which accompanied the programs so onerous that their costs indeed increased. Thus, after completion of the initial round of demonstration projects, the per unit costs of turnkey projects climbed sharply (US HUD, 1982).

Despite the problems associated with turnkey projects, they still have a potential advantage over the approach used by many housing agencies of contracting with private sector builders to construct public housing units. Most of these agencies use quantity surveys to establish

Honduras
Turnkey Construction to Increase Housing Delivery Capacity
Implementing Agency: Instituto De La Vivienda (INVA)

Using HG loan funds and technical assistance from AID, new housing construction which averaged 450 units annually prior to 1982 was dramatically increased to 3,400 units in 1982 and 2,100 units in 1983. Private builders and commercial banks provided the interim financing needed to complete construction which included site work as well as the cost of building the units.

the contract price for the construction, but the contract price seldom remains unchanged as provision is made for cost increases under certain circumstances. Some of the more common causes for increased cost are directly attributable to the failure of government agencies to perform their responsibilities efficiently. Such causes include lengthy review procedures, failure to provide utility hookups when needed, or failure to make prompt payments as construction progresses (LaNier, et al., 1986). These experiences suggest that a turnkey approach which removes government entirely from the construction process may be comparatively more efficient than other approaches where government contracts with private builders.

Stimulation of low-income housing production by builder/ developers through monetary incentives

Incentives to builder/developers are another option which governments have to stimulate private sector housing production. The types of incentives available to governments parallel those discussed in the chapter of 'Providing Loans for Housing,' but the benefits in this case accrue to the private developer rather than to the financial institution. The direct types of incentives include loans, loan guarantees, grants and tax concessions. The indirect types of incentives include such actions as modifying unrealistic building or planning standards, streamlining approval processes and deregulating rental housing. In each case, a monetary incentive is something which improves the likelihood that the developer will make a profit on the venture. Any action which reduces risk or uncertainty or eliminates delays will reduce cost to the developer and thus increase the likelihood of profit.

In a tight money market, loans may be made directly to developers or through private financial institutions for construction costs. Concessionary interest rates or interest deferral plans are sometimes used to make housing projects attractive to private developers, but such approaches are costly to government. Loan guarantees to developers in the form of take-out mortgages for eligible purchasers may be a less costly but equally effective incentive in situations where scarce mortgage money makes home purchase difficult.

Barbados Builder Incentives

Implementing Agency: Housing Credit Fund (HCF)

A quasi-public financial intermediary was established by the Ministry of Finance to encourage private sector production of housing for low and moderate-income families. The HCF was capitalized with a $10 million HG loan and operates as a revolving fund by on-lending to private financial institutions. To encourage private builders to produce low-cost units, the HCF devised a plan whereby the National Housing Corporation provided builders with serviced lots and private sector lenders provided stand-by loan commitments for purchasers using HCF funds.

Production was dramatically increased as a result of the program. Prior to 1986, the formal private sector had produced virtually no housing units affordable by low-income families. In 1986, production of low-cost units rose to about 250 units, a level which should be sustained as long as demand warrants.

Direct grants to developers can also be used to encourage them to undertake projects which would not otherwise be financially viable. In Great Britain, this approach is being used to rehabilitate dilapidated rental housing units owned by local governments. The buildings are sold to private developers at a nominal cost, and grants are provided equal to about one-third to three-quarters of the cost of the needed rehabilitation work. The developer obtains the balance of the funds from private, commercial lenders and sells the completed units to pre-qualified low-income purchasers who obtain mortgages from private building societies. But concern is growing in Britain that this approach will only work with the more desirable public rental housing units, leaving local governments to cope with those units the private developers do not want (David, 1985).

The US experience with monetary incentives is also instructive for governments considering a similar approach. A review of the Urban Development Action Grant and Community Development Block Grant programs shows that government, in providing private developers with incentives, initially went beyond what was really needed to stimulate the desired effect (US HUD, 1982).

Tax concessions for specific types of projects are another means of stimulating private sector actions desired by governments. In the US, rehabilitation tax credits and historic preservation tax credits have been used to stimulate private investment in upgrading the existing building stock. Special accelerated depreciation schedules which increase the allowable deductions in the early years of a project have also been used as an incentive for construction of low and moderate cost rental housing projects. While such approaches do encourage increased housing production, they are costly to government and should be carefully evaluated in terms of their economic and social returns. A strong case can be made that the tax credits given for preservation of historic structures and for rehabilitation of other older properties have increased government revenues on a net basis when increased property taxes are considered, but most other tax concessions have resulted in significant losses of revenue to the government.

Jordan
Financing Private Sector Developers

Implementing Agency: Jordan Housing Bank (JHB)

With proceeds from a $25 million HG loan, the JHB has initiated a program designed to stimulate private sector builder/developers to produce housing for low-income buyers. Jordan has an active private sector shelter industry but to date private developers have built only for the middle and upper income markets.

The JHB program consists of offering construction loans to the developers and individual mortgage loans to the buyers. The construction loans are offered at rates slightly below those available through the JHB commercial loan department. The mortgage loans offer the same terms but more flexible criteria for qualifying borrowers than is available under the normal JHB individual loans program. To assist JHB launch this new lending activity, USAID has provided a grant to cover the foreign currency costs of advisory services and training. An initial marketing plan has been outlined which appears to be attracting considerable interest among the private developers.

Promotion of low-income housing production by builder/developers through regulatory incentive

The key to developing an effective program for stimulating private sector housing production is to identify and take appropriate actions to limit constraints and disincentives present in a particular situation. In some cases, direct monetary incentives may be essential; in other cases, correcting regulatory disincentives which indirectly affect costs may be even more important. An example is the often deleterious effect which rent control laws have on the production and maintenance of rental housing in some cities.

As a result of regulations which restrict a landlord's ability to adjust rents in response to market conditions, many private developers are unwilling to invest in moderate- income rental housing. In otherwise healthy housing markets, existing privately-owned rental buildings subject to rent control have fallen into disrepair or been abandoned completely, which has reduced the rental housing stock. Rent control also promotes 'milking' of existing rental stock with owners refusing to use rental income for maintenance and/or rehabilitation.

A similar maintenance problem exists in many less developed countries where rents charged in government-owned housing are so low that the revenue generated is not sufficient to cover maintenance and administrative costs, much less to amortize capital investment. Movement toward rents based on economic factors rather than social or political concerns is essential if governments are to sustain their own rental housing programs without massive subsidies. If the private sector is to be persuaded to build rental housing, then market forces must be allowed to set rents.

"The establishment of realistic standards which conform to affordability criteria may be the single most effective action government can take to encourage the private sector to build shelter for low-income households."

Facilitation of housing production by setting realistic standards for housing construction

The same concerns for public welfare which prompt governments to intervene in rental rate structure often lead to unrealistic planning, subdivision and building standards. In many countries, such standards were established prior to independence or are based on European models. In some cases, the standards have not even been adapted to local environmental and climatic conditions. In very few instances do the standards reflect social and economic conditions of the country. Yet governments are often reluctant to adopt realistic standards. The result of this attitude is that the cost of new residential development is unnecessarily high and unaffordable for a large proportion of the population. To avoid the need for continuing government subsidies, construction standards must be consistent with affordability.

Standards cannot be used to improve people's living conditions above the level they can afford. This is not their purpose. The officials who prepare standards are generally well-intentioned professionals who believe they are helping to achieve a desirable social objective when they proscribe large lot sizes and high infrastructure standards, and preclude the use of 'inferior' construction materials. While the objective may be admirable, the approach is counterproductive, unnecessarily constraining the private sector from building shelter affordable by lower-income families. The growth of illegal settlements can, in many instances, be directly attributable to unrealistic building and land development standards.

The formal process for revising standards is an arduous one. In some instances, it may be necessary to 'officially' allow exceptions to the approved standards while the revisions are being made. Exceptions can be made by designating specific areas or specific types of construction, such as low-income housing, for nonconforming development. The establishment of realistic standards which conform to affordability criteria may be the single most effective action government can take to encourage the private sector to build shelter for low-income households.

Governments often attempt to protect the health and safety of the public by establishing standards for allowable land use and development densities; for the level of infrastructure and services; and for the design and structural qualities of buildings. In the industrialized

Botswana
Realistic Codes and Standards

Prior to 1978, all urban housing construction was required to meet standards modeled on British codes. With technical assistance from AID, a two tier code was approved in 1980 allowing low-income housing areas developed by the Self-Help Housing Agencies (SHHA) to use a separate set of standards from those which apply to other developments. The SHHA code is specifically structured for the progressive building approach common in SHHA areas. The SHHA code specifies minimum height of floor above ground level. allows well constructed, traditional houses to be built in urban areas. specifies improved earth roads with gravel for main roads within low-income neighborhoods and graded earth roads for the minor roads. Drainage standards are the same as those required in the standard code due primarily to the heavy occasional rains. On-site pit latrines are allowed due to larger lots which are common in Botswana.

world, use of performance standards for buildings is usually motivated by a desire to eliminate restrictions on the use of newly developed materials not included in proscriptive type codes. In less developed countries, building materials included in a proscriptive list often reflect more than simple concern for their engineering properties. Often the personal biases of the authors of the standards or the collective biases of the governmental bodies which must adopt them intervene. For this reason, traditional building materials commonly used in house construction by lower-income, urban and rural families are often omitted from a list of approved materials. In some instances, such materials are excluded even when they are quite adequate for the purposes to be served. The result of this capricious use of standards may be to unnecessarily increase the cost of all officially approved housing, and thus encourage construction of more unauthorized housing.

Expansion of on-site production of basic construction materials and use of traditional building technology

Small scale production of basic construction materials such as sundried bricks or concrete blocks is often done on-site, particularly when a single builder is constructing several houses at the same location. On-site production is generally the least costly approach to production of building materials when appropriate raw materials and tradesmen with the necessary skills are available locally. In some circumstances, modest assistance with start-up capital for equipment and a physical plant can be used to launch a new enterprise. Technical assistance may also be required in such aspects as determining demand for the products, establishing prices and marketing the products.

Development of domestic capacity to manufacture building materials when economically viable on an appropriate scale

Government assistance or even regional cooperation among several governments may be necessary to launch a major building materials production operation. One factor in determining the feasibility of producing building materials is the availability and cost of raw

Ecuador
Codes and Standards

Ecuador's two largest urban areas - Quito and Guayaquil - have experienced rapid growth in recent years. Most of the growth has been as a result of rural to urban migration by poor families. The settlement patterns in these cities are different, but the consequences for the local and national governments are similar - large areas of 'spontaneous' low-income neighborhoods with inadequate or no essential services. The cost to provide potable water, sewerage, and basic access roadways to an existing settlement is estimated to be three times the cost to provide the same services to a vacant, but designated expansion area due primarily to the needed relocation of units in unplanned settlements.

Two local governments, in collaboration with the National Housing Institute (Junta Nacional de la Vivienda), are responding to the problems by establishing appropriate land use and building standards. The standards are not only intended to plan the prudent use of land and the building of safe and sanitary housing units, but also to be sure that the developer (private promoter or public agency) plans and actually provides the essential services. The standards have also been developed to reflect the reality of incremental construction services and housing units must meet basic standards initially and higher standards at a later date.

materials or basic components. Another key factor is the competitive cost of labor on a wage/productivity basis. The third principal factor is the size and stability of demand for the product in relation to the level of production anticipated. For example, it may not be prudent to build a plant capable of producing for peak demand while a plant which can produce some portion of domestic demand at or below the price of an imported product may be quite feasible.

