

PN-ABT-220

LSM-91406

**PRELIMINARY REPORT AND CONCLUSIONS
REGARDING THE FOUNDATIONS FOR
A SHELTER FINANCING POLICY
INTRODUCING A SUBSIDY SYSTEM**

Consultants' Report
Contract No. 518-0076-C-00-3293-00

Presented to the:

**Regional Office of Housing and Urban Development
for South America (RHUDO S/A)**

By

**Vicente Domínguez-Vial
CG Consultores C. Ltda.**

May 1994

PRELIMINARY REPORT AND CONCLUSIONS REGARDING THE FOUNDATIONS FOR A SHELTER FINANCING POLICY INTRODUCING A SUBSIDY SYSTEM

1. INTRODUCTORY CONSIDERATIONS

To establish a proper housing policy that is well-suited to the country's possibilities, measures must be taken that go beyond efficient placement of people's savings, transparent allocation of subsidies and the existence of an adequate mortgage loan market, which are the aspects that this case study will be considering, along with the provision of water supply and sewerage infrastructure.

I shall mention these additional considerations so we can keep them in mind:

1.1 Development and regulation of ownership

The new policy implicitly assumes that housing will belong to whoever purchases it with a subsidy. Thus, housing is an investment asset, and not just an item that is used.

For this purpose, it will be necessary, according to the preliminary information now available, to undertake aggressive regulatory action to modernize systems currently in force.

1.2 Administrative simplification

Currently, transfer of ownership and mortgage-loan borrowing is surrounded by an exasperating, costly tangle of paperwork. Efforts must be made to simplify notarial, registration and taxation systems. Taxes levied on ownership transfer are applied to savings, and generally yield very little. Thus it could be expected that they could be repealed, as one step toward simplifying transactions and lowering their costs.

1.3 Market development

A major role for the facilitating State, which is inherent in the granting of subsidies, is to transform potential demand into actual demand and, consequently, to provide purchasing power so that the supply can expand to cover.

However, it does not stop there. It is necessary to make sure that there are no artificial barriers preventing market entry, or monopolistic practices within the building industry that could prevent healthy competition. In this regard, it would be advisable to encourage companies to increase their capacity, to reduce their rate of product importation by forcing local industrialists, at the same time, to improve their quality and pricing, and to demand minimum standards.

2. FINANCING SOURCES

Buyers of shelter solutions can use funds from three sources:

- a) Their own savings, and those of their families -- in money, land or materials;
- b) Economic support from the government, public agencies or centralized/decentralized institutions, which we shall call "shelter subsidies"; and
- c) Long-term mortgage credit which they have enough income to repay.

2.1 Prior savings

In Ecuador, savings are currently held in banks, building and loan associations, credit unions, other savings cooperatives, and the Ecuadorian Housing Bank (BEV).

I have been informed that the BEV will withdraw from banking operations, at least from dealing directly with the public (first-story banking) and consequently will no longer be receiving savings.

Moreover, banks in general have not seen any real thrust in the direction of receiving savings from the grassroots, since operationally smaller customers are more costly and because, to date, banks have had high enough liquidity that they

have not had to make any additional sacrifices to attract deposits. And now, the new financial law authorizes building and loan associations to perform most operations that have been banks' private domain; consequently, they may follow banks (which are leading the market) in moving away from small-scale savers. Finally, cooperatives that are open to the public, with official recognition and subject to audit procedures, do not always have a very good public reputation.

In summary, the institutional infrastructure for grassroots savings seems quite restricted.

2.2 Profitability and safety of savings

Interest rates on savings deposits are currently negative, and have been so for some months. This has meant that depositing money in the bank means a loss for savers, who sees some of their effort slipping through the cracks.

Naturally, encouraging saving under circumstances where interest rates are negative is tremendously difficult, and any success would be precarious.

Constant Value Units (UVC) have opened up a new perspective in this regard. If this unit begins to be used more in savings deposited for over one year's time, the profitability that has not been available so far would provide an incentive.

As for safety, there does not seem to be any real threat to formal savings deposits, and it would not be necessary, initially, to reinforce the security aspect.

