ABRIDGED EDITION

FINANCING URBAN SHELTER

GLOBAL REPORT ON HUMAN SETTLEMENTS 2005

UNITED NATIONS HUMAN SETTLEMENTS PROGRAMME

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United Nations Human Settlements Programme

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INTRODUCTION

This publication is an abridged edition of *Financing Urban Shelter: Global Report on Human Settlements 2005* (the main report). It examines the challenges of financing urban shelter development, focusing on the shelter needs of the poor and within the overall context of the Millennium Declaration targets on slums, water supply and sanitation. Recent estimates demonstrate that more than 2 billion people will be added to the number of urban dwellers in the developing countries over the next 25 years. This implies an unprecedented growth in the demand for housing, water supply, sanitation, and other urban infrastructure and services. This new challenge exists in a context of already widespread poverty and inequality in cities, with millions of people living in slums, without adequate basic services. Providing these services to new residents will be essential if this additional population is not to be trapped in urban poverty, poor health and low productivity.

This abridged edition, which follows the structure of the main report, is divided into three parts. Part I, which consists of three chapters, presents the overall economic and urban development contexts of shelter financing. Chapter 1 presents a macroeconomic framework within which to situate the problem of financing urban shelter and to understand its broader implications. Chapter 2 discusses the general trends in housing and urban development policy, thus providing the overall policy context for financing shelter development. Chapter 3 reviews the broader challenge of financing urban development, especially the development of city-wide shelter-related infrastructure, as an important context for the financing of urban shelter development.

Part II analyses global trends in shelter finance policies and practices. The part is divided into four chapters that seek to take account of the diversity of housing and housing finance strategies in both developed and developing counties, as well as in countries with economies in transition. Chapter 4 looks at the most conventional financing strategy, that is mortgage finance, which involves long-term loans secured on the property for the purchase of a home that is complete. Chapter 5 examines the financing of social housing, mainly through subsidies, as significant numbers of households in many developed and developing countries cannot afford the costs of home purchase either directly or through loan finance. Chapters 6 and 7 consider small-scale finance (or small loans); that is, the provision of small loans and, in some cases, subsidies to enable the incremental construction, extension and improvement of homes as well as the upgrading of whole neighbourhoods. Chapter 6 focuses on shelter or housing microfinance, which involves the provision of small loans for individual homeowners to improve their existing dwellings, while Chapter 7 examines community funds, which have been used mainly to finance group-based purchase of land and installation or improvement of infrastructure and services within urban informal settlements.

Part III, which consists of two chapters, is forward looking. Chapter 8 assesses the adequacy of the current shelter financing systems examined in Part II, including issues of affordability and the difficulties of reaching the poor, as well as the challenges of sustainability. Chapter 9 discusses the ways in which shelter finance systems could be strengthened, in terms of both performance and sustainability, on the basis of the experiences reviewed in the preceding chapters. It also points the way forward by highlighting best policies and practices, as well as emerging policy directions.

The main report has a fourth part, not reproduced in this abridged edition: the Statistical Annex, which contains key indicators on global human settlements conditions and trends, including demographic, social, economic and more specific shelter indicators, such as the numbers of slum dwellers. The indicators are presented at three levels: regional, country and city.

MDG SPECIAL FEATURE: FINANCING THE TARGET ON SLUMS

MILLENNIUM DEVELOPMENT GOALS AND THE TARGET ON SLUMS

The history of cities is the history of civilization. For centuries, migrants have sought improved lives for themselves and their families in increasingly dense urban landscapes. Cities represent the greatest hopes of every age. The *Global Report on Human Settlements 2005* focuses on broadening existing knowledge of the complex financial foundation lying at the heart of the growing urban challenge. The report critically asks and answers, with examples, the question of how the costs of growing demographic pressures across different regions of the world will be met. It is known that roughly one out of every six people live in what can be characterized as 'slums' in small and large cities alike.

In the face of many adversities, the urban poor have emerged with creative solutions. 'Slums' are often a solution in progress – a gradual realization of the abiding hope to make a home in the city and create a better life. It was in this context that the United Nations Millennium Assembly of 2000 highlighted the need to improve the lives of the urban poor through the inclusion of a 'slums goal' in the Millennium Declaration. This goal – 'by 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers, as proposed in the Cities without Slums Initiative' – was later subsumed as Target 11 of Millennium Development Goal (MDG) 7, that of environmental sustainability.

From the beginning, it was evident to the Millennium Project Task Force 8 on Improving the Lives of Slum Dwellers that addressing Target 11, as the slum target is described in the MDGs, in essence meant not only improving the lives of an existing 100 million slum dwellers, but also creating alternatives to slums for the future urban poor. The task force's report therefore highlights an investment model for upgrading today's slums and planning alternatives for tomorrow that assumes the active participation and commitment of the urban poor themselves, in partnership with the more usual actors: local and national governments, as well as international organizations.

Realigning Target 11

Task Force 8's report, *A Home in the City*, highlights two distinct and necessarily related routes to achieving the scale and sustainability of Target 11 – that of slum upgrading today and urban planning for tomorrow. In this interpretation, the task force refrained from the use of 'stopping slum formation' to avoid any confusion regarding its position against forced evictions. This interpretation is also fully consistent with the other targets of the MDGs, which call for a halving of identified poverty challenges. Using recent estimated and projected slum population figures, Task Force 8's interpretation of Target 11 calls for halving the number of the slum population to be expected in the world by 2020 if no remedial action is taken. A calculation exercise shows that the currently projected number of slum dwellers in 2020 if no action is taken (1.6 billion people), would be halved through a combination of the improvement of 100 million current slum dwellers' lives and the creation of alternatives for future urban poor residents, thus aligning Target 11 with other MDG targets.