The decision to develop domestic capacity to manufacture building materials should be weighed carefully against alternatives. There are numerous examples of governments investing in costly manufacturing plants which produce construction materials such as cement at a cost well above world market prices. Often the problem is the size of the domestic market, but it may also be a case of using a highly sophisticated technology with high opportunity costs when a simpler and less capital intensive process would have resulted in a more cost competitive product. All too often, governments make investment decisions on some basis other than economic feasibility. In the case of essential commodities needed to sustain life or supply major industries, uneconomical investment decisions may be justified, but building materials can hardly be classified as essential commodities and, in any event, governments should be aware of the long-term cost of such investments.

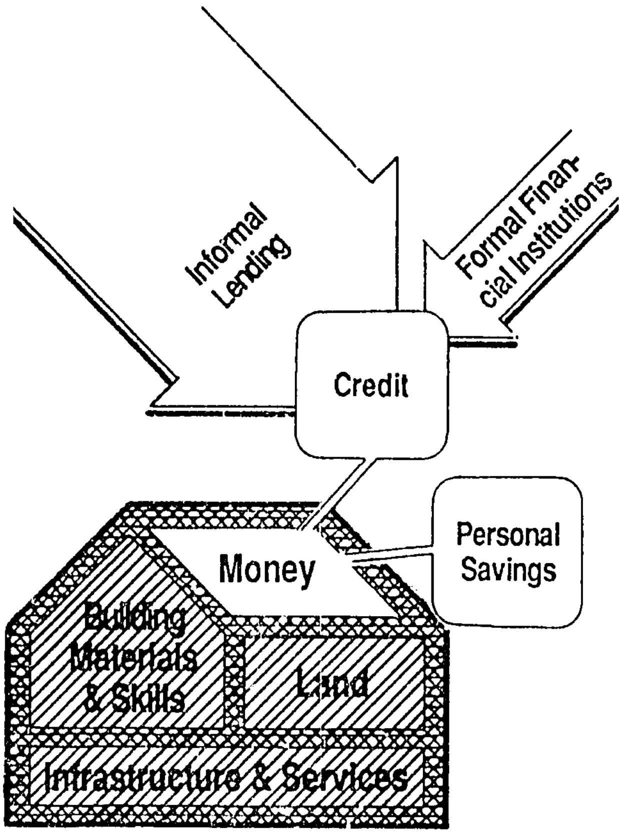
Lesotho
Building Material Production

Implementing Agency: Production Systems (PS), a division of the Lower Income Housing Company operating under Lesotho Department of Commerce and Industry.

Products include: concrete blocks, wooden window and door frames, kitchen cabinets and simple household furniture.

The company was initially formed in the mid-1970s to sponsor the construction of 200 self-help houses. PS was established to supply building materials for that project at lower than the existing market cost. Concrete block production depends on imported cement (from South Africa). Joinery production also depends on imported materials. With technical assistance and grant funds from USAID, PS expanded its staff after completing the initial project and currently competes with other local producers of building materials on a profit making basis. PS receives no government subsidies other than the initial start up funds for equipment purchase and staff training. Its products are sold to both the public sector and to private contractors. PS currently has 70 employees and produces about 2,400 blocks per day as well as a variety of joinery products.

Mobilizing Funds for Housing



Access to finance is a necessary ingredient for housing production and improvement. Money is required for initial construction and for making home improvements, as well as for purchase of both houses and land. In developing countries, funds for housing loans, and particularly long-term mortgage financing, are typically very limited. The private sector resources vastly exceed government resources and the challenge is to mobilize these funds and direct them to housing. This section describes the major sources of housing finance and discusses ways in which the private sector resources can be mobilized, including actions government can take to facilitate private participation and encourage development of a functioning housing finance system.

Typically in developed countries, financial institutions provide the needed funds by acting as intermediaries to accumulate funds from various sources and lend these resources for housing. These formally organized institutions may be wholly owned by either the government or the private sector or they may be jointly constituted. They may specialize in providing housing finance such as national housing banks, building societies, and savings and loan associations, or have broad lending functions such as commercial banks. The full range of institutions that participate in financing shelter constitute a formal housing finance system.

Few developing countries have fully functioning housing finance systems, whether public or private. Specialized housing finance institutions either do not exist or have limited capacity to meet the varied needs for housing finance. Latin America is the one region where specialized, private housing finance institutions have been developed most extensively. Other financial institutions whose primary activities are outside housing finance often do not have the resources and expertise to lend for shelter or are unwilling to lend except in a minor way. Sources of funds for shelter are often scarce, particularly for long-term lending. When loans for housing are available, access is not usually broad, with high-income households and targeted groups such as civil servants obtaining the limited funds. Low-income households, in particular, have limited access to housing loans. Government attention typically focuses on sectors of the economy other than housing and economic policies generally reflect governmental priorities. Budget allocations, credit and interest rate controls, and regulatory and tax policy in most countries, deliberately or not, tend to inhibit housing investment.

The two essential ingredients in any housing finance system are the mobilizing of funds for lending and the actual lending for shelter. Without funds, there is no capacity to lend. Thus mobilizing funds must be considered an integral part of any housing finance system. The major sources of funds for housing are household savings, government resources, domestic and international borrowing, and pension and insurance funds.

Mobilizing Household Savings for Housing

In the industrialized countries, household savings in formal financial institutions comprise the largest source of funds for housing lending. In developing countries, housing finance is largely informal. People rely principally on their own savings to finance shelter or use other informal financial arrangements. Individuals may borrow from family, friends or moneylenders, obtain loans from community-based organizations formed for this purpose, or seek credit from building materials suppliers. In the absence of loans from formal housing finance institutions, low-income households accumulate funds from these informal sources to purchase building materials and pay small contractors to build their houses gradually.

Despite popular views to the contrary, a very large proportion of housing investment in developing countries is financed through an informal system of individual household savings. This experience illustrates the significant capacity of low-income households to save for housing. If this capacity to save can be channeled to housing finance institutions, it represents a major potential source of funds. However,

Latin America
Savings and Loan Associations

In a number of countries in Latin America, including Bolivia, Peru, Ecuador, Brazil and Venezuela, savings and loan association systems were developed in the late 1950s, 1960s and 1970s with assistance from savings and loan association executives in the United States and USAID funding. These institutions were primarily established as mutual institutions on the US model where depositors are in effect owners. Their objective was to mobilize funds for housing loans from savers. Most were purely private sector creations. High rates of inflation in a number of Latin American countries slowed the development of the S&L systems in the late 1970s and the 1980s and innovative solutions such as indexing both deposits and loans were required to support further growth. While most of these savings and loan institutions initially supplied loans to middle and upper-income families, several have turned to financing low-income housing with the use of USAID Housing Guaranty funds, to supplement resources generated from deposits.

Overseeing Housing Finance

In Latin America, concurrent with the establishment of S&Ls, government regulatory bodies such as the National Housing Bank of Peru and the National Housing Bank of Brazil were founded, among other reasons, to provide deposit insurance and protect the interest of both depositors and borrowers. In some cases these organizations were set up to raise funds and provide liquidity to the S&L's as well as to provide regulatory oversight. The Venezuelan National Bank for Savings and Loan and the Caja Central de Ahorros y Prestamo para la Vivienda in Bolivia are examples. Several have received USAID technical and financial assistance.

" . . . while informal savings constitute the major potential source of funds (for housing), they are largely untapped by financial institutions. "

little effort has been made by formal sector institutions to tap this resource because they doubt low-income households' ability to save, and because the transaction costs associated with small deposits and branch office systems are too great. Thus, in many developing countries, while informal savings constitute the major potential source of funds, they are largely untapped by financial institutions.

Several mechanisms can be used to tap household savings. The primary one is voluntary savings through open market competition for funds. Another is contract savings where savings is linked to obtaining a loan. Others are mandatory savings schemes where government assessments are made on individuals and/or companies to create lending pools specifically to finance housing.

Voluntary savings as a source of funds
With voluntary savings, the savers determine whether to save and where to save based on an assessment of what competing financial institutions offer to obtain these funds. In order to attract savings, financial institutions must provide the depositor assurance that the funds will be safe and accessible according to the conditions agreed upon; with a reward either as interest payments or some financial service that is adequate compensation to the holder for use of the funds; and with access to credit. To obtain savings from a broad range of savers, the potential for access to credit is important, although it is not necessary to actually provide credit to all savers. Savers can choose to deposit funds with a specific commercial bank, savings and loan association, postal system saving scheme, a credit union or other financial institutions. Alternatively, the money may be invested in government or other securities, in insurance annuity policies, or in the stock market. If none of these options offer what the savers require, the money may be held in cash (under the mattress), invested in a non-earning asset such as jewelry or gold, or spent on consumer goods or services.

In developing countries, savers typically do not have many investment options, and low-income households are virtually ignored as potential savers. Primary financial institutions are public or private commercial banks which generally view their clients as businesses, and middle to upper-income individuals. Where savings and loan associations or building societies exist alongside commercial banks, they are concentrated in major cities and similarly serve middle-income and wealthy individuals. Government-run postal savings schemes may have more convenient locations for savings, but offer minimal interest rates to savers, rarely make housing loans, and generally only lend to specific groups such as salaried workers or civil servants. Credit unions serve only their members who, in turn, share some common characteristic such as employment. Capital markets are relatively undeveloped with stock and bond investment opportunities scarce and concentrated on government securities or stocks and bonds of a few large companies. Low-income savers rarely have the knowledge or sufficient resources to make these investments. Investment in pension and insurance annuities is generally restricted to salaried employees, and particularly civil servants. While over a third of household savings deposited with financial institutions in the US and UK is used for housing credit, very little is directed to housing loans in developing countries. As a result, not only is a large portion of household savings not tapped for housing finance, but those other resources that do exist are not widely used for housing.

Contract savings as a source of funds

Another way to attract savings to housing finance institutions is to offer contract savings plans, where depositors who save a specific amount over a specific period of time are automatically entitled to a loan that is some multiple of the savings accumulated. The amount saved over the contract period is often used as a downpayment. In this scheme, the saver is able to earn interest on the savings deposit and know that access to a loan is guaranteed. The loan term and interest rate may also be fixed at the time of contract.

While contract savings plans have had initial success in generating funds for housing lending in a number of developing countries, they are not without problems. In order for enough loan money to be available for people who have completed savings contracts, a continuous

India

HDFC Savings Products

The various savings products offered by the Housing Development Finance Corporation (HDFC), the single specialized housing finance institution in India, are an example of the array of methods that can be used to generate savings deposits. Two deposit schemes link savings with a home loan (the Loan Linked Deposit Scheme requires no specific monthly deposit amount, while the Home Savings Plan ties regular deposits to a low interest rate loan). Certificates of Deposit (CDs) at market interest rates are available for companies and individuals and for non-residents. Under the Cumulative Interest Scheme, interest is compounded and paid on maturity of deposits. Charities, religions and public funds can also invest in HDFC CDs without losing any tax benefits.

flow of new savings contracts is necessary. If there are no houses available for purchase, or if the loan amounts are insufficient to buy a home because of inflation during the contract period, people may decide not to start new contracts or may withdraw savings from completed contracts. Dependence on contract savings plans may also mean that the institution is passing up the opportunity to tap money from other savers. When these plans include provisions for loans at below market interest rates, people who could pay more get subsidies while those who need subsidies are unable to obtain low rate loans. Because of problems associated with contract savings plans, they should be approached cautiously, terms and conditions should be set carefully, and they should not be used as the sole source of funding for the institution.

