

Indonesia:
Housing Sector Assessment

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Housing Sector Assessment Executive Summary

There was an extensive examination of the Indonesian shelter market in 1988 under a study done by the Urban Institute and funded by the World Bank. The single most important conclusion of the study was that most Indonesians acquire housing services through transactions in "informal" markets and that these informal markets work relatively well. These markets are relatively efficient at providing housing commensurate with the purchasing power of the populace. Thus, as real incomes have steadily risen, so has housing consumption. Problems ascribable to poorly developed housing markets, such as difficult job mobility, excessive commutation time, and multi-household sharing of living or kitchen space generally have been avoided. The situation is definitely not as sanguine with respect to housing-related infrastructure. Public provision of water, sanitation, and drainage and sewer facilities has lagged far behind development.

Partly because of the reliance on informal development, credit has not played a significant role in the acquisition of housing for most Indonesians. However, this is likely to change rapidly in the next stage of economic development, both because the financial sector is developing a greater interest in retail banking and consumer lending and because of the rising share of households seeking housing units and housing credit in the formal sector.

Up until recently, the government has played a major role in the development of formal-sector housing, both through providing subsidized credit and through actual construction activities. More recently, private-sector developers and financial institutions have become more important market participants. However, the legal and institutional infrastructure needed to support large-scale, low-cost formal sector construction of housing not been fully developed. The most important issue facing the GOI is to facilitate this process whereby the private sector replaces the public sector in formal sector development and formal development replaces informal development. The most important way to achieve this is to redirect government efforts from direct participation in the housing market towards improving the legal and institutional infrastructure for formal sector development and housing credit. These actions should markedly reduce the cost of formal development, improve access to housing credit, and reduce the volatility of house prices.

This policy environment suggests the need for two types of policy advice to the GOI and other important actors. One is detailed technical assistance on issues of land policy, on infrastructure standards, on development regulations, on secondary mortgage market options, and possibly alternative mortgage instruments. The second type of advice is more macro perspectives on the efficient role of the public sector in housing development. Only with a commitment to low-cost, private-sector, formal-sector development will all of the detailed technical advice be effective. Achieving the political commitment may require significant assistance of the "big-picture" type.

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INDONESIA FINANCING BASIC SERVICES PROJECT

Housing Sector Assessment

1. Overview of the housing sector

There was an extensive examination of the Indonesian shelter market in 1988 under a study done by the Urban Institute (U.I.) and funded by the World Bank.¹ The single most important conclusion of the 1988 study was that most Indonesians acquire housing services through transactions in "informal" markets and that these informal markets work relatively well. However, quantity and quality of housing structure is high by comparative standards and, more importantly, markets are relatively efficient at providing housing commensurate with the purchasing power of the populace.² Thus, as real incomes have steadily risen, so has housing consumption. Problems ascribable to poorly developed housing markets, such as difficult job mobility, excessive commutation time, and multi-household sharing of living or kitchen space generally have been avoided.

Several specifics may illustrate the situation. In physical quantity, housing production kept pace in the 1980s with rapid urban growth (See Table 1). Between 1980 and 1990, the average size of households declined over 10 percent in urban areas, despite a rate of population growth of about five percent per year. In 1989, the median size housing unit was about 59 square meters in urban areas, up from 52 square meters in 1980. In the country as a whole, more than 80 percent of the units exceeded 30 square meters and sixty percent of the units have two or more bedrooms (Statistical Yearbook of Indonesia, 1992). The great majority of urban units were made of permanent materials, primarily concrete and brick, with tile roofs.

¹ Struyk et al, The Market for Shelter in Indonesian Cities, The Urban Institute Press, 1990.

² If housing were partly a "public-type" good, where significant societal benefits accrue from higher private consumption or there are no marginal costs of additional consumers, then simply seeking an effective market in housing would not be enough. Major subsidies or direct government provision could be appropriate. This is a distinction between housing and education or health care. However, some aspects of housing i.e., water supply and sanitation, do have important public good aspects. So do the legal and institutional infrastructure that support property rights, titling, and credit markets.

TABLE 1
KEY HOUSING INDICATORS

POPULATION AND HOUSEHOLDS:		1970	1980	1990
Population (000's)	Urban	20,742	32,890	55,231
	Rural	98,466	114,600	124,091
	Total	119,208	147,490	179,322
Population per Household	Urban	5.3	5.3	4.7
	Rural	4.8	4.7	4.5
	Total	4.9	4.9	4.5
Households (000's)	Urban	3,914	6,206	11,751
	Rural	20,514	24,383	27,576
	Total	24,427	30,589	39,327
ESTIMATES OF ANNUAL NEW UNIT CONSTRUCTION: (000 UNITS)			Annual Average 1970-80	Annual Average 1980-90
Construction for Annual House-hold Growth	Urban		229	554
	Rural		387	319
	Total		616	873
Estimated Annual Replacements for decay	Urban		51	89
	Rural		224	259
	Total		275	348
Estimated Annual Total New Construction	Urban		280	643
	Rural		611	578
	Total		891	1,221

Moreover, the land and housing market works reasonably well to supply the expanded housing stock where and when it is desired and in the appropriate types and tenure. New kampungs are established, housing in existing ones is upgraded, rental housing is available for recent in-migrants and young households, and an increasing supply of formal sector housing is coming on-stream as demand expands. During the 1980s, few of the signs of a deeply constrained and distorted market appeared, such as truly "spontaneous" shantytowns of flimsy structures, dangerous overcrowding of low-cost rental units, or rapidly rising real prices and rents.