2.3 Savings as an eligibility criterion for subsidy beneficiaries

To set up a subsidy system, it is necessary to set up the requirements for access. Prior savings is an important element because:

- it reflects the family's efforts to earn access to the subsidy;
- it decreases the risks for any lending operations, and gives an indication of the initial risk that applicants are in a position to assume;
- it is easy to measure in terms of both time and amount, which simplifies the government's task;

- it cannot be manipulated, and it is easy to certify.

d) Preliminary conclusions

A shelter subsidy system, demands institutional arrangements that provide adequate mechanisms and instruments to encourage prior savings. This will also doubtlessly provide benefits for individual people and for the economy as a whole.

The current institutional scheme --without any enterprises working to appeal to grassroots savers except for cooperatives that are open to the public and regulated by the Superintendency of Banks, but pay negative interest rates-- is not favorable for beginning a campaign to promote savings. However, if a specific instrument is created to save for housing, and all formal entities are authorized to operate it, this would give rise to competition for savers, since financial requirements for building and buying would probably motivate financial institutions.

If savings were a prerequisite for access to the subsidy, people would save even if interest were negative, because the opportunity to receive the subsidy would compensate for the loss.

Cooperatives initially appear to be the institutions best suited for appealing to savers for grassroots housing.

2.2 Shelter Subsidies

The Ecuadorian government has provided shelter subsidies of various types. Generally through specialized public agencies or through social security entities, it has lent money for home building, buying or improvement at interest rates that have been negative in real terms. There is also a very high default rate on repayment of these commitments.

This policy is inefficient and inequitable. Inefficient because the actual amount of the subsidy is unknown and the high administrative costs (of collecting repayment amounts that depreciate to very low levels over time) are not taken into account. Inequitable because the more one borrows, the more one benefits. Far from healthy, this criterion produces the opposite effect, discouraging saving and encouraging borrowers to go for shelter solutions that are beyond their means, because the obligation of repayment is known to be relative.

Subsidies granted to municipal governments and theoretically passed on to individuals, under BEDE operations based on IDB and World Bank loans, do use more equitable criteria, although the decision mechanism may sometimes be discriminatory.

In summary, there are no models for shelter subsidies based on the principles outlined in the first part of this report. Therefore, introducing such mechanisms will be a new concept, and no easy job to implement.

For this purpose, the following must be defined:

- a) Institutional arrangements for the system and its operating regulations;
- b) System operations;
- c) Training for personnel who will operate the system; and
- d) Dissemination of the system among parties with potential interest and among the private sector.

Such a task may be subdivided into the following functions:

- i. Issuance of norms;
- ii. Establishment of regulations;
- iii. Call for applicants;
- iv. Reception of applications;
- v. Processing of applications and selection of grantees;
- vi. Publications of beneficiary lists and delivery of the corresponding certificates; and
- vii. Payment of certificates.

a) Institutional arrangements for the system and its operating regulations

The major issues of prospective implementation of a shelter subsidy system in Ecuador include requirements for eligibility, transparent operation, and determination of who will regulate the system and its operation. I was amazed to find how deeply the people mistrust the public shelter sector, because of both its bureaucratic approach and its arbitrary actions.

I think, in view of this perception, it is possible for government and private parties to work together within a different framework of public-private relationships regarding their respective roles.

However, there is no possibility for anyone but the government to generate the overall norms.

Where there could be disagreements is in regard to whether the State should participate directly or not in these operations. If, because of its background, it should no longer participate directly, then at least it should retain the regulatory function.

b) System operations

A subsidy system requires efficient, believable institutional arrangements.

On several occasions, it was suggested to us that the government should be moved out of these operations (especially in the coastal region) because it cannot assure either efficiency or transparency.

However, there is some governmental capacity and experience that could be tapped.

It is also necessary to make the system coherent nationwide, even if regionalized. Therefore, the institutional arrangements should be chosen on the basis of national coverage.

c) Training for personnel who will operate the system

A key to operating shelter subsidies is to prepare the people who will keep them going. Since this will be a major change, and norms and procedures must be

enforced quite strictly, this training must be complete, recycling personnel who have the capacity to relearn their jobs, and incorporating new support elements.

d) Disseminating the system

For such a mass system, dissemination will be a key to success. The private sector, building companies, financial firms, NGOs, cooperatives and so on must be reached, as well as the people themselves. The public must understand the new arrangements, in simple terms.

2.3 Mortgage Loans

a) Current status

The formal sector seems to have no restrictions on shelter financing for the upper and middle-income sectors. However, there are no mortgage loans for low-income people, much less for the truly poor.