Mandatory savings plans as a source of funds
Another variation on the contract savings plan is the government-decreed, mandatory savings plan. In some developing countries, employment taxes and compulsory savings schemes have been used as a source of public sector long-term funds for housing. Jamaica, Peru, Chile and Mexico, for example, have created social housing funds for mortgage loans by levying payroll taxes on both employees and employers; Brazil and the Philippines have utilized required savings schemes for employees but pay interest on the funds. Whether or not these techniques create a cost effective funding source depends on such factors as effectiveness of collection and the rate, terms and repayment experience on mortgage loans made or purchased with these funds in relation to the cost of the funds. Poor program design and administration leading to inadequate collection rates and margins between the cost of funds and mortgage lending rates have resulted in poor performance and threats to the financial viability of these funds in some countries including Jamaica and Peru. Brazil, however, has had notable success using compulsory savings to create a fund which purchases mortgages made by public and private sector financial institutions. A disadvantage is that mandatory savings are often a form of regressive tax where large numbers of people are required to contribute but only a few receive housing loans. Often these loans are made with

subsidized interest rates that benefit middle and high-income people who have less need for subsidy than low-income individuals who do not receive loans.

Using Government Resources

Another source of funding is the government itself. Government may direct resources, primarily from taxation, to finance housing. The government may operate its own mortgage loan programs for civil servants or low-income households, or direct funds as contributions or loans to state-owned housing banks. Government may also make loans to private sector or jointly-held financial institutions that agree to make specific types of housing loans. Government loans may be made at lower rates or for longer terms than other sources of funds the financial institution has at its disposal, thus encouraging the institution to make housing loans. In some developing countries, government resources may be the only source of funding, particularly long-term funds, available for housing, and may be necessary to induce private financial institutions to make specific types of housing loans such as loans to low-income households.

The disadvantages of using government funds for housing finance are that these funds are often in short supply and costly. The government must either use budget resources or borrow funds. In a period like the present where most governments are experiencing deficits and have heavy debt servicing obligations, the cost to government of providing loan funds may indeed be high, particularly if other uses of these funds are more productive in the economy or if the cost of borrowing funds exceeds the earnings from housing loans. Money made available for long-term loans and mortgages has an even higher cost when not funded by long-term borrowed money, particularly if government is required to borrow in the future at rates higher than it earns on the loans it makes. More importantly, government also has an opportunity cost associated with long-term lending because funds are recovered slowly and, in an inflationary environment, have less value when received.

India
HDFC Funding Sources
In India, the HDFC, which was established 8 years ago as a primarily private housing finance institution, has tapped a number of different sources of funds. In addition to generating about 58% of resources from deposits, HDFC sold its first bond issue in 1984 for $10 million, and has obtained loan resources from three insurance companies, as well as $50 million in HG loans from AID with an additional $40 million approved. The HDFC does not benefit from any government subsidies. In just a few short years, HDFC has become a fully functioning housing finance institution which operates as a private sector entity making a substantial contribution to both mobilizing resources for housing and promoting home ownership for the Indian people.

" In many developing countries, the secondary market potential may be quite limited because the amount of funds actually available for long-term investment is small."

Borrowing From Domestic and International Sources

In countries with well-established financial systems, housing finance institutions can borrow money domestically to provide funds for housing. In other countries, government may borrow domestically and on-lend for the same purpose. The most common form of domestic borrowing is selling bonds to investors, particularly to pension funds and insurance companies that need long-term investments. These borrowings can be secured by mortgage loans and sold in a secondary market by government or financial institutions.

Funds thus obtained can be used to make more mortgage loans. While the prospect of tapping such a market has broad appeal among housing finance institutions, it may not be easily accomplished. In many developing countries, the secondary market potential may be quite limited because the amount of funds actually available for long-term investment is small.

In some countries, government has required the purchase of bonds by financial institutions, pension and insurance funds, and even individual builders who want building permits. Typically, this is a device to fund government deficits, and the required purchase represents the expected contribution of these institutions. This is, in effect, another form of mandatory savings. While this is one way to make funds available for housing, it has the disadvantage of disrupting the market. By requiring investments that generally earn less than market rates, such programs eventually result in higher consumer costs as bond purchasers seek to restore their financial position by charging more for their products and services.

Another source of funding for low-income housing is borrowing on international markets. In developing countries, few domestic housing finance institutions have the capacity to borrow internationally, so government must provide support in the form of guarantees or be the borrower itself. Programs such as the AID Housing Guaranty Program and World Bank urban projects loans provide a source of long-term funds at or below the rates prevailing in international markets. This may be the only source of long-term funds available in some countries. International borrowing for housing may have an additional appeal in situations where local currency can be used for the actual housing loans freeing all or most of the foreign currency borrowed for other essential imports. Whether or not international borrowing is economically feasible depends on how the funds are used.

Borrowing internationally for housing is essentially a two-step process. The international borrowing provides foreign exchange to the country which is used to pay for imports or other purposes. Repayment terms are typically 20-30 years with a grace period on repayment of principal and thus are an attractive source of long-term funds, as long as sufficient foreign exchange resources can be generated to repay the borrowing over the loan period. In a second transaction, government makes local currency, equivalent to the international borrowing, available to finance housing. At this level funds are lent on terms and conditions prevailing in the local credit markets. These terms and conditions should be adequate to cover loan administration costs and to provide a return on the funds sufficient to compensate for the risk assumed in making housing loans.

Tapping Insurance and Pension Fund Resources

Contract savings plans with life insurance companies and pension funds are excellent potential sources of funds for housing. Purchasers of life insurance policies make regular payments over time without the expectation of receiving benefits in the near future. Employers and/or employees make regular contributions over time into a retirement fund. In both cases, the need for these funds to be paid out to beneficiaries at some time in the future can be estimated with some certainty.

Programs like these represent a source of funds for long-term investment. Both pension funds and insurance companies typically want to invest in long-term assets such as mortgages, but they do not want to make and service the loans since they can make other long-term investments that have much lower administrative costs and similar yields. Therefore, these institutions will be interested in purchasing the loans or securities backed by mortgage loans in a secondary market where relatively large amounts are bought and sold. They will only seek investments in mortgages and mortgage-backed securities when the mortgages are sound, with little risk of default, or where a public or private entity guarantees repayment. Mortgage insurance is one common form of guarantee for both mortgages and for mortgage securities. Government and private guarantees have been used extensively in the United States to induce long-term investors, private individuals as well as insurance and pension funds, to invest in mortgage securities. Where insurance companies are owned by or own a financial institution, the insurance companies may buy mortgages originated by the financial institution. The sale of mortgages or mortgages backed by securities to insurance and pension funds provides a source of liquidity to financial institutions which allows them to make additional loans. In developing countries, insurance and pension funds often represent the only domestic source of long-term funds. These funds are usually directed, however, primarily toward financing development needs other than housing.

Haiti
Banque de Credit Immobiliere
In Haiti, AID actively encouraged the founding of a privately-held savings and loan type housing bank which is the first financing institution in the country specialized in housing. The Banque de Credit Immobiliere (BCI) started operating in January of 1986 with $2.5 million in capital contributed primarily by private individuals and institutions. Despite difficult economic and political circumstances in the country, BCI has succeeded in generating an additional $2.5 million in savings and has made more than 80 loans in less than one year of operation. AID has provided technical assistance in S&L operation to BCI and is funding a pilot project to build low-income housing, which will be the first significant low-income housing project developed by formal private sector institutions in Haiti.

Policies and Programs Which Encourage Private Initiative for Housing Finance

In developing countries, a number of initiatives can be taken by both the private and public sectors to stimulate voluntary savings by households and increase the resources available for housing finance.

Promotion of voluntary savings with financial institutions

Developing countries can mobilize savings by creating specialized housing institutions or allowing existing financial institutions to offer savings opportunities which meet household needs. This can be done by offering higher interest rates, requiring small minimum balances, having convenient locations for saving, or providing various types of housing loans that meet the needs of savers. All such actions require careful consideration of the costs associated with attracting new customers. If higher interest rates are offered, for example, the financial institution must be sure that it is able to make loans at a high enough rate to both pay interest on the deposits and cover its administrative costs, including building reserves for both expansion and potential loan losses. Consideration must also be given to attracting stable and long-term balances appropriate to funding housing loans.

A key requirement for obtaining household savings is providing convenient locations for savings. Branch offices are the most common way to reach households. This can be expensive, however, and the costs could well exceed the benefits earned from the deposits collected. Small storefront branches and mobile units are low-cost alternatives to fully staffed branches. Other institutions such as the post office, utility companies and financial institutions operating jointly can be used as savings locations. The financial institution on whose behalf the deposits are collected could pay a fee to the institutions whose office were used or could share the costs of the branch operation.

By actively promoting the advantages of saving and access to loans, housing finance institutions can focus attention of potential savers toward making deposits with the institution. In countries where people do not traditionally use any financial institution, significant promotional efforts will be required to induce people to save. Advertising, newspaper articles, and radio broadcasts can be useful. In some areas, institutions have used lotteries with prizes for new account holders to induce people to open accounts. In other cases, agents, both employees of the institutions and others, are paid commissions for bringing in new customers.

Another action which can contribute to encouraging savings is for government to protect the interests of depositors through providing deposit insurance. Thus, depositors' confidence that their money will be safe in a financial institution can be enhanced.

Use of interest rate policy to encourage household savings

The previous discussion of attracting savings through

Bolivia
Assistance to S&L System

In Bolivia, the private S&Ls were severely weakened during the economic crisis of the early 1980s when inflation reduced the value of mortgage loans, made repayment of dollar-denominated debt difficult and savers withdrew deposits as government-allowed interest rate policies were inadequate. With inflation not now as serious a problem, S&Ls are recovering assisted with USAID funds for technical assistance in lending, marketing and management. Lending is being diversified to short and medium-term loans to families. Extensive marketing and promotion campaigns are being launched to attract savings deposits. Training in all facets of S&L operation are underway. It is expected that these efforts will enable S&Ls to better cope with changing economic conditions and continue to provide opportunities for modest income families to attain homeownership.

competing for funds assumes that free-market conditions exist which allow competition in such areas as setting interest rates for deposits and loans. This is not the case in many countries. Financial institutions are generally regulated by government to both protect depositors and to meet the economic and social policy objectives of the government. For example, the interest rates paid for deposits and charged on loans are often fixed in an effort to control the money supply and hold down inflation. This can have both positive and negative consequences for housing finance institutions. Where housing finance institutions are allowed to offer higher rates of interest than other financial institutions, savers are encouraged to use these institutions and, consequently, more money is made available for housing lending. The United States and many other countries have used such techniques to direct resources to housing. If at the same time, however, lending rates are circumscribed so that earnings from loans do not recover the costs of obtaining savings and administering loans, financial institutions will tend to carefully ration credit concentrating on the clients with substantial collateral which limit loss potential and on large loans which result in lower transaction costs than numerous smaller loans. In such circumstances where lending is in effect unprofitable, the viability of the financial institution may be compromised, government subsidies will be required to induce lending, even in public institutions, or lending will be curtailed, particularly to low-income households. For private sector institutions to mobilize funds for housing, it is clear that interest rates for both lending and saving must be sufficiently flexible to allow the institution to operate profitably. To the extent government mandated changes in interest rates occur frequently, private sector institutions may be even more hesitant to commit resources to generate savings or make loans because of the uncertainty associated with potential future changes.

If the interest rate environment is conducive, private sector financial institutions can be encouraged to pursue household savings as a source of funding for housing.

Use of tax policy to stimulate household savings

Tax policy is one method that government can use to encourage savings and thus increase funds available for financing housing. One taxation mechanism which can encourage individual savings is to exempt all or part of the interest income on deposits or other investments from income tax. This is only meaningful where income tax is paid by a large part of the population and appeals particularly to those individuals who must pay a significant portion of income in taxes.