The situation is definitely not as sanguine with respect to housing-related infrastructure. Public provision of water, sanitation, and drainage and sewer facilities has lagged far behind development. Nor has the legal and institutional infrastructure needed to support large-scale, low-cost formal sector construction of housing been developed. Fortunately for urban development, the private provision of public transport seems to have been encouraged. Moreover, the land market has been flexible enough to accommodate the development of new nodes of business activities in response to construction of roadways and to rising congestion in central areas.

Because of the failure of the public finance system to provide efficient levels of water-related and roadway infrastructure, housing growth has occurred usually in the absence of most on-site infrastructure. However, it may be that the GOI approach of letting such growth occur where market pressures exist and then following later with the Kampung Improvement Program (KIP) was the best practical approach. First, the level of quality of infrastructure appropriate to the income levels of the residents is relatively low, certainly relative to formal sector infrastructure levels. Second, trying to forecast areas of development and pre-service the sites in advance of construction is highly problematic, especially through the cumbersome bureaucratic processes in Indonesia. It just may have been more efficient to come along later to "clean up the mess" than to constrain the land market.

How has all of this growth in housing been financed? The Urban Institute study found that over 90 percent of the acquisitions of urban houses have been self-financed, i.e., a private purchaser of new housing paid cash or inherited the house. Even if the 30 percent of owners who inherited their unit are removed and only recent purchasers are considered, still only 19 percent acquired their home with a loan of any kind. Of those who utilized loans, only 30 percent received long-term (10 to 20 years) loans from formal sector institutions. Another 30 percent received housing credit from their employer. Still another 30 percent benefitted from relatively short-term credit from family sources. High-cost informal-sector financing appears not to be an important source of funds for housing acquisition.

However, credit has played a more significant role in the financing of the purchase of newly constructed houses, especially for formal sector development. The government-

owned housing bank, Bank Tabungan Negara (BTN), has financed about 70,000 units per year over the last 10 years, about 10 percent of all new urban units and probably over two-thirds of the units built in the formal sector. The government-sponsored lender, Bank Papan Sejahtera (BPS), and the other commercial banks have generated fewer than 10,000 loans annually until recently.

Credit also plays a more important role in the acquisition of land. Typically, lots for informal development are sold on an installment basis over one to three years. This option is important, since land price can be as much as half of the cost of a simple house. Installment sales of land are simple transactions because little or no cash is needed by the seller to develop the land (since little infrastructure is provided) and construction is not permitted until the land is paid for.

Does the general need to rely on full upfront payment distort the market for housing? In principle, investment in housing would be more efficiently determined if funds could be cheaply intermediated between savers and those purchasing long-term assets such as housing. Households will purchase more housing and sooner in their life-cycle if credit is available. However, it appears that the basic ability of households to obtain an independent unit in the informal sector has not been severely constrained by the lack of formal credit. The costs of a basic, non-permanent structure in rural areas is minimal. The costs of a basic permanent structure in urban areas appear to be accommodated through land contracts, low basic building costs, and low standards of infrastructure. In both urban and rural areas, the higher levels of housing quality which could be achieved at initial construction if long-term credit were available are instead achieved through subsequent gradual improvements to the structure.³ This mild failure of the housing market due to lack of credit becomes more serious as real incomes rise and the higher standards of structure and infrastructure associated with formal sector housing are desired. In fact, formal sector housing developers see the limited availability of formal sector housing credit as an important impediment to expanding their market share.

Because the informal sector has had such a "laissez-faire" character to it in Indonesia, the housing problems of the poor are primarily related to their low purchasing power and not to inefficiencies or distortions in the housing market. Most importantly for the poor, markets in rental housing are active and relatively efficient and about 27 percent of urban households pay rent for their accommodations. There is no notably costly regulatory burden, including no rent controls. The public sector has not attempted to compete with private, small-scale landlords, who appear to readily supply accommodations of all types in response to market signals. There is little or no formal credit available for rental housing, but direct investment in rental housing appears to be a popular form of accumulating wealth or generating income in retirement.

³ An important exception to this lack of credit appears to be the Kupedes program of BRI of short-term loans for improving houses.

Although the poor endure low levels of structural quality primarily because of their lack of purchasing power, they endure poor water quality and sanitation partly because of failure of government policy to facilitate the provision of adequate infrastructure. Some of those shortcomings are being addressed by two on-going AID-funded programs, the Private Participation in Urban Services Project (PURSE) and the Municipal Finance Project (MFP). Another key failure of government policy has been the absence of low-cost methods of establishing land title or other occupancy rights. This has left lower-income households exposed to uncertainty with respect to term of occupancy of a site and sometimes to inappropriate loss of property rights.