A demand financing scheme for large population sectors would not be complete without access to mortgage loans. In Ecuador, both private entities and the BEV operate on a mortgage basis. Of course, these institutions are not lending to low-income families, because their funding sources would not allow them to do so, and the costs of granting and managing mortgage loans in the long term are quite high.

Also, a "political" risk lies in the impossibility of foreclosing in the event of default on repayment, especially if the creditor is a government agency.

Building and loan associations, the current specialists in lending to lower-income families, are likely to cut back in this area because the new Law of Banks enables them to act just as banks do.

Looking at financing from the angle of funding sources, it has not yet been clearly defined what will happen with institutional funds, which are the major buyer of instruments issued to finance demand.

Only the UVC opens any significant expectations for developing the market, because it will guarantee actual profitability.

b) Refinancing and the role of the State

Mortgage refinancing, essential for market development, is currently the subject of a specialized consultancy, so I will only mention this issue.

However, what is truly in flux is the role of the State in long-term shelter financing and what contributions the State is willing to make.

At present, the government is lending directly, with all the negative consequences that this entails. This camouflages the "political ineffectiveness" of mortgage collateral and delivers hidden subsidies.

We have already outlined the problems with this approach, and we feel that the government's input must strike at the actual causes, namely:

- high cost with low profitability, and
- lack of security.

c) Preliminary conclusions

A system of eligibility for mortgage credit is an indispensable complement, along with savings, in order to make the shelter subsidy system technically coherent.

At present, any system to grant loans to low-income people either does not exist, or is becoming extinct.

However, there is some specialized expertise in this field, which could be tapped.

The government should consequently act by granting sufficient inputs or guarantees to make it attractive for the private sector to become involved. This could mean a commission, with a ceiling equivalent to the amount that the government no longer loses under this arrangement, or a guarantee to underwrite the political risk, if the mortgage proves impossible to foreclose on at some point.

3. SUBSIDIES FOR SHELTER, FOR WATER SUPPLY AND FOR SEWERAGE

3.1 General aspects of sanitation policy

As the trip report shows, the government of Ecuador has been making major investments in sanitation infrastructure, and efforts to change the way municipal governments approach these activities and the way users pay for investments and for operating and maintenance costs.

I feel that, despite some criticism about operational efficiency, all these efforts are taking the right direction.

Criteria applied to subsidize investments, encourage savings, account for external factors, and take income level into consideration, although their determination may be too sophisticated for most people to comprehend, involve interesting criteria of efficiency and equity.

What is not clear in this respect is how those subsidies granted by BEDE to help them service their debts are passed on to users. There are no provisions to define this; it is simply assumed that at least part of income-related considerations are passed on to users. It is also assumed that municipalities should get the funds from the direct beneficiaries of these investments to repay the reimbursable part of the loan.

Regarding consumption charges, it is correct to set up a sliding scale that rewards frugal consumers and punishes over-consumption. This policy must be reinforced by an intensive campaign to promote saving, especially in order to get the system working properly (faucets, piping) to reduce leakage and other such losses. This is particularly relevant for low-income families living in owner-built shanty homes, where installations are often makeshift and low-quality.

This campaign must include advertising, consciousness-raising documents and technical assistance.

3.2 Subsidies for investment, maintenance, operation and consumption of drinking water and sewage

It is coherent and reasonable for the State's social action to be governed by an overall policy. In this case, we suggest that shelter subsidies must be one-time-only, transparent and focussed. This will make it necessary to coordinate shelter subsidies with others such as drinking water and sewerage systems.

Current governmental programs, as stated above, are geared toward upgrading or sanitation in places where communities are already living, albeit under precarious conditions. Consequently, projects funded through the BEDE are not designed for new urban developments, but rather for existing human settlements. Therefore, if shelter subsidies are granted for home improvements (to overcome the qualitative deficit) care must be taken to ensure that they do not overlap with subsidies for investment in sanitary infrastructure and, if this happens, for both to be accounted for, to remain within whatever limits are established.

3.3 Preliminary conclusions

It seems to me that, in this area in general, there are well-structured policies. Nevertheless, it will be necessary to define how families will make use of the non-reimbursable part of the investment in infrastructure that favors them (the part considering users' socioeconomic level).

A shelter subsidy policy including home improvements should be complementary, in order to avoid duplication of efforts.