The substantive issue in using tax policy to stimulate housing investment is the cost to government of foregoing tax revenue that could be directed to housing or other uses. Often tax policies are implemented without sufficient study of the possible loss of government income. Likewise, tax policies that reduce taxes may not, in fact, be necessary to stimulate housing investment and may represent a windfall to those who can most afford to pay taxes that could subsequently be used to support housing for low-income individuals. When using tax policy to promote housing investment, the potential benefits must be carefully weighed against the loss of government revenue.

Development of housing investment programs and secondary market mechanisms to increase funds for long-term lending

The creation of housing securities is one way in which government can encourage the formation of a capital market as well as achieve the objective of raising funds for housing. The government, through a National Housing Bank, the Central Bank or an institution created for this purpose, can buy, package and resell mortgages as mortgage securities or mortgage-backed securities. The mortgages could be those made by both private and public sector institutions. Having access to a means of selling loans to make them liquid can encourage private sector institutions to make long-term loans when they would otherwise be reluctant to do so because of concerns about risks. To be effective, these investment programs must be structured so that private sector institutions can earn a reasonable profit, mortgage terms respond to market demand, the

Jordan Housing Bank Developer Originated Mortgages

In order to facilitate the sale of their units, private developers in Jordan have begun to raise equity from investors and use the funds to provide buyers with long-term loans, often on terms of up to 30 years and with little or no downpayment. While interest rates on these loans are usually 3 to 4 percentage points above the rates offered by JHB, the payments are lower due to the longer terms (JHB loans do not exceed 15 years). With long-term funds obtained through a HG loan, the JHB has begun cautiously to explore mechanisms of providing liquidity to private developers who wish to package eligible loans and sell them to the JHB or borrow against them. While this activity does not constitute a secondary market, it does serve some secondary market functions and provides a basis for a wider range of services in the future.

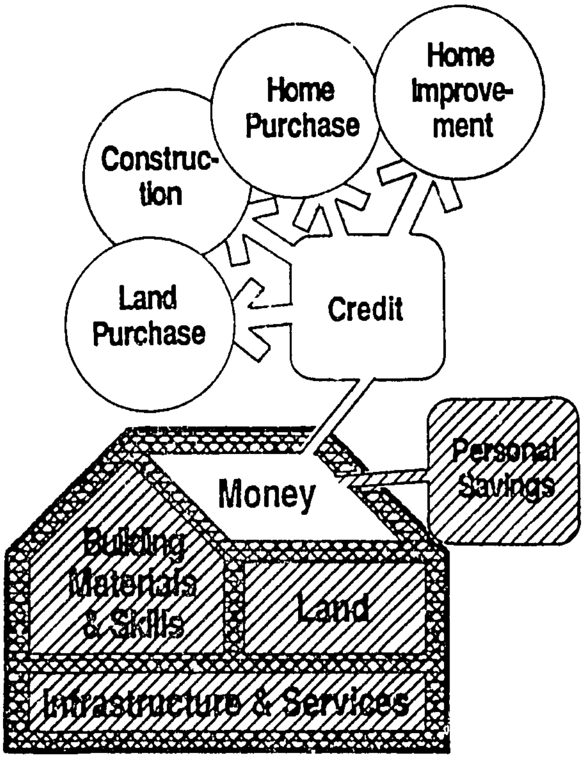
programs are competitive with alternate investments, and these institutions can be assured that the program will be available over time. In addition, for these programs to be attractive, the volume of mortgages purchased and sold must be sufficient to warrant the expense of administering as well as packaging the loans for sale.

In order for a secondary market to operate, investors must be available. The government can play a role here by making housing securities eligible investments for public and private sector pension and insurance funds. The securities can be structured in terms of yield and maturity to attract the largest number of investors. The government can purchase securities itself when outside investors are not available.

For housing bonds and other securities, whether public or private, to be seen as attractive investments, investors must be confident that the issuing institution is sound and can repay the obligation fully in a timely manner. Likewise, purchased mortgages must be sound with reasonable expectations of timely repayment. Concern about the quality of mortgages purchased may necessitate government providing a guarantee. With a guarantee that minimizes risk, investors may be willing to supply funds which they would not do in the absence of a guarantee of repayment for all or a portion of the mortgages or for the bond itself which reduces investment risk. This technique has been used extensively in the industrialized countries, and has been implemented in some developing countries as capital markets are developed.

Guarantees can be costly to government if the loans are not sound. When undertaking to guarantee mortgages, as is the case with purchase and sale, government needs to have the expertise to evaluate the quality of the loans and assure that they are properly serviced. Without this expertise, such activities are unlikely to be successful because investors will not have confidence in the programs.

Providing Loans for Housing



Basically four types of lending are required for housing - construction, home purchase, land purchase and home improvement loans. In developing countries, all four are generally in short supply, particularly for low-income families, because funding sources for housing loans are lacking, as described in the previous section. Financial institutions do not believe that low-income households are good risks and that loans to them can be made profitably. This section describes the four types of housing lending and discusses actions which government can take to facilitate participation by private institutions by providing an opportunity for increasing profits or by reducing the perceived risk associated with this type of financing. Involving the private sector in housing lending has several potential benefits to government: (1) funds available for housing can be increased; (2) private funds can be substituted for public funds; (3) funds can be targeted to meet specific objectives; (4) administrative costs to the public sector can be reduced; and (5) lending expertise and efficiency can be enhanced by substituting private sector management for public sector management.

It is important to note that any incentive has a cost to government which should be weighed carefully before being implemented. Incentives may have a budget impact (e.g., government loans and tax exemptions). They may distort the operation of financial markets and have unintended effects, such as increasing the money supply, contributing to inflation. Also, such incentives may not be necessary once financing institutions become experienced. It may be better to try to avoid incentives until they are proven necessary. Likewise, ascertaining that these benefits accrue to the people who really need assistance is important. Some of the incentive techniques described are, in effect, subsidies, and if these techniques are used, the cost must be carefully calculated to determine if they are necessary to achieve the policy objective.

Providing Construction Loans

Construction loans are made either to individuals building their own homes or to builder/developers constructing homes for sale or rental. Construction loans to individuals generally take on the characteristics of permanent mortgage financing which is payable over a period ranging from 5 to 25 years, normally at a fixed rate of interest. They differ from permanent mortgage loans in that initial disbursements are made as building progresses rather than as a lump sum disbursement, as in a purchase. These loans are made either by commercial banks or specialized housing finance institutions such as savings and loan associations. In developing countries, construction loans may also be made to low-income households for building materials.

Building material loans are often part of sites and services projects where low-income households can obtain a loan for land purchase and subsequently borrow for building materials based on their ability to pay and their record in making land purchase loan payments.

Construction loans to builder/developers resemble regular commercial loans and are typically made by commercial banks. However, savings and loans and government housing banks in some countries also make construction loans.

Loans to builder/developers for construction of single units, subdivisions or multifamily units are made on a fixed or floating rate basis and are typically for the construction period with disbursements made as building progresses. Construction loans generally have a maturity of one to two years, but may be as long as five years for large subdivisions where construction is phased. These construction loans are paid off from the proceeds of the sale of the units, which come from the buyer's downpayment and the permanent mortgage loan obtained by the buyer. Typically, the land and improvements are put up as security for the loan, although personal assets of the builder/developer may be substituted, in effect creating a line of credit which is drawn on as construction progresses. In lending for subdivision construction, land and buildings are released from the mortgage securing the loan as homes are sold and payment received.

Construction of low-income housing by private sector builder/developers presents some special problems. Often builder/developers are reluctant to begin construction of low-income housing because they do not believe that buyers exist who can obtain a mortgage loan on a timely basis. Therefore, they prefer not to take the risk of building for this market without some assurance of sale such as receiving substantial downpayments from buyers before beginning construction.

Providing Home Purchase Loans

The most important housing finance need is for permanent financing; in other words, access to a home purchase loan. The long-term mortgage loan enables many families to afford a home who could not do so if no financing or only short-term financing were available. This is a key means of providing access to home ownership for low-income families and the chief reason home ownership is so extensive in the developed countries.

A home mortgage loan is made for a percentage of the value of the home, typically 70% to 80%, with the homeowner supplying the balance from savings as a downpayment. Loan maturity terms range from 10 to 30 years, although a term of 20 to 25 years is most common. Interest rates may be fixed or adjustable. Fixed rates allow homeowners to know the exact amount they will pay over the life of the loan, and as their income increases and/or inflation decreases the relative value of the payment, owners benefit by paying less of their income in real terms for the mortgage loan. Adjustable mortgages limit the housing finance institution's potential profit should interest rates fall and limit loss when increases occur, but require the borrower to be able to pay more when interest rates increase.

To be eligible for a mortgage loan, the potential borrower must have a downpayment and sufficient income so that the loan can be serviced by spending no

India
HDFC Loan Products

Examples of various loan schemes that can be undertaken to support homeownership are the loan products offered by the HDFC in India. HDFC's clients are individuals, associations of individuals and corporate entities. HDFC has a limit on the size of individual loans, finances only new construction (i.e. not second mortgages), and will not finance second homes. Thus, limited resources are spread as widely as possible to those who are in need of housing and HDFC's major objective, the promotion of homeownership, is realized. In addition to direct loans to individuals, HDFC also has a line-of-credit scheme whereby employers guaranty housing loans made to employees. In support of the government's industrial decentralization policy, HDFC has developed a loan program to corporations for the provision of worker housing in industrially backward areas.

more than some maximum percentage (generally about 25%) of total income. The home and land secure the loan and, in the event of default on the loan, the lender can foreclose and sell the home to recover the outstanding loan amount. Many lenders also require borrowers to have life insurance adequate to pay the loan if the borrower dies; fire insurance is also generally required. In industrialized countries, where the downpayment is less than 20%, the lender often requires additional mortgage insurance to protect itself in the event of default from the possibility that the home might be sold for less than the amount of the loan.

In most developing countries, long-term mortgage finance is at best very limited and is typically only available to middle-income professionals and higher-income households. The lack of long-term finance, particularly for low-income families, is related to the lack of long-term sources of funds, discussed in the previous section, as well as the perception by financial intermediaries that low-income families do not have the capacity to repay a long-term loan and that such small loans are costly to make and service.

The major providers of long-term mortgage financing are the specialized housing finance institutions-savings and loan associations or building societies, national housing banks and mortgage banking companies. These may be privately-owned or public institutions. The main activity of savings and loan associations and building societies is to make mortgage loans to households using savings as the primary source of funds. National housing banks have many types of lending programs, although providing long-term mortgage loans is the major activity for many. The housing banks may be funded from government resources, including budget funds, borrowed funds, resources of social security trust funds, and possibly private savings and borrowings as well. Mortgage companies act as intermediaries which make and service loans and then sell the loans to investors, using the proceeds of sales to fund more loans.

In some countries, cooperatives and credit unions also make long-term finance available to their members.

However, because these associations often lack sufficiently skilled staff to make and service these loans, they are more likely to concentrate their lending efforts in shorter term housing loans for building materials, construction of an addition to an existing house or other home improvements. Where these associations make long-term loans, they often act as intermediaries using long-term loan funds supplied by the government or housing finance institutions which they re-lend to their members. The cooperative or credit union is responsible for repaying the loan. This is one way for a number of families to obtain long-term financing and for the financial institution supplying the funds to reduce the risk and cost it believes is associated with making many small loans to low-income borrowers.

What distinguishes private and public sector housing finance institutions from one another is the willingness of public sector institutions to make loans which private sector companies might be unwilling to do without incentives from government. For example, some government loan programs are directed specifically at providing mortgages for civil servants; others are geared to low-income households. Loans may be made at below market interest rates, in effect providing subsidies to selected loan beneficiaries, with the cost of these subsidies being absorbed by government. Public sector housing institutions may also be willing to finance a greater percentage of the value of the home, and require less security in terms of insurance or other quarantees. Some government programs in effect do not require downpayments from loan beneficiaries.