As the Urban Institute study concluded, urban housing markets are primarily composed of "the large and productive [informal] sector serving a broad share of the income distribution [that is] vibrant, responsive to demand, and flexible enough to adjust to changing conditions."⁴ However, as Indonesia reaches higher levels of development, the demand for housing will grow more rapidly.⁵ In this case, certain limitations to the current systems will become more critical. These limitations relate to the areas of housing credit, land titling, regulation of formal-sector housing development, and provision of infrastructure. In order to better assess these areas of policy concern, the current situation with respect to each of these will be examined in more detail, after some comments on the formal sector provision of housing.

2. Formal-sector housing

The formal sector is the relatively more inefficient, distorted and difficult to understand portion of the housing market in Indonesia. But it has been growing relative to the informal sector in the last decade (see Table 2). For example, formal sector development by private developers averaged 46,000 units from 1980 to 1984, 60,000 units from 1985 to 1989, and 71,000 for 1990-91.⁶ In addition, the government-owned home

⁴ Struyk et al, The Market for Shelter in Indonesian Cities, The Urban Institute Press, 1990, page 112.

⁵ Malpezzi and Mayo, "The Demand for Housing in Developing Countries," Economic Development and Cultural Change, Vol. 35, 4, July, 1987, the authors found that investment in housing occurs at the highest rates in countries in the middle ranges of development. Presumably, once basic needs are met, improved housing becomes a prime target for incremental income.

⁶ There are no annual data on informal housing production. Formal-sector production is defined here as units produced by members of Real Estate Indonesia, as compiled by REI since 1980. Other data compiled by the Central Bureau of Statistics and published by Data Consult on private developer activity shows about the same level of activity on average, but differs markedly for specific years from the REI data.

TABLE 2
HOUSING UNITS CONSTRUCTED BY MEMBERS OF REI

YEAR	LOW-COST UNITS (LESS THAN 71 SQ. METERS)	MEDIUM COST UNITS (71 TO 200 SQ. METERS)	LUXURY UNITS (MORE THAN 200 SQ. METERS)	TOTALS
1980	12,506	7,099	684	20,289
1981	9,235	3,636	908	13,779
1982	26,795	18,565	2,287	47,647
1983	96,635	28,566	3,819	129,020
1984	17,150	2,415	569	20,134
1985	23,490	3,589	377	27,456
1986	22,702	4,199	231	27,132
1987	22,285	5,960	566	28,811
1988	126,040	13,438	632	140,110
1989	58,814	13,638	2,509	74,961
1990	75,963	8,698	1,693	86,354
1991	43,192	11,546	827	55,565

Source: Real Estate Indonesia (REI)

builder, Perum Perumnas, averaged another 26,000 units annually from 1987 to 1991. Visual and anecdotal evidence is that formal sector building of housing has accelerated recently. In any case, formal sector development will play a predominant role eventually in providing urban housing. Thus policy with respect to this sector is becoming more important.

What defines a house as being in the formal sector? Much as in the case of formal versus informal enterprise, formal housing is that which is developed within the full structure of existing laws and regulations. As a practical matter, this does not necessarily mean that formal housing is in full accord with all rules, regulations, and laws, but that the development process does attempt to (more or less) follow, or appear to follow, officially recognized procedures.

Why does anyone bother with formal housing when informal development avoids so many costs? Presumably, the key advantages are:

1. the provision of full infrastructure, including on-site roads, drains, water, lighting and so on;
2. the desire to access formal sector finance, either because of available subsidies or simply the desire to obtain a large amount of housing at one time, rather than to acquire it incrementally; and
3. a sharply higher likelihood that property rights will be legally defensible against strong economic and political interests.

It is often noted that, unless subsidized by government or employers, the formal sector serves only the upper-income strata, as if it could not make a profit from lower and middle-income housing. In principle, lower and middle-income housing can be just as profitable. Thus, a more useful perspective may be that either (1) only those with higher incomes are willing to pay the cost of the advantages of formal development, or (2) they are the only ones with access to enough credit to avoid building incrementally. This situation may simply reflect a strong increase in the desire for these advantages as income rises, but it may also be encouraged by the presence of large fixed costs of dealing with regulatory barriers, which decline as a percentage of the total price for a house as the value of structure and site advantages rises. The extra 10 million rupiahs to go "formal" is negligible for a 200 million rupiah house but overwhelming for a 10 million rupiah house. In addition, limitations to the widespread availability of credit for housing may be operating. In either case, continuing growth in income levels and expansion of formal private sector employment and credit in Indonesia has meant, and will continue to imply, a rising share of housing coming from the formal sector.

Unfortunately, if the regulatory burden on formal development is not decreased, the net costs to society will expand as formal development expands. How large are these costs?