The proposed path takes a relatively innovative, yet obvious, approach to urban development – one which embraces the historic reality of the urbanization trend. In short, it is a strategy to recognize the great macro and micropotentials of urbanization, while also ensuring that its

Demographic pressure on urban infrastructure and services is one of the key challenges for developing country cities

Slums have emerged as a creative solution by the urban poor

challenges are adequately addressed. But is meeting Target 11 in Task Force 8's interpretation realizable – financially *and* politically? The answer is yes.

While it is crucial that Target 11's financial outlook is seen within the greater context of financing the MDGs overall, the specific components of the investment model developed by Task Force 8 to achieve Target 11 reveals how movement towards this target is already under way. Most notably, while achieving the MDGs overall will require significant contributions from donors – contributions which, in fact, have already been promised – it is of interest that the Target 11 component of the overall financing of the MDGs is largely based on domestic capital. This is the case both in upgrading slums today and in planning alternatives for tomorrow.

MODELLING INVESTMENT IN SLUM UPGRADING AND PROVIDING ADEQUATE ALTERNATIVES

The task force combined estimations of demand for regularization and upgrading, based on UN-Habitat's 2001 estimation of slum dwellers, with programme examples and expert studies to derive its own estimations regarding which interventions to include and which to exclude from its model. The Task Force 8 investment model included five overall components:

1. land;
2. physical improvements to the housing stock;
3. basic physical infrastructure (water, sanitation, drainage, road paving, electricity);
4. basic community services (schools and clinics); and
5. security of tenure.

The five components of the model all require human, infrastructural and financial resources that clearly vary with context. For this reason, the aim of the task force was not to treat the model as an exact estimation, but as an opportunity to demonstrate – using data from existing programmes – the range of investment costs required to upgrade slums and to plan for alternatives. The resulting estimates show the significance of cost ranges across regions, largely due to differences in the cost of labour and land.

Attaining the target of improving the lives of an existing 100 million slum dwellers between 2005 and 2020 will require investment of US$4.2 billion per year, or roughly US$42 per beneficiary per year.

The amount required to provide adequate alternatives to new slum formation is roughly US$14 billion per year from 2005 to 2020, or roughly US$25 per person per year.

The combined upgrading and planning models indicate that Target 11, in its full original intent, can be achieved with an average investment of approximately US$294 billion, or US$440 per person, over the period of 2005–2020. Such an investment would touch the lives of roughly 670 million poor residents of urban centres. This is not an unrealizable figure. It is already known that the urban poor significantly contribute to housing and settlement upgrading. Thus, the call here is to mobilize national, international and private-sector financial support for such efforts that are already under way and for scaling up the example of urban poor-led upgrading.

In considering the subsidies, loans and personal household contributions necessary for both upgrading and planning alternatives, Task Force 8 formulated the following distribution model of responsibility:

- 30 per cent of investment needs could be secured through small loans to participating households;
- 10 per cent of required funds would be contributed by beneficiaries themselves; and
- 60 per cent of resources would be provided in the form of subsidies from national and local governments, through a mix of domestic and international resources.

Of course, the model of responsibility here also varies according to income-level context, as well as the overall needs assessment of the locale and the country in question.

This principle also holds wider meaning with regard to the role of international actors and donor assistance. Donor contributions are necessary to enable local and national governments to provide required subsidies for upgrading and planning. Donor guarantees can also facilitate the involvement of the private banking sector, thus ensuring that small loans are accessible when required and appropriate.

PART I

ECONOMIC AND URBAN DEVELOPMENT CONTEXT

CHAPTER 1

CHALLENGES OF SUSTAINABLE SHELTER DEVELOPMENT IN MACROECONOMIC CONTEXT

Chapter 1 presents a framework within which to situate the problem and to understand its broader implications. It also presents the macroeconomic factors which condition the growth of cities and shows how the macroeconomic performance of developing countries is in turn affected by economic activities in cities. It shows that, despite the importance of shelter, there is a structural scarcity of financial resources available within national economies, national budgets, global private finance and the international community to support essential investments in shelter development.

UNDERSTANDING URBAN SHELTER DEVELOPMENT CHALLENGES

Latest projections and assessments of expected demographic growth in developing countries during the next 25 years indicate that about 90 per cent of the expected demographic growth, as well as growth in demand for shelter and related urban infrastructure and services, will be in 48 countries, with most of this growth occurring in East and South Asia, particularly China and India. Africa will continue to experience the urbanization of poverty. Latin American cities have become the loci of economic productivity and employment growth, while also being concentrations of growing urban poverty and inequality between rich and poor.

The current global backlog of slum dwellers is about 925 million people. When this figure is combined with the projected 1.9 billion additional urban population, it is apparent that 2.825 billion people will need housing and urban services by 2030. This projection is the starting point for this Global Report (see Table 1).

This challenge is not just about the quantity of population, but also its composition. Cities are changing rapidly, especially in terms of both the scale and rate of demographic transformation. There are not only more people in cities, but they eat, work, play, educate, dress, and express themselves differently. These processes of differentiation also have financial implications, with more elderly populations requiring special services at the same time that there are more school-age children needing more schools and teachers. A wider diversity and range of social needs implies a wider and more diverse set of services, whether provided by government or non-governmental organizations.