To establish subsidies for consumption, there seems to be no alternative to the way being pursued at present, i.e. encouraging low consumption and attempting to avert leakage and other losses. Consumption subsidies are best based on precise social stratifications, but such tools for analysis are not available in this case.

4. FINAL CONCLUSIONS

4.1 Existing conditions

The purpose of introducing the shelter subsidy instrument as the State's response to the shelter deficit and the country's growing need for sanitary and housing infrastructure would seem reasonable in view of the following conditions:

a) There is a major housing deficit, both quantitatively and qualitatively. In fact, for a population of 9,648,189 persons, there are 2,339,281 housing units, but at least 27.1% (i.e. 633,945) are highly unsatisfactory, being categorized as sheds, huts, lean-to buildings and so on.¹ Furthermore, the birth rate, although it has slowed somewhat, is still quite high, and new households are also multiplying rapidly. Therefore, shelter requirements are also growing fast.

Additionally, sanitary infrastructure data show that 37.2% of homes have no water supply connection, and 27.7% have no system for sewage disposal; only 49.6% of homes have their own exclusive toilet, and only 39.7% have their own shower.

These alarming figures are even lower in the coastal region and in rural areas in general.

b) Those shelter policies that have been followed have been discredited, leaving no survivor that would be recognized as a model to generalize.

This image problem is related to the State's reputation for inefficient implementation of equitable social policy. It is common to hear complaints of:

- inefficiency
- delays (impassable "red tape")
- high real costs
- hidden, unfocussed subsidies
- favoritism and lack of transparency

¹See the Fifth Population Census and Fourth Housing Census (1990), Definitive Findings, National Summary. National Statistics and Census Institute.

c) There is a perceived atmosphere of change in regard to social matters from a protective, patronizing State to a facilitating State that encourages individual initiative and widespread consensus that this is the direction that change should take.

d) Government institutions specializing in shelter, especially the BEV and the National Housing Board, have a reputation for ignoring the poorest people and suffering from all the problems outlined above.

4.2 Limitations

In theory, then, the time is ripe for implementing a subsidy policy, but there are limitations to overcome, including:

a) Shortage of public resources. State budgets are saturated, and there is still a fiscal deficit, although headway has been made. Accordingly, efforts must be made to raise funding. We suggest exploring the following possibilities to support a subsidy policy, at least at the outset:

i. The land that the government owns. This endowment can be used directly or liquidated on a tender basis, to provide the wherewithal to fund subsidies.

ii. Monies repaid to the National Housing Board and the BEV (if not reoriented for some other function) and other repayments to the government for infrastructure or housing investments that are not required to repay international loans.

iii. Government savings from reductions in sectoral operating expenditures (personnel, offices, etc.).

In the medium and long term, this program should be funded under the national budget, with no regard for the origin or source of funds.

b) Lack of local know-how regarding this type of social policy, which will call for the efforts indicated in items 2.2 c) and d) above.

c) Lack of government or private institutions equipped to handle a program of this type. We have analyzed this above in terms of appeal for savings, operation of subsidies, and mortgage lending.

I suggest the following initial definition of duties:

- i. Norm-setting and regulatory function: Ministry of Urban Development and Housing (MIDUVI)
- ii. Operational function: National Housing Board
- iii. Financial function: To receive savings, savings and loan cooperatives that are open to the public, and other financial entities that wish to participate.

To pay subsidies: formal financial institutions and government banks, if so decided.

To grant loans: formal financial institutions.

d) The non-existence of valid systems to measure poverty standards. This makes it impossible to judge relative degrees of poverty in order to allocate benefits, which should rely solely on:

- i. A suitably structured segmentation
- ii. Savings: time, money or site
- iii. Composition of the family group, although this aspect is highly informal.

4.3 Advantages

Along with the limitations, there are also advantages that should be highlighted, including:

a) Subsidies granted by the BEDE which, although not demand-driven (oriented toward people, but rather toward municipalities), have been properly formulated in terms of incentives, and could be tied in as part of shelter activities

or to complement them. These subsidies (at least the way that they are formulated) show that social policies can be linked with economic incentives and social goals, which are not contradictory concepts.

b) The urgent need for the government to demonstrate that it can provide leadership in social policy, enabling the public to clearly identify how money is spent, what it is spent on, and who is benefitted. This will certainly yield political dividends that cannot be ignored.

c) The socioeconomic impact of inducing saving, investment and specialization. This will be a by-product of a different social policy with promising profitability.