Not enough research has been done on the topic in Indonesia to give an informed estimate. A partial indication is that the processing related just to transfer of land title was found to cost between 10 to 29 percent of the land value in the Urban Institute study. Work in Malaysia under admittedly more onerous regulations found that house prices were increased by 50 to 100 percent due to all regulatory delays and expenses. More casual evidence can be gleaned from the newspapers and personal conversations about the large number of "middlemen" and large amounts of payments necessary in Indonesia to take a project from site assembly to receipt of clear land title by the new residents.⁷

Because the development process is cloaked in illegal and extra-legal transactions, analysis of the way it actually works can be more difficult than understanding the informal sector. And actual allocation of land and development credit is likely to be more distorted than if the system were transparent, but still much less distorted than if the process were not "facilitated" by side-payments and intermediaries. These issues are examined in greater detail below.

3. Current Government Programs

There are at least five major GOI efforts to improve the functioning of housing markets and/or the distribution of housing quality across income groups. The largest one is the provision of subsidized credits for the purchase of "low-cost" housing. This program is financed by below-market credits directly from the Bank Indonesia, channeled through both the government housing bank, BTN, and private commercial banks. The subsidy conveyed by these credits is about one-third to one-half of the loan amount and the loan amount can be up to 90 percent of the cost of the house.

Perhaps in response to criticism of the targeting of the subsidies, the GOI has steadily reduced the subsidy received by purchasers of higher-quality house types. Only two house types are eligible for explicit subsidy, the "low-cost" type, of floor space up to 21 square meters, and cost of up to about Rp. 8 million, and the "very low-cost" of floor space up to 36 square meters, but of very minimal finish (reflected in a very low price ceiling of about Rp. 4 million).

⁷ An unrelated example of how a regulatory system can be quite costly is provided by an article in The Jakarta Post on October 13, 1993 that asserts that the "simple" task of renewing a driver's license is so difficult and time-consuming that one of the many "middlemen" can charge Rp. 75,000 to 125,000 to complete the job. Multiplying this amount by the number of permissions needed to build in the formal sector could be an indication as to the impact on housing costs.

These restrictions do not, in principle, imply tight targeting of the subsidy to the lowest income levels, but the targeting appears to be much tighter than at the time of the Urban Institute and World Bank studies. Households with incomes as low as Rp. 120 to 150,000 per month can carry the subsidized loans for the very low-cost houses. These incomes are at the bottom end of the civil service pay scale, and somewhat below median incomes. Household income of Rp. 300,000 or more are needed to buy the "low-cost" units; such an income is probably above the median income, but it appears to be relatively attainable. Information on actual incomes of recent borrowers under these subsidized programs is not available, and they could be much higher than the minimum incomes noted here.

The second major program of the GOI in this sector is the actual production of low-cost houses through the state-owned construction company, Perum Perumnas. The direct subsidy available to this operation appears to be minimal currently, but some indirect assistance is gained through favored access to land and infrastructure. Over 80 percent of the units built by Perumnas are of the low or very low-cost type (it is not clear why this figure is not 100 percent). Historically, Perumnas had been the only formal-sector builder of these types of units, and thus worked closely with BTN. However, private developers have been permitted to enter that market. Private developers also have "obligations" under the 6-3-1 rule (discussed below).⁸

A very recent GOI initiative is intended to complement the activities of BTN and Perumnas. The scheme involves a deduction from payroll of as much as 5 to 7 percent of base salary at lower-levels and 2 to 3 percent at higher levels. The savings will accrue to BTN and appear to provide BTN with a substantial source of low-cost funds. No interest will be paid on the savings, nor will interest be charged on loans under the scheme. Loans are available only for a 10 percent down payment on a low-cost home for those civil servants who have not owned a home previously. All others receive back their contributions at the time of retirement.

⁸ An important digression is needed here. While one will find references to "low-cost" houses or "houses financed through subsidized BTN loans," it is not usually clear what exactly is being referred to. The key question is whether a middle range of houses of up to 70 square meters in space and much higher quality finish, and thus prices, are included. These houses used to benefit from GOI subsidies to BTN, but not today. Similarly, Perumnas used to build such houses, but only builds relatively few today. However, the 6-3-1 rule for private developers refers to such houses as qualifying for "low-cost" status and thus REI does not collect data on the number that are truly "low-cost." Unfortunately, the range between a low-quality 36 square meter house and a high quality 70 square house encompasses a huge portion of the income and housing consumption range in the society.

This scheme seems to have taken a life of its own through high-level sponsorship (the President will chair the governing board) and its eventual form, function and impact have not benefitted from any systematic analysis. It may be viewed as a starting point for a Singapore-style general forced savings plan for financing housing. In any case, it seems that many aspects of the plan are fluid still and it would benefit from additional analysis.

The fourth effort by the GOI is the 6-3-1 plan, that requires that private developers build houses in a ratio of six "low-cost" ones for every three "medium-cost" ones and one luxury unit. Apparently, this plan has been in effect since 1974 but has generally been ignored. It was reformulated earlier this year and has been the subject of much rhetoric, presumably to counter the impression that enormous amounts of resources are flowing towards luxury houses.