This pattern of growth will also place additional strains on environmental resources needed for cities, such as clean

Table 1

Housing requirements to accommodate increments in the number of households over the next 25 years

Increments in the number of households over a 25-year period	877,364,000
Average size of annual increments	35,094,000
Per day	96,150
Per hour	4,000

Source: Statistical Annex of the main report

Urbanization of poverty is a notable feature of Africa's fast-growing cities

water and clean air. Growing demand for infrastructure services places immediate pressures on natural resources. Environmental studies show that cities have important impacts on the natural environments in which they are located, what is known as their 'ecological footprint'. Consumption of natural resources by urban residents, for example firewood in Africa, is frequently growing faster than nature is able to reproduce those resources. This pressure on natural resources is most dramatically shown by the increasing cost of potable water in almost every city in the world.

While these urban problems have important local, regional, and national consequences, they also have global impacts. These environmental issues need to be included in any financial and economic framework for cities in developing countries. The notion of 'sustainable development' needs to be made operational, rather than just a normative and rhetorical objective of governments and the international community.

With this backdrop, it is clear that the capacity of developing countries to finance their needs depends largely on their level of future economic growth and development. If countries are able to generate employment and incomes for growing populations at an accelerated rate, they will be able to generate and mobilize the savings and investment to finance housing and infrastructure services. If, however, they remain at current growth rates or, as in some cases, are unable to grow economically, there will be little likelihood that these resources will be available. In this sense, macroeconomic growth is a necessary but not a sufficient condition for addressing the urban shelter problem.

Two key factors are needed to translate macroeconomic growth into finance for urban development. The first is governance – how public, private, and non-governmental institutions work together to plan and manage cities. These institutional challenges range from establishing the laws and regulations governing life in the city, to developing new residential areas for the growing population, to decentralized problem-solving at the community level. The growing trend towards decentralization in most national governments in developing countries has transformed the roles and responsibilities of these institutions over the last two decades. However, this process also is insufficient to provide the needed housing and infrastructure services for growing populations. The second factor, finance, is essential for this process.

THE MACROECONOMIC CONTEXT OF URBAN SHELTER DEVELOPMENT

Turning to the macroeconomic context for urban development, 2004–2005 has been a period of unprecedented economic growth at the global level. In 2004, the global gross domestic product (GDP) grew by 4 per cent. All developing regions grew at a pace faster than their growth rates of the 1980s and 1990s. Global trade also expanded considerably, with China's demand for imported raw materials and food spurring exports from other developing countries. The most striking feature of economic growth has been the high rate of growth for the developing countries, going above 6 per cent for the first time. This was heavily fuelled by China at 8.8 per cent. From a distribution perspective, these patterns are worrying because they continue the trend towards greater disparity in income levels between the regions, as well as between developing and developed countries. Global inequality between rich and poor countries, therefore, continues to worsen, even when there have been extraordinarily high rates of economic growth.

The most questionable aspect of this growth in 2004, however, is whether it is likely to be sustained in the future. This depends on many factors, including the changing position of the dollar in global currencies, and hence the power of the United States' economy; whether the landing of China will be soft or hard as it copes with the danger of inflation; and whether global interest rates will affect debt payments by developing countries and their ability to finance needed investments for growth. These exogenous factors are obviously important influences on national macroeconomic performance.

The growing importance of world trade means that 'tradeables', whether manufacturing products or commodities, have become increasingly central to the

economic growth of all countries, whether developed or developing. While this places great emphasis on agriculture and production of raw materials, it also requires improvements in the efficiency of infrastructure in telecommunications, transport and key services such as electricity and water supply needed for manufacturing and other industries.

The financial sector has demonstrated continued growth and has also benefited from the absence of major crises in 2003 and 2004. While the decline of the dollar and the growing strength of the euro are likely to produce some adjustments in 2005 and 2006, there is little likelihood of major changes in the sectoral composition of growth in most countries. Information technology continues to contribute to notable increased efficiencies in industry and services in most countries. Indeed, high returns to industries relying on information technologies, such as the financial sector, have contributed to growing inequalities in earnings between sectors within countries.

One of the consequences of the pattern of economic growth described above is growing inequality. Inequality has become increasingly recognized not just as a problem to be addressed in its own right, but also because of its substantial impacts on economic growth, poverty reduction and productive investment strategies for the development of human capital. Studies over the past decade have demonstrated the high correlation between inequality and poor performance in other aspects of development. While inequality is frequently linked to education, there are also many forms of inequality which can be attributed to the policies of national and local governments in urban areas. Inequality through skewed local public investment can therefore be a local product and cannot always be blamed on external forces outside the country.

Despite the impressive economic growth of the past few years, the enduring problem of massive poverty in the developing countries remains the top priority problem facing the world today. The incidence of poverty at the national level is highly correlated with low levels of education and poor health status, lack of access to basic infrastructure services such as clean water supply, sanitation and electricity.

	Percentage of GDP	Current US$
Sub-Saharan Africa	14	1,783,690,767
Middle East	24.5	27,261,325,959
Southeast and East Asia	35	321,936,208,750
South Asia	13	37,536,526,160
Latin America	16	38,121,260,000
North America	19	817,705,450,000
Europe	21	305,467,000,000

Source: World Bank (2004) *World Development Indicators 2004*, World Bank, Washington, DC

Table 2

Gross domestic savings, 2003

The informal sector is the main source of income for the majority of the urban poor in Africa

The most direct and important factor contributing to urban poverty is the shortage of well-paid employment in cities. The challenge here is both the creation of jobs and the level of wages. The generation of employment depends generally on savings and investment within the macroeconomy and local economies as well. As noted earlier, much of the growth of economies over the past decade has been in technology industries and financial services, neither of which requires large labour forces to be productive. With growing global pressures towards profits in manufacturing and services industries, there has also been little incentive for medium- and large-scale enterprises to pay 'living wages' to those lucky people who do find jobs.