Providing Land Acquisition Loans

Because unimproved land does not produce income and the value may vary significantly, both up and down, over time, financial institutions generally will only finance land purchase for terms of up to 5 years. Downpayments of over 20% are usually required, and the land is mortgaged as security for the loan. In addition, other assets of the purchaser often must be pledged as security.

One exception to these general characteristics of land purchase loans is the loans for sites and services

Panama
Mortgage Banks

In Panama, USAID is working on an innovative program with four mortgage banks, including three private ones, to institute mortgage lending programs for low-income households, a segment of the population which has not previously been served by mortgage banks because other markets appeared to be more profitable and dynamic. The project is expected to demonstrate that low-income families can and will pay mortgage loans and that they represent a new clientele as depositors and for consumer loans. About 3,500 households are expected to benefit from this program in the first four years and $18.4 million in counterpart resources contributed in addition to HG funds. HG long-term funds totalling $25 million are being borrowed by the four banks from US investors. The money will be placed in a trust fund operated by a private commercial bank. The funds would then be on-lent from the trust fund to the mortgage banks which would collateralize the loans with eligible mortgages. The trust would repay the loan using resources paid in by the mortgage banks. This arrangement provides a simple, secure repayment mechanism to US lenders. At the same time, the trust also will generate new resources and accumulate reserves which could be reinvested in mortgages or used to back the sale of bonds to mobilize more resources for mortgage lending. Using the trust fund mechanism as a banking service will also serve to strengthen Panama's role as a banking center.

projects undertaken in many developing countries, which are described elsewhere in this monograph. In these projects, loans are made available to low-income purchasers of serviced lots, usually with minimum downpayments for terms up to 15 years, with a first mortgage on the property as security. The purchasers then proceed to build a home on the lot using their own resources or possibly by obtaining small loans over time to pay for building materials and for the services of small contractors who assist them. The advantage of supplying loans to purchase these lots is that many low-income families can afford to borrow the sum required for a small lot and building a modest home but few can afford to purchase an already constructed home.

The loans made in sites and services projects may be made by both private and public sector housing finance institutions. However, for the same reasons they are reluctant to make home mortgage loans to low-income households, private sector institutions often are hesitant to make loans for serviced lots.

Providing Home Improvement Loans

Home improvement loans are made to households that wish to add to or improve their homes. These loans can be used to add a kitchen or bath or an entire second floor. They can be used for repairs such as a new roof or for painting. Generally, such loans are made for 1 to 3 years, but may be as long as 15 years for major improvements. Except for small loans for repairs, these loans are typically secured by a first or second mortgage on the house. Disbursements are made gradually as the work progresses, and may be paid directly to the material supplier or contractor doing the work.

Home improvement loans can be a solution to improvement of housing conditions for many low-income families in developing countries who live in overcrowded conditions lacking basic amenities and for whom a new home would be well beyond their capacity to pay. Here again, unless incentives are provided, most private sector financial institutions may be reluctant to make small loans to low-income households, believing that the repayment risks and costs of servicing are too high.

Policies and Programs Which Encourage Private Initiative in Lending for Housing

Government can encourage private sector participation through policies such as making funds available for lending and on-lending, issuing guarantees and providing regulatory incentives.

Provision of government funds for lending and on-lending and issuance of guarantees for loan repayment

Government can induce private sector participation through direct lending and on-lending. Government loans may represent the only available funds for low-income shelter development when financial institutions do not have other resources available to lend or are unwilling to take the risk of lending for different purposes or on different terms from their normal practices.

In order to encourage building for low-income housing, government can take actions to provide loan funding that will reduce the risk as perceived by the private sector builder/developers.

Providing government funds as loans for construction, site development or purchase of housing by the private sector is one way that government can encourage increased shelter production. Loans can be made available to formal private sector enterprises and households or funds can be provided to financial institutions for on-lending.

Administration of a direct government loan program presents several difficulties. Loans must be originated, serviced and collected. Loan administration can be expensive in manpower terms and poor administration can result in losses when loans are not repaid. This can be a serious problem, particularly if 'government' loans are perceived by borrowers as 'gifts' to which they are entitled rather than loans which must be repaid. High delinquency and default rates are common in government loan programs.

Another option is for government to lend money to financial institutions for on-lending to specific groups or

Barbados
Government On-Lending
In Barbados, commercial banks, credit unions and private developers operated successfully in the country, but did not serve the housing needs of low-income people. HG funds totaling $10 million lent to the Barbadan government were on-lent to public and private commercial banks, and to credit unions. Using the HG funds, these financial institutions for the first time made home improvement and mortgage loans to low-income households on their normal credit terms. Government facilitated their participation by exempting home improvement loans funded with HG resources from credit ceilings, and in the case of credit unions on-lent at slightly subsidized interest rates to allow more beneficiaries to be able to afford a loan. As a result of the experience gained in this program, commercial banks now lend to low-income households using their own resources.

for specific purposes. While this approach does not eliminate the high cost of using budget or borrowed resources, the servicing costs and the risk of loss can be transferred to the financial institutions. This approach has an additional potential advantage in that private sector financial institutions may decide to use their own funds for similar loans once they have gained experience originating and servicing loans using government resources. This experience could lead to an increase in the overall supply of funding for housing, one of the main reasons for using the on-lending approach.

A variation on this approach is to use government funds for on-lending in combination with resources from private sector financial institutions to meet targeted objectives. This, in effect, leverages government funds by providing seed money to encourage private sector financial institutions to use their own resources. Leveraging government funds can be achieved by using many other techniques including buydowns, blending, guarantees and grants. In the buydown technique, public funds are used to subsidize the interest rate on private sector loans in order to make loans affordable. In blending, government resources are made available to fund part of the loan at a lower interest rate so that the combined (blended) interest rate on the loans is lower which makes the loan more affordable and creditworthy. Under the guarantee technique, government funds are set aside to guarantee all or a portion of loans made with private sector funds, which can encourage private lending by reducing the risk to the lender, particularly to make loans which they would not otherwise make. As long as the underlying loans are good, this type of guarantee is a low-cost, effective way to mobilize private sector housing finance.

Grants to purchasers reduce the amount of money which private financial institutions must supply as well as improve the creditworthiness and affordability of the private loans. These leveraging techniques have been used extensively in the United States and have resulted in generation of significant funds for low-income housing from private sources. Grants have been used successfully in the United Kingdom for rehabilitation of existing units and sale of government housing, where the grants have made lending feasible by reducing the percentage of value that must be financed by a loan.

Once experience has been gained with these types of lending, institutions may continue to lend without incentives. Programs that provide incentives should be structured with the goal of eventually removing them as the financial institutions gain experience.

On the other hand, when government funds are to be on-lent or guarantees provided for specific purposes or on specific terms different from the normal lending practices of private financial institutions, these institutions may be reluctant to participate because they perceive an additional risk of loss that is unacceptable. Other incentives may be required to encourage participation. Incentives which government could provide include tax exemptions, credit control and other regulatory exemptions or more favorable interest rates.

As was discussed in the previous section on mobilizing resources, government can encourage lending through secondary market type operations where loans are purchased or packaged for resale, which provide liquid funds to financial institutions for additional housing loans, or guarantees provided which make loans or securities backed by mortgages saleable in private markets. This approach has been used extensively in the United States. The Government National Mortgage Association, Federal Home Loan Mortgage Corporation and the Federal National Mortgage Corporation are examples of US government efforts to support a viable secondary market that encourages long-term mortgage lending.

Encouragement of private sector financial institution participation through regulatory incentives

In addition to providing funds and guarantees, government can encourage participation of private sector financing institutions by using its regulatory and taxation powers. Where credit controls exist, exemptions can be made on the rate or amount lent if

"To the extent that interest rates are tightly controlled or changed often, the uncertainty created may cause private sector institutions to be unwilling to lend for shelter."

loans are made for shelter or to specific groups. Specialized housing finance institutions or small local institutions, such as cooperatives and credit unions, may be exempted from rules governing other financial institutions. For example, reserve requirements might be lowered or interest rate ceilings on deposits raised to increase savings available for investment in housing loans.

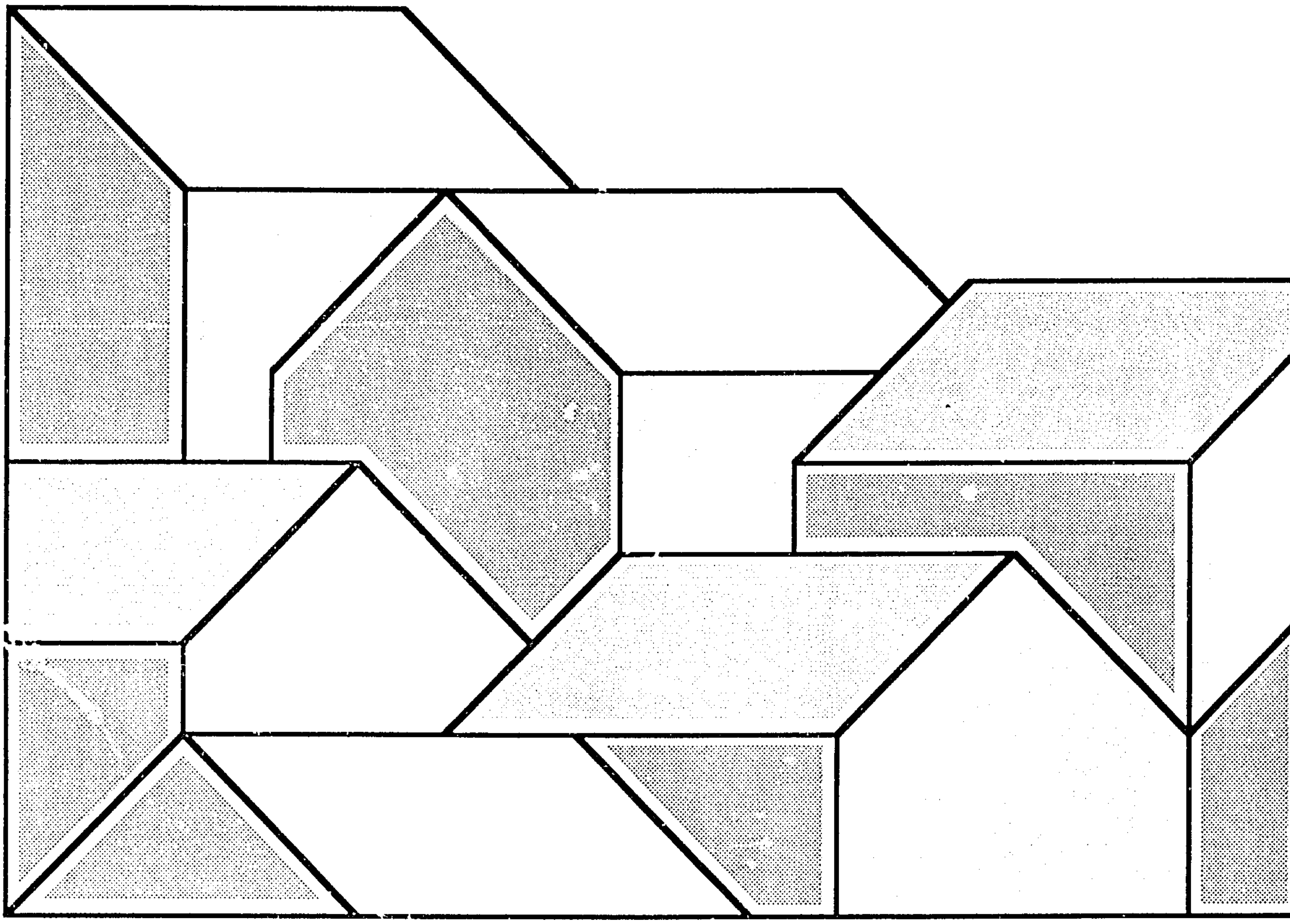
Setting of interest rates that can be charged for loans and received on deposits is a common technique used by governments to control the amount of money available for different uses in the economy. The interest rates can be set on what financial institutions pay to or charge customers and on what financial institutions pay each other to borrow and lend funds. Interest rate policy can be used to promote economic activity by making credit less expensive, and to curtail spending and investment by making credit more expensive. Limiting credit is often used to slow spending and the growth of the money supply in an effort to control inflation. As discussed in the previous section, savings can be promoted by allowing payment of higher rates for deposits and reduced through lower rates. Financial institutions will be more willing to lend if the spread between the cost of money (what it pays for deposits and other sources of funds) and the rate it can charge on loans is large and less willing if it is small and/or insufficient to cover the costs of administering loans.