The full details of the program do not appear to have been translated into English at this point in time and major questions remain as to how it would be enforced. What does seem to be clear is that "low-cost" in the program includes houses up to 70 square meters (and perhaps some price ceiling).

This definition probably negates the impact of the program, since REI members in total have built to excess of that ratio all along. However, if the program eventually includes a requirement that each development fit these ratios, then there could be effects on the proliferation of "exclusive" or high-prestige developments.

If the intent is to truly tax higher-priced houses to subsidize lower-priced houses, this could be more efficiently achieved by:

1. defining low-cost in the same manner as the subsidized credit programs, and
2. requiring that developers of all other housing acquire the requisite number of "certificates of completion" from the builders of the low-cost houses in order to get a building permit.

This would cause a market in such certificates to arise that would put a clear value on the benefit accruing to the building of "low-cost homes and the "tax" being paid by those seeking higher cost homes. It would be relatively easy to enforce and let developers specialize in their marketing without a lot of regulatory apparatus relating to what qualifies as a "joint project." On the other hand, if the 6-3-1 plan is to primarily remain an approach to mollifying public apprehensions about luxury development, hopefully it does not engender a regulatory burden for enforcement.

The fifth GOI program, the Kampung Improvement Program, is generally regarded as efficient and effective for upgrading the living conditions of the lowest half of the urban income distribution. There seems to be some concern about the emphasis in the

program on walkway and roadway improvement, and about the high degree of centralized control. This study has not considered any of these questions in detail.

4. Housing credit

As noted above, credit has not played a significant role in the acquisition of housing for most Indonesians. However, this is likely to change rapidly in the next stage of economic development, both because the financial sector will be developing a greater interest in retail banking and consumer lending (and the government policy permits it to) and because of the rising share of households seeking housing units and housing credit in the formal sector. Financial sector policy will become more important for housing, and housing policies will become more important for the financial sector.

In the case of formal sector credit, as in the case of on-site infrastructure, policymaker concern about the shortcomings should be moderated by recognition that many alternative policy options are much worse. A common alternative, government provision of housing credit, usually entails inefficient and inequitable subsidies, both explicit and implicit. Explicit subsidies usually take the form of a reduction in the interest rate, the present value of which may easily be half or more of the loan amount. Such subsidies are inequitable because only a relatively few households can receive them. They are inefficient both because they require a larger government taxation effort to finance them and because they are usually available only for housing units that meet inappropriately high standards of housing quality and infrastructure, units that would not be purchased except in order to benefit from the financing subsidy (and whatever subsidies may also be provided to the development process).

The implicit subsidies take the form of inappropriate underwriting standards or lax enforcement of repayments. For both reasons, repayment rates are usually unacceptably low, with the consequence that 1) actual subsidies are larger than planned subsidies, and 2) the public perception grows that housing loans need not be repaid. Both of these consequences can be costly to a society.

The Urban Institute study devotes considerable attention to existing GOI programs to channel subsidized credit to housing. The principal vehicle for this effort has been the state-owned Bank Tabungan Negara (BTN) through special programs of subsidized lending.

The present value of the subsidy under these programs is in excess of one-third of the amount of the loan.⁹ (The interest rate is fixed at 10 or 12 percent, in contrast to a

⁹ The criticism had been made that the total value of these subsidies to housing credits is three times that for the Kampung Improvement Program (KIP), which directly

floating market rate currently at 18 percent.) This large subsidy does not lead to the beneficiaries directly consuming more housing, since most of the eligible units are either 21 square meters or 36 square meters in size, actually less space than what the purchasers would probably buy on the informal market (since the borrowers under the program are not in the lowest deciles by income).¹⁰

Up to the present, though, the value of such subsidies has not been significant relative to the GDP or the GOI budget. There appears to be increasing interest, though, among policymakers to expand the production of "low-cost" housing units by the formal sector and provide subsidized loans for those additional units. Thus, private banks are being pressed to participate (with the benefit of some government subsidy, but not as much as BTN receives) and BTN may receive more resources to expand its "low-income" lending.

At the time of the U.I. study, the amount of unsubsidized housing credit provided by the financial sector was small relative to that provided for low-cost housing and relative to the production of formal sector housing. Since 1988, however, two important shifts have occurred. First, as noted above, BTN has nearly eliminated the subsidy to middle-income units. Since these units are affordable only by upper middle-income households, the subsidy to their financing was the basis for the Urban Institutes' criticism of the targeting of GOI subsidies, and had the effect of deterring private, unsubsidized entrance into housing finance.

Second, a veritable revolution has taken place in the financial sector, due to deregulation. The result has been a continuing rapid rise in the overall financial depth of the economy, including greater popularization of consumer banking, including checking and savings deposits and credit cards and consumer lending. Most of this growth has been among the private banks, and a number of them appear to have chosen a strategy of aggressive retail banking, as reflected in the rapid expansion of branches throughout Indonesia. For example, total bank deposits tripled between 1988 and 1992,

improves living conditions and property values among the low and moderate-income households (U.I. study, p.10, p.308). However, since moderate-cost houses no longer benefit from a GOI subsidy, the expenditures may be closer to being equal.