An important result of high levels of poverty is a lack of domestic savings within national economies. Low levels of domestic savings – both public and private – contribute to low levels of capitalization of the financial institutions in poor countries (see Table 2). They are also reflected in low levels of tax revenue collection and therefore place great limitations on public expenditures and public budgets. The issue of savings is particularly important to the financing of urban infrastructure and housing. Both infrastructure and housing are durables – they are expected to have a long life, at least 50 years in the case of infrastructure – but they require large upfront investments in the expectation that they will provide a long stream of benefits well into the future. Savings is the foundation of investment. Without some surplus, investment in these future benefits is impossible. Therefore, patterns of

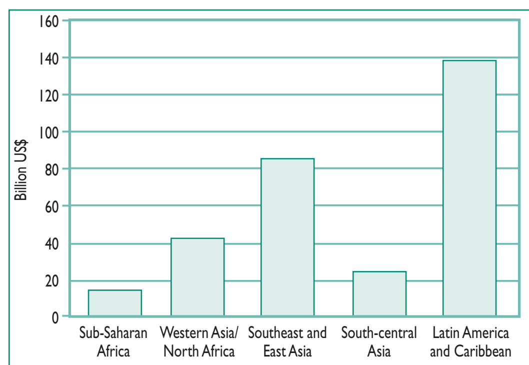


Figure 1

Debt service, 2002

Source: World Bank (2004) *World Development Indicators 2004*, World Bank, Washington, DC

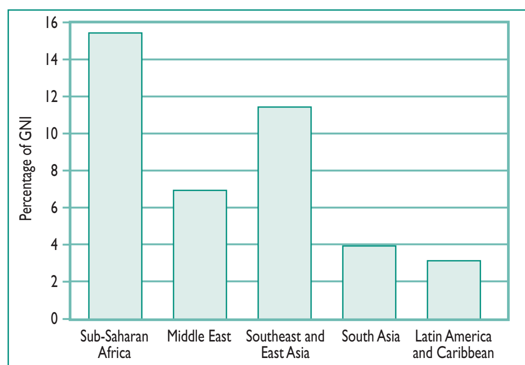


Figure 2

Official development assistance (percentage of gross national income), 2002

Source: World Bank (2004) *World Development Indicators 2004*, World Bank, Washington, DC

income generation are critical factors in determining whether households will be able to invest at all in their future.

Another factor heavily affecting the macroeconomic environment of developing countries is external debt. The legacy of external borrowing for diverse purposes has left many countries with unsustainable levels of external debt service. In some countries, particularly in Africa, the debt service to GDP ratio has reached over 400 per cent (see Figure 1). These levels of debt immediately reduce available domestic capital for investment. The net transfer out of developing countries to both public and private institutions in the developed countries, as well as to the multilateral institutions, underlines the fact that, in some countries, the external community is not only a source of funds for domestic investment, but is a net drain on available surpluses which individual countries can generate.

Given the above, the patterns of investment in the developing countries have changed markedly over the past decade. Whereas during the 1970s and 1980s, many countries relied on the international institutions to provide needed capital, the transaction costs and conditions of these lenders have reduced their attractiveness for those countries able to go into the global financial markets to raise investment capital. At the same time, there has also been an important segmentation in the global financial markets, with some countries – particularly the East Asian countries and notably China – being able to attract high levels of foreign direct investment (FDI). Public investment as a share of GDP is also low in most developing countries. They have relatively large deficits in their public budgets, with items such as the maintenance of infrastructure being a low priority in most countries.

The lack of resources for public investment in the poorest countries poses a serious dilemma. Many of these countries do not qualify for FDI. They are dependent on official development assistance (ODA) as the major source of financial support for economic development. Yet ODA is also severely limited (see Figure 2). Even with promises of additional aid from the developed countries at the Financing for Development Summit held at Monterrey, Mexico, in 2003, the actual levels of official finance for development are constrained by lack of domestic political support in the developed countries, or by the restrictions of macroeconomic agreements with the international financial institutions.

Here urban development must compete with other priorities in the allocation of ODA for specific countries, as well as within their own national budgets, which are clearly politically determined within individual governments. This is also determined by the institutional level from which allocations are made. For example, many governments increasingly assign responsibility for housing and urban development to the provincial, state and local levels, rather than to the national level. This means that patterns of inter-governmental financial relations and specifically financial transfers have a large impact on what level and type of funds find their way to cities and towns. The weaknesses of the public sector and its inability to mobilize substantial resources for urban development therefore point to the need to give greater attention to private sources of finance, including the role of privatization of infrastructure services.

A final characteristic of the macroeconomic context for urban development is the urbanization of national economies themselves. Abundant evidence exists to demonstrate the growing importance of cities in the overall productivity of countries. The increasing share of national GDP produced in cities has been well documented.

Despite historically rapid rates of economic growth, there is little likelihood that conventional sources of funds will be available for investment on the scale needed to meet the projected demand for urban shelter and related infrastructure. How those savings are mobilized through diverse mechanisms is the subject of subsequent chapters of this report.

Urbanization plays an important role in national economic development

CHAPTER 2

SHELTER POLICY AND FINANCE: RETROSPECTIVE OVERVIEW

Chapter 2 discusses the general trends in housing and urban development policy since the end of World War II and highlights the paradigm shifts that have occurred particularly in the last 30 years. In doing this, the chapter provides, through a historical approach, the policy context of urban shelter finance.