Any interest rate policy interferes with market forces of supply and demand for money. The specific impact of these policies is rarely predictable with any degree of accuracy since the responses of many individuals to these policies cannot be ascertained in advance.

Because interest rate policy is often set to achieve broad economic objectives, its effect on the shelter sector may not be taken into account. Since interest rates have differing impacts on different sectors, it is important to consider the specific effect on each sector so as to minimize unintended effects of these policies. Housing is particularly responsive to changes in interest rates because of the need for long-term funds and loans. To the extent that interest rates are tightly controlled or changed often, the uncertainty created may cause private sector institutions to be unwilling to lend for shelter. In other words, interest rate policy can facilitate or impede mobilization of private sector funds and lending.

While interest rate policy may affect the supply of credit, government may choose to control directly the amount of credit that financial institutions can extend in general or for specific purposes. The objectives of credit controls are essentially the same as interest rate policies. Credit controls can be instituted in a number of ways. The absolute amount a financial institution can lend during a specified period can be fixed, a percentage for loan growth for all purposes or specific purposes can be set for a specific period, or the growth of the assets can be circumscribed. Any such actions interfere with market supply and demand for credit.

Credit controls can stop the flow of money to housing when financial institutions become reluctant to make anything but short-term loans where the volume can be more easily controlled in order to meet the credit control restrictions. Once again, it is important for policymakers to consider the impact on particular sectors when deciding to institute credit controls. Some countries, for example, have found it useful to exempt home improvement loans or housing loans for low-income families from credit controls. This allows targeted households to continue to have access to loans, yet achieves other objectives through the credit controls. The effects of government actions need to be carefully considered so that resources continue to flow consistent with government's policy objectives. Private sector financial institutions are unlikely to participate in providing funds for low-income housing if they perceive that restrictions prevent them from making sound, profitable loans.



Part Two:

Strategies for Private Initiative

Understanding the Private Sector

Defining National Policy

Formulating a Private Sector Housing Strategy

Identifying an Initial Program

Developing an Appropriate Approach

Understanding the Private Sector

Formulating and implementing shelter programs which rely on private sector initiatives require that LDC government officials and development assistance agency staff come to understand the objectives, motivations, and operating procedures which distinguish the private sector from the public sector. The differences within the private sector, between private lenders, stockholders (or equity investors), and private builders and developers must also be understood. It is not enough to view profit as the sole motive of the private sector, nor is it accurate to assume that eliminating risk is essential, or even desirable, in seeking to motivate private initiative in housing.

The private sector is hardly monolithic in its viewpoint. In the critical matter of risk evaluation, private sector lenders differ dramatically from private sector developers - for risk is at the heart of the entrepreneurial function in development while most other key players shun risk. The function of the entrepreneur, by definition, is to perceive an opportunity and assume the necessary risk in order to realize a profit. By contrast, lenders seek multiple layers of security in order to avoid risk. Lenders are seldom entrepreneurs; generally they see their function as fiduciary, investing other people's money in the safest possible manner.

Developers, on the other hand, expect to assume risk, but also expect sufficient freedom of action to be confident they can achieve their objectives. The way developers assess limitations and options offered by potential projects is often as important in determining their willingness to proceed with the investment as are the financial risks and the potential profit. Financial incentives may be effective in stimulating certain types of private investments, but removal of restrictions or modification of regulations may be more effective and less costly in terms of public resources.

The key to formulating a successful program of public incentives to private sector shelter efforts is to assure that the objectives of both parties are compatible, i.e. that projects are structured so that achieving the desired

"It is not enough to view profit as the sole motive of the private sector, nor is it accurate to assume that eliminating risk is essential, or even desirable, in seeking to motivate private initiative in housing."

result will serve the interests of both parties. For example, if a project is structured to insulate the private developer from cost overruns, the normal financial incentives which make private sector builders more efficient than public agencies in producing lower cost housing units will no longer operate. On the other hand, builders should not suffer economic penalties due to delays in completing construction which are outside of their control, such as lack of timely public utility hookups, inspections, or agency review processes. Finally, while public agencies cannot be motivated to perform their tasks efficiently by profit incentives, other means such as promotions or bonuses must be found to reward performance for public managers. Understanding and respecting these differences should allow project planners to tailor programs to each party without undermining the objectives of the joint effort.

Defining National Policy

The strategies for facilitating private initiative range from full-fledged national strategies of privatization to mixed approaches where public funds are used to promote various private sector activities.

Governments which wish to attract private sector participation in housing finance and housing production must first examine national policies to determine if they are conducive to private sector investment. Fiscal, monetary, exchange rate, wage, and trade policy all have potential for price distortions which result in misallocations of resources, loss of efficiency and contraction of private sector investment which will reduce growth in the economy.

Formulating a national strategy which will be supportive of private sector initiatives can be a major undertaking, but one which can achieve dramatic results. For example, in 1984 the People's Republic of China approved reforms and made major concessions in its planned economy to attract foreign investment and to stimulate the creation of private enterprises. The basic purpose of the economic reforms was to introduce market mechanisms within a state-controlled economy and begin to seek a new balance between each of these economic forces to achieve modernization. These economic reforms and privatization efforts were massive in terms of their implications for modernization and their impact on the largest single population in the world. China has been able to deal swiftly with inequalities and abuses in the marketplace that initially arose as urban economic reforms were introduced through changes in laws and regulations. It is currently attempting to find a delicate balance between support for the introduction of market economic forces and liberalization of its centrally planned economy.

In more limited ways, a number of countries have embraced national strategies of privatization. Both Barbados and Zanzibar have taken such an approach by beginning with a national strategy or plan for increased privatization of the housing sector. In both cases, broad policy issues were debated by government until a consensus was reached. The consensus resulted in legislative and policy changes which affected program activities and responsibilities of government agencies and led to new initiatives aimed at stimulating private sector housing activities and to modification of inhibiting regulations. Experience worldwide suggests that where the private sector has significant capacity, government should play a supportive role. Where private sector capacity is more limited, direct government action may be required to stimulate growth of a viable private sector housing industry.

A national strategy to encourage private participation in housing should create a policy and regulatory environment that supports development of the private sector. In the absence of such a policy environment, success in attracting private investment will be very limited.

Formulating a Private Sector Housing Strategy

Research and experienced observation of those developing countries that have most effectively met their shelter needs suggest shared characteristics of public policies and programs. These characteristics include:

Recognition of the significance of the shelter industry to national economic development

Developing country governments of widely varying

"Direct jobs in housing construction have been estimated to be about 10 percent of all formal sector jobs in developing countries."

political philosophies are faced with hard decisions regarding allocation of limited fiscal resources among different sectors of the economy. Housing and urban services must compete for investment with industry, agriculture, education and other sectors. In making choices between sectors, a common misperception is that shelter investment uses scarce capital resources without producing as many economic benefits (i.e. employment generation and capital formation) as, for example, manufacturing and agriculture. To the contrary, shelter does have a significant impact on national and local economic development.

The shelter industry accounts for a substantial proportion of most countries' economic activity. Housing is a major creator of jobs, both directly and indirectly. Direct jobs in housing construction have been estimated to be about 10 percent of all formal sector jobs in developing countries. Construction's labor intensive character creates a high level of employment per unit of investment. Indirectly, construction generates demand for construction materials, furnishings, and related goods and services which translates into jobs in the manufacturing and services sectors. While little quantitative material is available on indirect job creation, a review of studies conducted in several countries indicates that the income multiplier for housing construction would be about two.

Some economists have suggested that governments should limit investment in housing to avoid diverting scarce savings and investment resources from other sectors, but the evidence does not support this conclusion. Experience suggests that the prospects of improved housing conditions and security of tenure can generate substantial savings at all income levels, savings well beyond those invested in shelter. (Christian, 1980) In addition, access to home ownership has been linked to greater investment of time in housing improvement, which translates into formation of 'sweat equity' capital. Through home improvement, individuals are able to transform labor into permanent assets where wage employment and other income producing opportunities are not available. The incremental approach to home building common in most developing countries is a clear example of this process.

LDC Economic Growth

In developing countries, residential construction is estimated to represent about one-third of all construction and about 15 to 25 percent of gross fixed capital formation. Construction is an important contributor to economic growth. In the 1960-1977 period, construction grew at an average annual rate of 7.1 percent compared to 2.8 percent and 7.6 percent for agriculture and manufacturing respectively. This construction growth rate is over twice that of total GDP in the same period where increases averaged 3.5 percent per annum (Nathan, 1985).

Thus, the shelter industry can play a powerful role in economic development as a creator of employment and stimulant to investment while also directly benefiting society through improved living conditions.

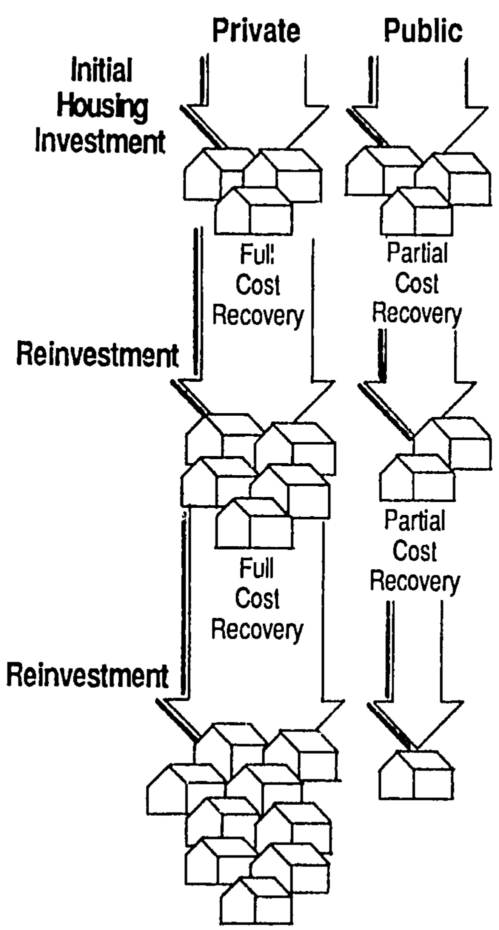
High degree of reliance on market systems and the private development of housing

In many developing countries, the housing market is not competitive: as noted earlier, governments regulate the flow of capital, the availability of land, and the standards under which housing can be built. Many governments have attempted to provide housing for the poor by direct construction. Unfortunately, government efforts to build housing for the poor with direct allocation of public funds usually misfires. Resources are never sufficient to meet the need and governments are usually reluctant to build housing at standards which are truly affordable by low-income households. Similarly, government attempts to intervene in other aspects of the housing market seldom work in the manner intended.