¹⁰ In some ways, the small sizes of the units represent a reasonable compromise between formal and informal development. A core unit of 21 square meters really represents a serviced site with all needed building permits and certified title. Apparently, buyers of such houses immediately begin to add "informal" structure to their minimal "formal" structure. Similarly, buyers are not interested in simply serviced sites, because they do not have the capital and expertise for getting the permits needed to proceed with the "formal" development of the site. They would prefer to buy a minimum core unit as well.

but rose by 450 percent among private banks, to almost equal those in state-owned banks.

In addition, the private banks learned the perils of aggressive lending for commercial and industrial enterprises during the period of "tight money" policy that started in 1991. This experience has combined with 1) a strong demand for housing credit, 2) rising housing prices, and 3) the classification of housing loans as a 50 percent risk weight in calculating capital adequacy ratios, to create significantly greater interest in mortgage lending by several private banks. This interest burst into competing marketing drives in June of this year, soon after Bank Indonesia relaxed certain requirements for allocating funds to other uses.

Based on conversations with three of the banks which are now active in the mortgage market, their combined lending should exceed the total lending activity of BTN in 1993. Effectively, loan originations may double in a year, and the private market overtake the government-sponsored institutions.¹¹

Thus, at the same time as the GOI is considering expanding its subsidized housing credits to the lower income households, the private sector is showing strong signs of expanding unsubsidized housing credit. These may appear as consistent tendencies reflecting a general increase in the popular interest in housing credits and formal financial sector activity in general. It can also be seen as conflicting forces, since expanded subsidized credit can undermine the interest of private sector lenders in providing unsubsidized credit to the same audience.

Neither perspective may adequately capture the situation. The private banks admit that currently they are targeting upper-income households (incomes of at least 1 million rupiahs per month) and they cite three reasons for doing so. First, this clientele includes many potential customers for other banking services. Second, they tend to buy formal sector houses, a necessary but not sufficient condition for using the house as collateral. Third, the fixed costs of origination and servicing smaller loans cannot be adequately recovered through fees and interest charges.

Does this imply that government programs are needed to provide housing credit for lower and middle-income households? Not necessarily. For example, at recent rates of growth in real income, many middle-class urban households will be earning over one million rupiahs a month by the end of the decade. Second, the banks will find that there are only so many young professional households earning 5 million rupiahs a month and

¹¹ This may be a temporary phenomenon unless some kind of secondary market facility is provided to give the banks the liquidity of assets that they need to expand mortgage lending much beyond 20 percent of their portfolios. Such a facility could also evolve towards being a conduit for long-term institutional funds for housing.

buying luxury housing units. Competitive pressures should push some banks towards serving those with less income, although not those outside formal sector development. Third, if more of the new housing construction occurs within the formal sector, there should be an increasing opportunity for formal sector credit operations.

The situation is perhaps illuminated by the current activities of Bank Papan Sejahtera (BPS), a government-sponsored, privately owned bank specializing in housing finance for the upper middle-class. Within an environment of a rapidly growing financial sector, BPS is not growing, despite the supposed need for middle-income credit. (More information is needed to judge whether it is low demand for loans in this segment of the market or a lack of resources that is limiting the growth of BPS. What is clear is the moderate subsidies BPS received previously have been ended.)

The other government-sponsored housing lender, BTN, is reporting some growth in their lending, but this is occurring primarily in the upper-income portion of the market. Lending in the upper middle-income range (Rp. 500,000 to 900,000 per month) has declined relative to the lower and upper ranges, presumably because of the removal of subsidies to this group. If both BPS and BTN, which have a corporate mission to provide credit to lower and middle-income households, are not experiencing high levels of demand at unsubsidized rates, then why should private banks be pursuing this part of the market?

The key to understanding the market for housing credit to lower-income households may be to recognize that it is probably not the market price of credit that keeps it from being utilized by lower-income people. In fact, the local branches of the Bank Rakyat Indonesia (BRI), which serve mostly rural communities but some urban areas as well, are reasonably successful making short-term loans for housing improvement at a 32 percent rate of interest. More important barriers are the low share of lower-income houses which receive a land certificate, both because of the high cost of obtaining the certificate, and because of the "informal" origin of the house. In other words, the major constraint on the demand for unsubsidized credit on the part of lower and middle-income households is probably that they are not in the market for formal sector development. The opposite proposition, i.e., that they would be in the market for formal sector housing if institutions were willing to make them loans, seems unlikely, since there are at least two institutions (and to some extent BRI) willing to do so.¹²

In this context, how should the current government programs for lower-income households be judged? It appears that the purpose of the deeply subsidized programs is to facilitate the purchase of the formal sector houses being built for lower-income

¹² Of course, any binding constraint on formal sector credit will deter the construction of formal sector housing. It just appears that at the moment the greater constraint is the great cost of formal sector development.

households, both by the state-owned housing construction company Perum Perumnas (PP) and by private developers. The logic of policy seems to be that these households need and desire formal sector housing, but this is too expensive for them, so a subsidy is needed. The subsidy is conveyed through the credit provided for the home purchase, rather than directly in the price or through some other transparent grant assistance. The subsidized lending is not available for informal sector houses, but to the credit of the GOI, is available for the products of private developers, as well as for Perum Perumnas.