The context in which housing is provided has progressed from welfare provision, through an understanding that better conditions generate healthier and more productive people, to housing as a basic human right. In parallel, financing has moved from subsidizing the cost of a few high quality dwellings in well-serviced neighbourhoods, through enabling the finance markets to provide for most, to the beginnings of a recognition that some subsidized housing is required for households too poor to be catered for by the free market (see Table 3).

CONTEXT TO INTERNATIONAL THOUGHTS ON FINANCING FOR URBAN DEVELOPMENT

In the early post-World War II years, house building was regarded as a social overhead cost to economic development. This view focused on several issues: economic development; the construction industry and construction quality; development of human capital; social development; and subsidies for workers.

During the 1950s and 1960s, the modern movement in architecture generated a branch of interest in tropical architecture. Its concern with climatic comfort and use of local materials was set within the context of the view that good design and construction were key elements in creating affordable and appropriate towns.

By the early 1970s, the concept of intermediate technology had been developed and became popular, with the recognition that different technologies were appropriate in different contexts. Pioneering work in the early 1970 also recognized the presence and contribution of the informal sector in all manner of industrial and commercial sectors, not least construction.

In the late 1960s and early 1970s, John Turner's writings arising from his experiences in Peru, where squatter invasions were leading housing development, established the important place that self-help housing would have in social development.

In the formal sector, in the 1950s and 1960s, subsidies were an important part of housing policy. Both before and after the war, housing for urban workers tended to be rented out at less than economic rents, usually related to income.

TRENDS IN SHELTER AND MUNICIPAL FINANCE DEVELOPMENT: 1972–2004

Between 1972 and 1982, the focus of financing was on low-interest loans, loan guarantees, and subsidies as means of making housing affordable to low-income people. Interventions in this period concentrated on demonstration projects of limited size, with respect to a city or region, and usually confined to a particular neighbourhood or group of neighbourhoods.

Projects tended to be outside of municipal control, to have different standards from elsewhere, different means of

Phase and approximate dates	Focus of attention	Major instruments used	Key documents
Modernization and urban growth: 1945 to early 1970s	Physical planning and production of shelter by public agencies	Blueprint planning: direct construction (apartment blocks, core houses); eradication of informal settlements	
Redistribution with growth/basic needs:mid 1970s to mid 1980s	State support to self-help ownership on a project-by-project basis	Recognition of informal sector; squatter upgrading and sites-and-services projects; subsidies to land and housing	Vancouver Declaration (UNCHS, 1976); *Shelter, Poverty and Basic Needs* (World Bank, 1980); World Bank evaluations of sites-and-services (1981–1983) (e.g. Bamberger et al, 1982; Keare and Parris, 1982; Mayo and Gross, 1987)
The enabling approach/urban management: late 1980s to early 1990s	Securing an enabling framework for action by people, the private sector and markets	Public–private partnership; community participation; land assembly and housing finance; capacity-building	*The Global Shelter Strategy for Shelter to the Year 2000* (UNCHS, 1990); *Global Report on Human Settlements 1986* (UNCHS, 1987); *Urban Policy and Economic Development* (World Bank, 1991); *Cities, Poverty and People* (UNDP, 1991); *Agenda 21* (UNCED, 1992); *Housing: Enabling Markets to Work* (World Bank, 1993)
Sustainable urban development: mid 1990s onwards	Holistic planning to balance efficiency, equity and sustainability	As above, with more emphasis on environmental management and poverty alleviation	*Sustainable Human Settlements Development: Implementing Agenda 21* (UNCHS, 1994)
Habitat II: 1996	'Adequate shelter for all' and 'sustainable human settlements development'	Culmination and integration of all previous policy improvements	*The Habitat Agenda* (UNCHS, 1996); *An Urbanising World: Global Report on Human Settlements 1996* (UNCHS, 1996)
Istanbul+5 2001/the Millennium Declaration and the Millennium Development Goals (MDGs)	Review of the Habitat Agenda process	Renew Habitat Agenda commitments and seek/devise more effective strategies	*Declaration on Cities and other Human Settlements in the New Millennium* (UN, 2001); *Cities in a Globalising World: Global Report on Human Settlements, 2001* (UNCHS, 2001);

Table 3

Milestones of housing policy development

implementation (e.g., materials procurement through project depots at subsidized prices and soft loans) and to have little effect 'outside the fence'. Projects generally focused on self-help, providing a context in which the spare time and energy of low-income people could be devoted to house construction or infrastructure provision. They were broadly of two types: sites-and-services projects for new housing provision, and settlement upgrading for bringing squatter and other informal settlements up to an acceptable standard of servicing and public space provision.

The concept of adding value through physical work, referred to as 'sweat equity', was strongly ingrained in the projects of the 1970s. Participants in sites-and-services schemes were helped in their construction efforts by project staff who provided a range of services. However, evaluations have shown that many participants used professional building workers in lieu of sweat equity.

In addition to finance by sweat equity, there were many subsidies. Some were declared in the project (on-budget) and others were hidden (off-budget). The participants in sites-and-services schemes tended to have rather higher incomes than the rhetoric and intention implied. Dwelling owners in upgrading schemes, on the other hand, tended to be among the low income groups and their tenants were probably in even lower income echelons.