In most countries, people can build their own houses if given access to land, services and credit. The public sector almost always does best to withdraw from the business of building houses and to work to mitigate or remove market imperfections. At a minimum, the outcomes of government policies and programs affecting the housing market need to be carefully considered so that private and public resources are able to flow consistently with government's objectives.

Cost recovery in the provision and maintenance of housing and urban services

Cost recovery in the shelter sector means that government programs, whether the private sector is involved or not, are designed so that the beneficiaries of the programs can afford to pay for the housing or services received to the maximum extent possible. The objective of cost recovery is to minimize government subsidies and to reduce the distortion of the private market caused by those subsidies. Real cost recovery offers the opportunity to increase the quantity and quality of housing by tying standards and government resource expenditure to the ability of beneficiaries to pay for that improved housing. Government's lack of concern for full cost recovery affects the willingness of the private sector to provide shelter, particularly for low-income families. When cost recovery is not practiced, government is subsidizing the costs and, therefore, affecting the market price for housing, thus removing incentive for private sector participation.



By definition, the private sector attempts to fully recover the costs of the product it provides plus make a profit. Government is often less concerned with recovering the costs than it is with the perceived social benefit obtained from expenditures. In many developing countries, government programs in the shelter sector ignore the concept of cost recovery. Shelter programs for civil servants and low-income families, in particular, are viewed as a deserved social benefit. However, when government resources are limited, cost recovery is an important tool to expand the impact of scarce resources. Recovered costs can be reinvested to create additional housing. Thus, limited resources are leveraged and the volume of housing expands. A cost recovery program requires full evaluation of the real costs of providing shelter. Unfortunately, most cost recovery programs to date have attempted to recover only the direct costs incurred, and ignore a wide variety of indirect costs of subsidies. For example, government-owned land that is used for housing is usually thought of as having no cost other than possibly the cost of any infrastructure improvements which have been made. The cost of administering programs is ignored as is the time value of the money expended. Full costs are thought to be recovered even if many years go by before the money is actually received. The benefits of other uses for the money which are foregone as a result of recovering costs over time are not considered. Interest on money borrowed by government for these programs is an additional cost that is often ignored in recovery calculations. Also, potential losses due to loan default may not be taken into account. Losses result from poor initial loan underwriting standards and procedures as well as inefficient loan collection. Government loan programs also may be viewed by many as social benefits that do not require repayment. By ignoring these costs, the real cost of programs is not determined. Likewise, when programs are started, projections of the potential cost to government over time are rarely calculated to include these costs.

The challenge of cost recovery extends beyond estimating the true cost of housing to include determining the real ability of beneficiaries to pay and the market value of housing benefits. The link between cost and affordability is not made when programs are designed. As a result, subsidy benefits may accrue to those who do not need them or housing may be too costly to meet the needs of those families for whom it was designed. In order for cost recovery to be effective, beneficiaries must be able to afford to repay costs. Standards for land development and housing construction must be established which take into account the capacity of households to pay.

When households truly cannot afford to pay the full cost, government subsidies may be necessary. But direct subsidies are not the only solution. Those who can afford to pay can be charged a market rate that exceeds the real cost, and the 'profit' can be used to subsidize those who cannot afford to pay. Government land can be assigned a cost, a market rate for example, and the proceeds of the sale in excess of actual cost can be used to expand programs or provide subsidy assistance to those who cannot afford to pay the full cost. Such an approach invites abuse unless the standards used in the subsidized areas are well below those which would be accepted by higher income groups.

Government programs which seek private sector support in either the production or financing of housing must take into account the fact that the private sector not only seeks to fully recover costs but to make a profit. Government can facilitate private sector participation through provision of its own resources where the private sector does not believe cost recovery and profit are feasible, but government must also recognize that programs which do not recover full costs undermine private sector efforts to serve the same markets.

Rational administrative procedures that encourage private investment in housing and land development

A significant factor in the cost of housing may be the time required to obtain approvals to proceed with construction, obtain financing, close a loan, obtain title or clear some other administrative step in the long process of shelter production. The existence of restrictive standards may unnecessarily increase costs and inhibit private sector participation in the production of low-income housing. All too often, the administrative process itself may be so time consuming that private sector companies are unwilling to take the risk of undertaking low-income shelter projects. A six month delay in project completion, for whatever reason, would most likely absorb all of the projected profit and increase per unit costs above the level affordable by low-income households.

When government wishes to encourage private sector participation in the production of low-cost shelter, streamlining administrative procedures may be particularly effective. In an effort to encourage private development, some governments have created an administrative unit to process all governmental approvals needed to build a project. When properly administered, such an approach can significantly reduce the time required for administrative approvals and eliminate the risk that bureaucratic delays might adversely impact a project. Even with a coordinated governmental review and approval process in place, there may be other areas where modification of administrative processes could be helpful in reducing project costs. For example, the process of obtaining title to individual lots often takes longer than building the housing units, thus causing a delay in the critical step of transferring title from the builder to the purchaser. Such a delay is very costly to the builder who continues to pay interest on the construction loan until the actual day the sale transaction occurs. Governmental efforts to improve administrative procedures and to be responsive to the needs of private builders and housing finance institutions can be quite effective in lowering the cost of housing generally and in stimulating greater private sector involvement in the production of low-income shelter.

Assistance to Local Government Development Efforts

In order to effectively implement a national strategy for improving housing conditions, the public sector must have the administrative capacity and funds to pursue that strategy. Central governments as diverse as those of China and the United States have found that local government and local communities can more efficiently meet local housing needs than central government agencies, and are pursuing programs where local input and administration are essential.

In the United States, the federal government has moved from direct intervention in the housing market to providing funds to local communities which develop programs with local private groups and financial institutions (US HUD, 1984). In this way, local governments have been able to obtain financial participation from the private sector and, in effect, leverage public sector funds and obtain private sector expertise so that more housing activity can occur to benefit targeted low-income households and areas than would be possible using only government resources. One of the key factors making these programs successful in the presence of local governments and community groups capable of participating in joint efforts with private sector institutions and investors.

Most less developed countries do not have an administrative system in place which links policy decisions at the national level with project planning and capital budgeting at the local government level. In the absence of such a system, no national program of any kind is easily implemented. Centralization of authority is most governments' approach to the lack of a system for effectively influencing local development decisions. This results in weak and ineffectual local governments in most LDCs.

Assisting local government development efforts is an approach aimed at creating the capacity within the public sector to develop and participate in public/private initiatives. Without capable public sector partners, at both the central and the local government level, projects with the private sector may have limited success because of such factors as weak project design, slow regulatory reviews, insufficient funds or poor administration of funds. Strengthening public sector capacity may be essential in many cases to implement successful public/private initiatives.

Development of public and private financial institutions

The full benefits of private initiative can only be realized in a supportive environment in which the basic public responsibilities are executed efficiently and private sector institutions have the capacity to participate. It is important that both public and private institutions are sufficiently developed to take a role in providing finance for housing.

The role of financial institutions is to mobilize funds and direct those funds to financing housing in an efficient manner. The institutions involved in this process constitute a housing finance system. In most developing countries, this system is rudimentary or non-existent. Most housing investment in developing countries is undertaken by individuals on an incremental basis using savings and other informal sources of funds, while financial institutions play a very limited role, usually providing limited funding to high-income individuals or beneficiaries of government sponsored programs, in particular civil servants. Few, if any, institutions specialize in or take an active role in financing housing.

Private sector financial institutions typically finance commercial transactions and provide some lending facilities to individuals on a short-term basis. Institutions are hesitant to lend for long-term mortgages because economic conditions, particularly inflation and economic uncertainty, favor short-term lending where risk is lower. Often financial institution management either lacks skills in long-term lending or believes that only high-income households are capable of making regular mortgage payments. It is also true that sources of long-term funding are limited and it is generally perceived that most people do not have the capacity to save with a financial institution. Despite the overwhelming evidence that all households, and low-income households in particular, save significantly to build in the informal sector, few institutions attempt to tap this private sector source of funds.

Government financial institutions have also had limited success in providing mortgage funding. Programs often emphasize funding for civil servants and for low-income households and many include significant subsidies and inefficiencies in operation that result in losses.

To encourage private sector participation in housing finance, governments can design housing programs that do not compete with private sector institutions and target programs where the private sector is unwilling to participate. Government can provide incentives to private financial institutions that reduce the perception of risk involved in lending for housing using credit, tax and interest rate policy. Government can also expand the private resources available for housing by using such mechanisms as guarantees and secondary market facilities. The objectives of such policies are to encourage financial institutions to develop new resources for housing lending as well as to redirect existing resources. In other words, private funds are substituted for much smaller government resources to undertake mortgage lending activity and develop the capacity to mobilize savings for housing.

Identifying an Initial Program

Assistance to the Private Sector to Stimulate Investment in Shelter

Public sector actions intended to stimulate private sector housing production take a number of forms. Among the forms are: joint venture projects where public agencies enter into contractual agreements with private enterprises for developing and selling or renting housing units; programs where the public sector provides specific services such as land assembly or the installation of infrastructure on behalf of private sector developers; and programs where incentives such as loans, loan guarantees, grants, or tax concessions are offered to stimulate private sector initiatives. Removing obstacles, such as unrealistic building or planning standards, and eliminating disincentives, such as rent control, may be an equally important means of stimulating private sector housing production. All of these elements are discussed at length in Part One of this monograph. The crucial 'getting started' activities include assessing ways to remove public impediments to growth and stability of a private housing sector, and formulating initial public/private efforts which respect the needs of both the government and the private sector.

Reinforcement of Informal Private Sector Efforts
The simplest and perhaps the most effective way to initiate a program to encourage private sector initiative is for government to analyze the present efforts of the informal private sector and to seek ways to enhance its performance. This is the basic concept behind sites and services projects which provide assistance to individual households during the house consolidation period as well as a key component of virtually all neighborhood upgrading projects.

There are many viable approaches to public assistance for the informal private sector. A program of assistance which makes use of a system already in place has distinct advantages over programs which depart radically from the norm. In formulating a successful program, the key is a clear understanding of how the informal sector actually works in a particular country and what the financial, regulatory and other constraints are which affect it.

Reinforcing present efforts of the informal private sector is an approach designed to tap the skills and resources of an important part of the private sector and increase their capacity to produce shelter. What is needed here is an understanding of what public sector actions are required to stimulate the informal sector to increase its capacity and to improve the quality of the shelter it produces.

Refocusing of Formal Private Sector Efforts on Low-Income Housing
In many countries, the formal private sector is quite active in building and financing housing for the middle and upper-income market. An opportunity exists in these situations for public actions aimed at demonstrating the viability of expanding private sector activities to serve the low-income housing market.

The United States has adopted this approach and is directing its recent efforts toward involving private sector institutions in programs supporting improvement of low-income housing, a market not generally served by these institutions. Funds are leveraged at the local level through partnerships with local government, community groups and financial institutions (US HUD, 1983, 1984). Through such techniques as interest rate buydowns, blending, guarantees and grants, public funds are used, in effect, as 'seed' money to provide incentives for private sector financial institutions to commit their own loan funds to projects for low-income households.

Refocusing efforts of the formal private sector on low-income housing is an approach which uses existing private sector capacity and, through coordinated actions with the government, creates conditions where formal private sector institutions can see benefits in changing their normal ways of operating. For this approach to be successful, program design must take into consideration the capacity and requirements of both the public and private sectors, in such areas as the risk, amount and type of incentives which may be required, the cost vs benefit of such incentives, and the administrative skills of participants.