From the perspective of this analyst, there are good public policy arguments that there are substantial social and political benefits from bringing these households into the formal sector housing market. The subsidized credit provides the inducement to lower-income households to purchase a housing bundle that contains much more infrastructure and strength of land tenure than it would if they relied only on their own resources. However, this policy could be pursued more directly and efficiently through a direct grant or "downpayment assistance" combined with an unsubsidized loan, and perhaps some cross-subsidization through the 6-3-1 program. This approach would have the further benefit of encouraging the development of unsubsidized private-sector housing finance institutions.

Presumably, there are political concerns about appearances of "access" by all portions of the income distribution to housing credit that drive the choice of subsidy vehicle, although what is really being accomplished is greater access to formal sector housing standards. The unfortunate side-effect of such a policy is to perpetuate the notion that lower-income households cannot afford unsubsidized credit and to deter the appearance of private sector or NGO-sponsored housing finance intermediaries to serve that portion of the market.

5. Land-titling and land-market regulation

In Indonesia, the constitution gives the state strong rights to regulate the ownership and use of all land. These rights are not the same as ownership, but they are stronger than the claims of Western states to intervene in land issues as an exercise of "police power" for the public good. In practice, though, it appears that it is the specifics of land use regulations that are more important for housing policy than the broad principles:

In addition to the right of regulation, the government directly controls much land through state-related entities. However, much land is also owned by individuals under Hak Milik rights that approximate the fee simple status of most land ownership in the West. For a variety of reasons, though, much of the land developed into housing does not benefit from Hak Milik title. A variety of use rights are recognized in the basic land law, some of which include the right of using the land as security for a loan (see the Urban Institute study for a detailed discussion). As in the case of land use regulation, many of the problems in this area arise not from the general principles of land

ownership expressed in the basic land law, but in the specifics of how official bodies recognize and regulate the system.

Most donor-sponsored analyses of the housing market in Indonesia conclude that land-use issues are the single most important type of distortions in the market. Major concerns include:

1. The expense and difficulty of obtaining documented title,
2. distortion in the land-use conversion process, and
3. the expense and difficulty of obtaining required development permissions.

Fortunately, up to now there have been few other major restrictions on the land market, such as very inappropriate minimum lot size restrictions, green-belt requirements or growth restrictions of one sort or another. The major problems seem to relate one way or another to excessive expense of formal sector development and titling.

So far in the development of Indonesia's urban areas, these problems have not been a burden on most households. As noted above, most households, especially the lower and moderate-income households, have simply by-passed much of the formal development and titling process and met their housing needs simply and relatively cheaply in the informal market.¹³ But the costs of inefficient land use regulation, both in the form of charges and in the impact on the ready supply of developable land (and thus the volatility of house prices in response to economic swings), have risen as the role of formal sector development has grown.¹⁴

Despite the near unanimity on the need for reforms in this area, including frequent articles in the press, a sustained government effort to improve the situation has not been mounted.¹⁵ One reason for this may be that a huge potential for "unofficial" income is

¹³ The Urban Institute study estimates that the total costs of informal subdivision of land are 10 percent of the land price plus another 15 percent for provision of land for roads and services.

¹⁴ A publication by USAID, "Regularizing the Informal Land Development Process" (Volume 1 and 2), 1991, discusses some of the extra costs of meeting formal land development requirements and how these requirements are often excessive for lower-income housing development.

¹⁵ An important exception is in the area of processing of location permits (this precedes the building permit). The Urban Institute study found that in the mid-1980s, this took an average of nearly three years. Since a concerted effort on the part of the

generated by these conditions. The potential for income grows as the problems get worse. For example, rather than facilitate the processing of building permits directly, the Jakarta government is considering adding additional regulations to govern the activities of the "middleman" industry spawned by the current inefficient system (Jakarta Post, September 25, 1993). Regulating the circumventors of earlier regulations sounds like the surest way of compounding the "informal" revenue potential.

There appears to be heightened political sensitivity about the result of two other major policy problems in the area of land development. Both arise because of the tremendous pressures towards re-developing areas of earlier development. The traditional land title processes have worked reasonably well at a low cost to permit individuals to enjoy and improve their residences without fear of arbitrary competing claims. However, they do not provide protection against claims for redeveloping the property when these claims are backed by official legal processes that tend to recognize only other documented official legal processes. In other words, informal title is good protection against informal claims, but when the stakes are high enough to bring formal legal pressures to bear, only formal legal title is strong enough to resist (if even then).