Many beneficiaries found themselves unsuited to the project and bought their way out by selling to richer households, ignored some of the project requirements to better suit it to their needs, or defaulted on payments to make it affordable. Tenants did not benefit much as their rents would rise and they would tend to move out to other non-upgraded settlements where rents were still affordable. The projects were often too complex for the municipal authority to implement. The great majority of citizens, those outside the project 'fence' in the cities affected and those not finding work in the project, benefited hardly at all.

The 1980s were a period of change. The projects of the 1970s were subject to detailed analysis, both within

The urban housing sector plays an important role in welfare policy

international funding institutions and from outside. For all the efforts aimed at improving housing, the existence of unserviced informal settlements appeared to be continuing; indeed they appeared to be expanding rather than in decline. The limitations found in the project approach included the following: that they had a low impact on overall urban economic development; that they encouraged institutional reforms only in those organizations implementing the projects; and that the funder's funds were restricted to 'retail' rather than 'wholesale' roles. The 1980s saw 'step-by-step moves towards a more comprehensive whole housing sector approach' (see Box 1).

There was a perceived need to incorporate housing into the wider economic environment rather than dealing with it as a special sector requiring attention out of welfare considerations. It was recognized that the individual sites-and-services and slum upgrading projects alone could not affect the growing housing need and that a well-functioning finance system for housing for the majority was necessary.

This generated a paradigm shift from multi-sectoral but quite localized projects, affecting a fortunate few, to an emphasis on creating a sustainable capability for housing supply and urban development affecting most residents and congruent with the overall policy and economic environment. The locus of borrowing changed from almost exclusively public-sector institutions to financial intermediaries. In parallel, attention shifted from the physical asset financed to the institutional structure of the implementing agency and its ability to mobilize the development required.

For example, the World Bank developed programmatic projects in which the local municipalities and other institutions could propose side projects within an agreed range. The prototype for these was Brazil's Parana Market Towns Improvement Project, implemented between 1983 and 1988, in which a large number of municipalities could compete for investments according to local priorities.

In the early 1980s, World Bank loan financing was made available to enable governments to recover from years of decline through Structural Adjustment Programmes (SAPs). For many countries, the SAP was a condition on other loan finance. In this approach, the free market was seen as the means of improving efficiency and injecting dynamism into

Box 1 Seven-point conceptualization of whole-sector development

Sustainable development requires approaches that are integrated, reaching across sectors and touching physical, economic and social activities and institutions. Such integrated approaches have been promoted by major international organizations such as the United Nations system and the European Union (EU).

In its 1993 housing sector paper, *Housing: Enabling Markets to Work*, the World Bank conceptualized whole-sector housing development as comprising seven components, three on the demand side, three on the supply side and one appertaining to managing the sector:

Demand side

1 the development of property rights – for example, in regularizing tenure in squatter settlements and in removing rent controls;
2 the development of housing finance systems, especially mortgage finance;
3 the targeting of subsidies;

Supply side

4 infrastructure provision for residential land development;
5 the regulation of land and housing development, including introducing regulatory audits to remove barriers to development;
6 improved organization and competition in the building industry;

Managing the sector

7 appropriate institutionally loaded reform.

Sources: World Bank (1993) *Housing: Enabling Markets to Work*, World Bank Policy Paper, World Bank, Washington, DC; Pugh, C. (2001) 'The theory and practice of housing sector development for developing countries, 1950–1999', *Housing Studies* **16**(4)

the economy. The state's role was that of enablement: securing private property rights; reducing regulations in inhibited markets; achieving macroeconomic stability; developing finance capital markets; and providing sector policies and institutional frameworks for effective development.

There was a perceived need to be involved in the promotion of sound financial institutions in the borrowing countries, in which housing finance was seen to be a part. Externally-supported projects at the time channelled housing and urban loans into housing finance institutions and municipal development funds, where they would be disbursed more widely and quickly than could geographically-delineated inputs.

Recent reviews of housing policy transition have shown that there was a fulcrum of policy change during 1985 to 1987, a mid-point between the two major Habitat global conferences. By the end of this short period, the enabling approach had been put together and launched on the international agenda.

The enabling approach treated housing and urban development as a multi-sectoral issue, affected just as much by efficiencies and inefficiencies in finance as in the construction industry or land tenure systems or the regulatory framework. The task of the state was seen as creating the legal, institutional and economic framework for economic productivity and social effectiveness, in which efficient settlement development could then flourish.

The enabling approach also called for a housing policy environment that would oversee and regulate the sector, with the government not supplying housing directly, but leaving actual production and delivery of housing to the housing market, in which all 'actors', ranging from large formal-sector developers through artisans and individual households, to voluntary community organizations, would involve themselves at their most effective level in the production process.

In order to enable housing provision, six inputs (five markets and one intervention) in the housing supply system needed to be freed up to operate effectively. The six inputs were: land, finance, construction industry/labour, building materials, infrastructure and the regulatory framework.

The mid-1980s also saw the birth of sustainability as an overarching rubric for development activity. From that time on, no agency could ignore the need to consider environmental impact alongside social and economic benefits from its projects. Chapter 7 of Agenda 21 reiterated the overall objective of improving the social, economic and environmental quality of human settlements and the living and working environments of all people, particularly the poor.

At the same time, there was a realignment of emphasis from 'ability to pay' to 'willingness to pay' as a result of economic analysis which found that the latter produced much more accurate estimates in shelter-related cost recovery calculations.

The 1990s saw an intensification of the shift towards a sector-wide approach. Major donors started giving support in an agreed sector to be coordinated by governments at local or national level. This shifted donor interventions from direct programmes, which suited the donor's priorities, to supporting governments to implement their own priorities. The focus continued to move from physical targets to broad institutional development, including financially sustainable operation of upgrading programmes.