Developing an Appropriate Approach

At the outset, overall strategic decisions should be guided by an assessment of key issues. This assessment should provide the basis for determining a strategy for stimulating private sector initiatives. To determine specific programs in the housing area, questions such as those to the right will need to be answered.

In all cases, policies should be examined, public and private sector capabilities assessed, existing programs evaluated, housing needs determined, and the overall economic environment which affects shelter ascertained in order to develop strategies which can facilitate private sector participation in shelter. It will be important to determine the appropriate division of labor between government and the private sector, keeping foremost in

What are appropriate private sector and public sector roles in providing housing services?

What are the key constraints to joint public and private efforts and how can they be overcome?

How can housing finance and equity investment levels be expanded, particularly for low-income households?

What incentives, including subsidies, are needed, if any, for private sector participation? What will these incentives cost?

Can pilot programs be used to test specific approaches to stimulate private sector initiatives, and if so, in what areas?

What level of technical and financial assistance is needed? What potential sources exist? How much can realistically be expected?

How and when should the effectiveness of a policy of privatization be evaluated?

mind the need to have government expend its resources on those things individuals cannot do for themselves.

In exploring alternative approaches to increased private sector participation in housing, LDC government officials have various choices. In some countries, the most reasonable approach will be to begin with existing private sector housing activities and to find ways of stimulating and encouraging an expansion of these efforts or a broadening of the market segment being served. In other countries, more dramatic first steps will be needed before the private sector can be expected to participate in housing. In these cases, policies should be examined first with programs growing out of strategies which address constraints as well as incentives needed to build a vital private sector housing industry.

In determining which strategies would be most effective in achieving public policy objectives, governments need to carefully assess the situation in the country in general and the shelter sector in particular. Simply put, governments must establish policy objectives, determine the capabilities and the limitations of the public and private sectors, and adopt approaches, with private sector input, that reflect these assessments.

The questions on the opposite page are designed to provide a planning framework which will encourage analysis of current conditions and formulation of a strategy and programs which reflect those conditions. As answers are determined, the essential elements of a private sector program will emerge.

What is the capacity of the public sector?

What programs is government currently pursuing? How effective are these programs in meeting objectives and why have they succeeded or failed?

What budget and other financial resources are available? Are funds adequate to administer current programs or to add others?

What organizations have responsibilities in the shelter area and are the roles clear, well defined and coordinated?

What is the level of technical expertise in shelter development and finance? Do particular institutions need to be strengthened? If so, how?

What policies, regulations and standards affect the shelter sector? Are they effective or should they be revised, and if so, in what ways? How do they facilitate or hinder private sector participation in housing?

What housing incentives are being provided? What subsidies? What is the cost of subsidies and incentives? Are they necessary?

In what ways can the costs associated with producing shelter be recovered?

What is the relationship between the public and private sectors?

What is needed to facilitate the two sectors working together?

What is the capacity of the private sector?

In what areas does the private sector operate and what is its technical expertise in land development, construction and financing? Which areas could be strengthened?

Are private sector firms well-managed, profitable, and investing in the local economy? What factors affect this performance?

Is capacity widespread among many firms and individuals or is it confined to a few organizations operating in particular areas, i.e. what level of competition exists? Do public sector entities compete with private sector firms?

Do private sector firms have adequate access to manpower, equipment, materials, land and money? What factors affect private sector access to these inputs?

Does the private sector have the resources and capacity to expand activities? In what areas?

What is the capacity, both technical and financial, of the informal sector? In what areas is the informal sector active?

What is needed, if anything, to strengthen private sector capacity to provide shelter?

What is the shelter situation in the country?

What additions to the housing stock and what level of upgrading are needed to meet current and future needs?

How much of the needs are being met? By the private sector? By the public sector?

What are the impediments to needs being met?

What are the constraints on converting shelter needs into effective demand?

What has been the role of governmental agencies and international assistance organizations?

How effective has this assistance been?

What type of assistance is needed and what can be expected in the future?

What is the economic situation in the country and how does it affect the shelter sector?

How are different population groups affected?

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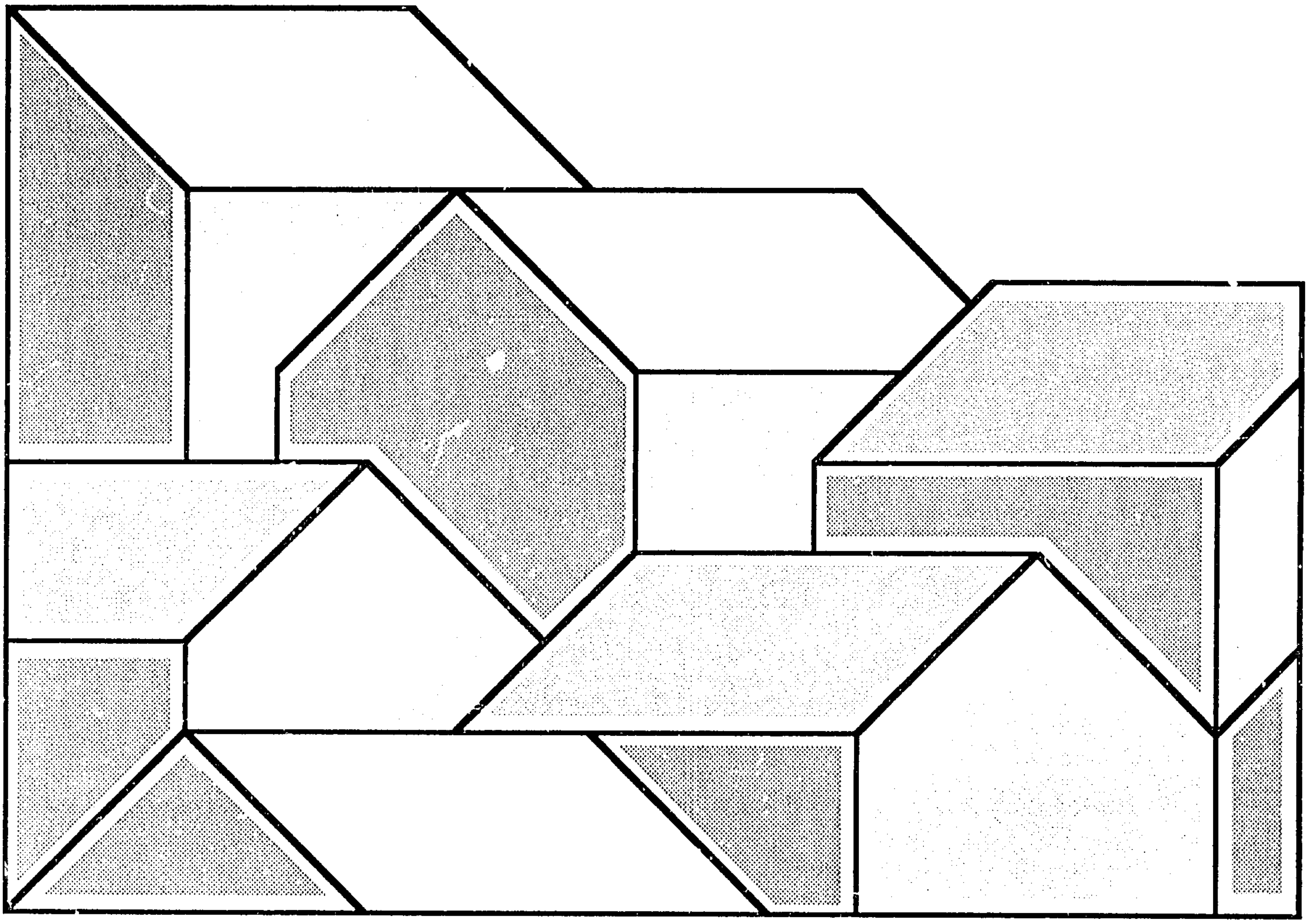

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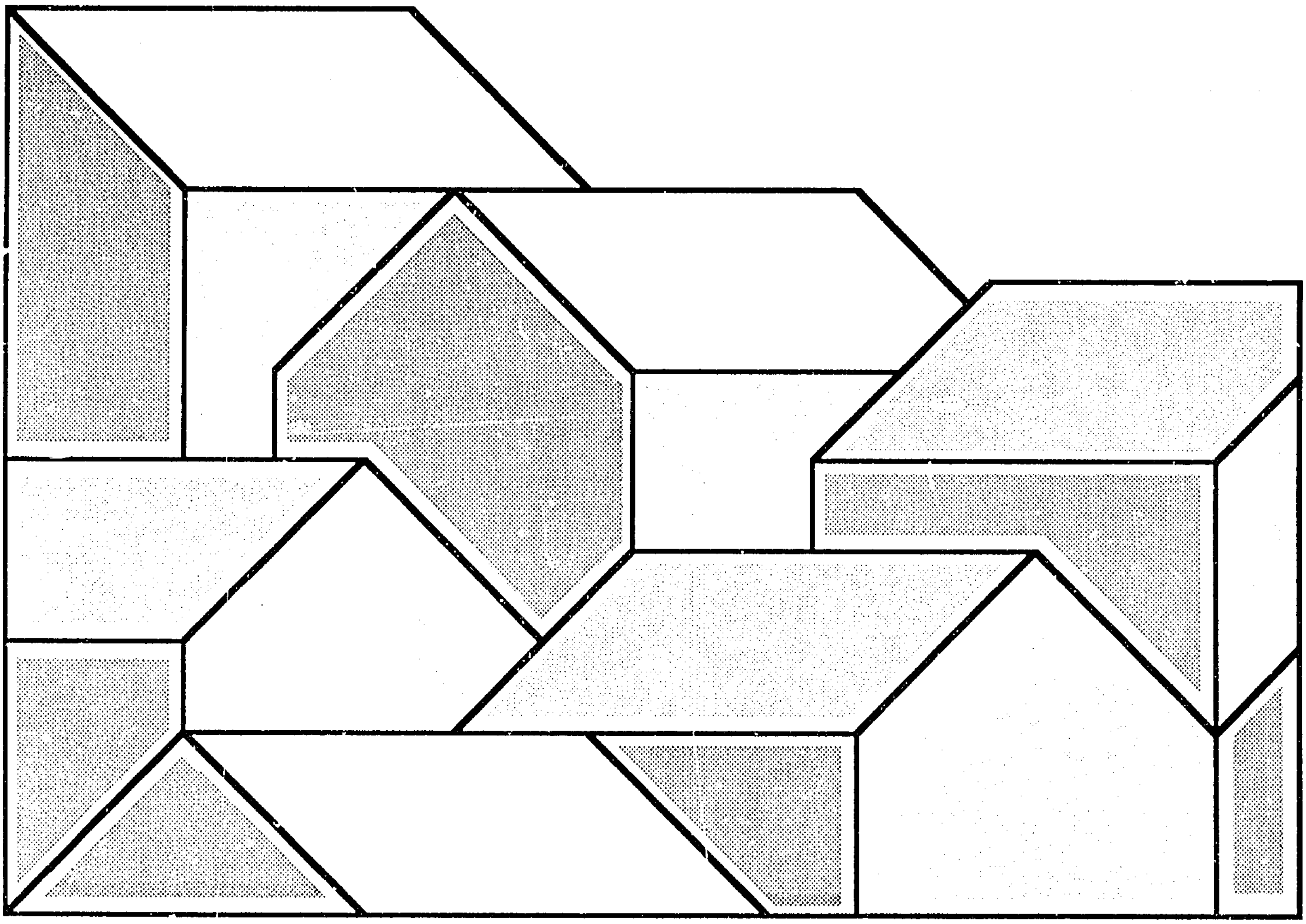

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