The second policy issue arises from the practice of the government appointing a single entity as an eligible buyer of land within an area subject to redevelopment. In economic terms, the single buyer is granted "monopoly" power over the sellers (technically referred to as a "monopsony.") This creates the potential for profits from assembling sites for redevelopment, profits which, of course, are a source of unofficial income to those who have some say as to appointment of the land buyer.

Oddly enough, the distortions on land use associated with such a system are not severe as long as in fact there is competition among potential land brokers for the redevelopment rights and also competition to sell assembled sites to the eventual re-developers. Only if government officials or government processes consciously or inadvertently hold back land from the market will the price to the end user of land be artificially inflated. This may happen in Indonesia, either due to collusion among government officials or due to the ability of land brokers to hold large tracts of land off the market at no direct cost.

GOI to rationalize this system, average processing times are apparently less than one year.

6. Infrastructure

As noted above, the provision of infrastructure is, by far, the weakest portion of the housing delivery system in Indonesia. This is not surprising. The informal, private sector efforts that can so readily sub-divide land, market the plots, build houses, rent housing, and maintain and improve the houses, are not as capable of organizing the provision of shared or "public" services, particularly ones that are very capital intensive. The result has been reliance on a process of "muddling through," with poor levels of quality of water supply, sanitation, and vehicular access.

Extensive policy analyses have been completed on the issues related to infrastructure and many of those issues are being addressed in separate donor-funded projects. Much of this effort has focused on shortfalls in infrastructure in informal sector areas and in the macro-provision of infrastructure, i.e., main trunk lines, main roads, sewage treatment capacity, etc.. Some additional research and policy development may be needed for on-site infrastructure in formal sector development, including standards of infrastructure (especially for roads and drains) and the financing options for providing on-site infrastructure and public utilities, particularly for capital cost recovery through taxes and charges.¹⁶

7. Policy analysis in the housing sector

As in every part of the lives of the average urban Indonesian, change is coming in the housing sector at a rapid rate. Most additions to the housing consumption of individuals and the housing stock of the country continue to come from the spontaneous individual efforts of households. But pressures are rising for greater provision of housing through the organized formal sector, relying on formal-sector provision of infrastructure, formal-sector land titling, formal-sector land use regulation, formal-sector credit and formal-sector construction and marketing.

These pressures are arising on both the demand and supply side of the market. As young couples enter the housing market with significantly higher incomes than their parents, (and more frequently formal-sector incomes) and perhaps with two working spouses, they have the income and inclination to use credit to buy a "off-the shelf"

¹⁶ These issues may have been examined already as background preparation for sites-and-services projects for low-income households. However, casual observation suggest that there remains a wide gap between standards in informal areas and formal areas, a gap that may constitute a significant barrier to the expansion of formal sector development and credit.

completed house, rather than endure the slow irregular process of acquiring a plot and incrementally adding to the housing unit. On the other side of the market, there now appears to be a ready supply of would-be developers and would-be mortgage institutions interested in serving the formal market at current market prices.

The most important issues facing the GOI are probably associated with facilitating this process whereby formal development replaces informal development, and the most important way to achieve this is to reduce the differential cost of formal development. Of course, an alternative way this goal can be accomplished is to push-up the cost of informal development or to truncate informal housing production levels. At some later stage of development, such actions as rigorous enforcement of the land and building permit process can, in fact, make sense. But as long as the majority of housing is supplied by the informal sector, the informal sector needs to be protected from forced formalization. Only market driven formalization will improve housing conditions.

As noted above, the key policy issues for facilitating the growth of formal sector housing include:

1. facilitating land titling and the land-development permitting process, and
2. facilitating access to market-rate credit for housing.

Within each of these broad areas, there are many specific issues. With respect to land, there are a variety of issues raised here and elsewhere that need reconsideration, as well as issues of the level of official resources that should be available to handle processing (and recovered through official fees). With respect to credit, continuing financial sector liberalizations and growth of private-sector intermediaries will probably take care of most credit supply issues, but some careful government intervention to facilitate bank liquidity and long-term intermediation may be useful.

It should also be emphasized that a common reaction of governments to such pressures is to increase the amounts of subsidized credit and control of land development regulation. Avoiding such policy mis-steps is as much of a concern as improving the policy environment.

As for the provision of housing or credit for lower-income households, some forced cross-subsidization in the development of formal sector housing can be achieved, but it cannot be relied on to coax lower income households out of the informal sector. Instead, downpayment assistance of a magnitude similar to the extra costs of formal-sector development would encourage formal developers and mortgage lenders to serve that part of the market.

This policy environment suggests the need for two types of policy advice to the GOI and other important actors. One is detailed technical assistance on issues of land policy, on infrastructure standards, on development regulations, on methods of subsidizing low-income housing, on secondary mortgage market options, and possibly alternative mortgage instruments. The second type of advice is more macro perspectives on the efficient role of the public sector in housing development. Only with a political commitment to low-cost, private-sector, formal sector development will all of the technical advice be effective. Achieving the political commitment may require significant assistance of the big-picture type.

Annex A
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