In parallel, the lending agencies moved away from a 'retailing role', involved in every detail of the project, to that of a 'wholesaler', with local municipalities or other institutions planning and implementing the details within broad programme parameters and demonstration of administrative capability. Loan conditions required 'sustainable finance', represented in cost recovery, and in the skilled management of receipts and expenditures within a context of operational effectiveness.

By 1990, UNCHS (Habitat) had formulated its comprehensive ideas of housing reform and released the Global Strategy for Shelter to the Year 2000. This had a laudable but over-optimistic objective of 'decent housing' for all by 2000. Later in the decade, this term was replaced by 'adequate housing'. The need for adequate housing has also been included in many UN Summit recommendations and closing declarations.

The Global Strategy for Shelter to the Year 2000 (GSS) recognized that governments had an obligation to ensure that an appropriate environment was created for the mobilization of finance for housing. The objectives of such an effort were seen as promoting and mobilizing savings, reducing costs, improving the efficiency of financial intermediation and assisting the free movement of capital through the national economy. Housing finance reform, which is a key component of a shelter strategy, was seen as part of a broad effort to reform and develop the financial sector.

The GSS encouraged providers to reduce the cost of housing finance to the lowest possible level, but urged that the days of housing subsidies, artificially low interest rates and political interventions to forgive defaults be left behind. Instead, government interventions had to be consistent with sound financial and economic principles, through prudent

Box 2 Housing finance institutions during the 1990s

Housing finance institutions during the 1990s were based on the following systems:

- *Undeveloped housing finance systems*: common in sub-Saharan Africa, with weak financial systems and commercial banks. Priority should be given to improving urban laws, policies and practices affecting housing, beginning with clarifying traditional property rights. Public efforts should concentrate on infrastructure development, the supply of serviced land and titling, all within realistic affordability parameters.
- *Missing housing finance systems in formerly centrally planned economies*: one of the many problems in the former Soviet bloc, China and Viet Nam. Coordinated improvements are needed to establish primary mortgage lenders and secondary market facilities.
- *Fragmented and unstable housing finance systems*: fairly common in Latin America, where housing finance systems are very small with respect to the economy because of macroeconomic mismanagement and/or external shocks, and inflation has been high. In highly unequal societies, most cannot afford mortgage finance, so subsidy distortions are built in, which can help the general economy to implode. It is essential to separate subsidy from finance and to target subsidies at social housing.
- *Segregated but stable housing finance systems*: in the Middle East and East Asia, where a seemingly (but actually not) very stable group of institutions provide housing finance within restrictions and special advantages. They provide poorly targeted subsidies and finance at preferential rates in a context in which numbers of units are important determinants of success. The informal sector has a major role in finance for those missing out, leading to a high implicit cost of capital for housing.
- *Sound and integrated housing finance systems*: some countries in Southeast Asia have developed sound and well-supervised housing finance systems with secondary mortgage markets that manage to reach well down in the income scales. Because the bankers can choose what to fund, building contractors produce better-quality work. In addition, investors seek out innovative technologies from around the world to improve their investments.
- *Advanced housing finance systems*: found in Organisation for Economic Co-operation and Development (OECD) countries, these have grown out of the UK building society tradition and the savings and loans societies in the US. The continental European market tends to use bond market funding; but all of these special mortgage institutions are shrinking as globalized banking provides specialized financing services to take over the mortgaging business.

Source: Renaud, B. (1999) 'The financing of social housing in integrating financial markets: a view from developing countries', *Urban Studies* **36**(4)

interventions in the deposit rate, servicing costs, the cost of risk, risks of default, fluctuations in interest rates, liquidity and repayment.

Personal savings were still seen as the cornerstone of housing finance for lower income groups and these had to be mobilized as fully as possible. The GSS accepted that subsidies were necessary for some groups, as long as they provided the greatest benefit to those most in need and treated equally those in equal need.

The new paradigm encouraged institutional reform and development. This coincided with the spread of decentralization of power from the centre to regions and municipalities and the growth of a local sense of responsibility for urban conditions.

Reflecting the globalization beginning in the early 1990s, the need for housing finance institutions to be able to compete for deposits and investments on equal terms with other financial institutions was emphasized. Thus, lending had to be at positive, real interest rates and deposits had to be of sufficient term to support long-term lending.

In the 1990s, some developing countries developed proactive and well-integrated housing finance policies and institutions. There was a recognition that purely government-managed finance institutions had failed in their laudable aims and become bureaucratic, inefficient and prey to exploitation by insiders (see Box 2).

Countries with well-developed housing finance sectors, mainly among middle-income developing countries

and some in Asia, benefited from the international concentration on housing finance. The new policy was an effort to improve the performance of financial institutions through providing guarantees to international investors similar to those of the Housing Loan Guaranty scheme used by the US Agency for International Development (USAID). However, some housing finance systems moved from boom to bust, with serious local consequences. One such was the Mexican housing finance system.

THE NEW MILLENNIUM: POLICIES AND ORGANIZATIONS IN SHELTER AND URBAN DEVELOPMENT

In the new millennium, formal bank financing is only one of several players in the field. Mortgage finance is available in most countries, but its limitations are obviously militating against its being the solution for most low-income households. In filling this gap, microfinancing has progressed from being only enterprise-focused to being an important feature of the housing finance system.

Just before the turn of the millennium, the Global Strategy for Shelter to the Year 2000 and Agenda 21, Chapter 7, were consolidated into the Habitat Agenda at the Istanbul Summit in 1996. The Habitat Agenda provides a basis for international and national housing and urban development policy for the 21st century. With regard to finance, the Agenda commits member states to strengthening existing financial mechanisms. It highlights the importance of developing innovative approaches for financing the implementation of the Habitat Agenda, including mobilization of additional resources from public, private, multilateral and bilateral sources, while at the same time recognizing that local institutions involved in microcredit hold the most potential for housing the poor (see Box 3).

The rise of community-based organizations (CBOs) involved in providing loans to people living in poverty has been an important feature of the last decade. Perhaps equally important has been the setting up of national and international umbrella organizations to enable and assist their operations, such as Shack/Slum Dwellers International (SDI) and Society for the Promotion of Area Resource Centres (SPARC) in India. This grassroots movement has introduced a new dimension to the financing of housing and urban development. Probably for the first time, the people who are the ultimate beneficiaries of major international loans are in the driving seat; determining how the money should be spent and organizing others to do the same.

Housing rights are an important component of the UN-Habitat Global Campaigns on Secure Tenure and Good Urban Governance

Finally, during the 1990s, the need to ensure adequate housing has been transformed to the *right to adequate housing*. In 1996, the UN Conference on Human Settlements reinforced the commitment of states to the full and progressive realization of the right to adequate housing, as provided for in international instruments. Any retrogressive measures, such as forced evictions, are regarded as violations of the right to housing. Indeed, states are seen as having a duty to respect, protect and fulfil housing rights. However, none of this is considered to entail a state obligation to provide everyone with free housing but, rather, to set up the legal, social and economic environment in which households have adequate chance to fulfil their needs.

Shelter and urban governance issues are matters of concern for all

Box 3 Commitments on shelter finance, Habitat Agenda, 1996

On finance, paragraph 47 of the Habitat Agenda commits member states to:

> *… strengthening existing financial mechanisms and, where appropriate, developing innovative approaches for financing the implementation of the Habitat Agenda, which will mobilize additional resources from various sources of finance – public, private, multilateral and bilateral – at the international, regional, national and local levels, and which will promote the efficient, effective and accountable allocation and management of resources, recognizing that local institutions involved in microcredit may hold the most potential for housing the poor.*

Paragraph 48 also commits member states to:

> *(a) [Stimulating] national and local economies through promoting economic development, social development and environmental protection that will attract domestic and international financial resources and private investment, generate employment and increase revenues, providing a stronger financial base to support adequate shelter and sustainable human settlements development.*
>
> *(b) [Strengthening] fiscal and financial management capacity at all levels, so as to fully develop the sources of revenue.*
>
> *(c) [Enhancing] public revenue through the use, as appropriate, of fiscal instruments that are conducive to environmentally sound practices in order to promote direct support for sustainable human settlements development.*
>
> *(d) [Strengthening] regulatory and legal frameworks to enable markets to work, overcome market failure and facilitate independent initiative and creativity, as well as to promote socially and environmentally responsible corporate investment and reinvestment in, and in partnership with, local communities and to encourage a wide range of other partnerships to finance shelter and human settlements development.*
>
> *(e) [Promoting] equal access to credit for all people.*
>
> *(f) [Adopting], where appropriate, transparent, timely, predictable and performance-based mechanisms for the allocation of resources among different levels of government and various actors.*
>
> *(g) [Fostering] the accessibility of the market for those who are less organized and informed or otherwise excluded from participation by providing subsidies, where appropriate, and promoting appropriate credit mechanisms and other instruments to address their needs.*

Source: UN (1996) *Istanbul Declaration*. Second United Nations Conference on Human Settlements (Habitat II), Istanbul, Turkey, 3–14 June

CHAPTER 3

FINANCING URBAN DEVELOPMENT

This chapter addresses the wide range of problems that face municipal authorities in financing urban development as they respond to the challenges of major shifts in their economic base, resulting from falling trade barriers and a globalizing economy. This chapter particularly highlights new and innovative approaches to financing urban development, as well as the contextual relevance of urban development finance to finance for shelter development. At the core of this linkage is the fact that municipal finance plays a central role in providing citywide infrastructure services, including within the slums that accommodate the majority of the urban population in developing countries. The chapter places emphasis on developing countries, where the challenges are the greatest and the resource constraints the most acute. These are the countries targeted by the Millennium Development Goals (MDGs) and associated 2015 targets adopted in 2001.

Several important global trends in municipal finance have emerged in recent years: the broadening of locally generated revenue sources; the strengthening of local financial management; partnerships to finance capital investments; and enhancement of access to long-term credit for municipalities.

MUNICIPAL FINANCE AND URBAN DEVELOPMENT: THE MAIN ISSUES

In advanced economies, the combination of strong local tax bases, structured central/local fiscal relations and well-targeted transfers give local governments the means to drive their own economic, social and physical development, to partner with private-sector entities on development initiatives and to work with non-governmental organizations (NGOs) on social programmes.

In transitional economies, the evolution of municipal finance for urban development reflects the path followed by each country as it integrates within the global economy. The sequencing of the reforms affecting legal and institutional frameworks and economic sectors is of paramount importance.

In many developing countries, local authorities depend heavily upon central transfers to cover deficits in their operating expenditures and upon grants from donors to address their most pressing environmental and social problems. External funds are the main source of financing projects to upgrade and expand infrastructure and urban services. Decentralization policies have devolved functional responsibilities to them without providing them with the fiscal resources needed to discharge this mandate.

Urban environment funds are playing an increasingly important role in developing country cities

Urban development cannot succeed without stable revenue sources and vibrant private capital

NATIONAL MUNICIPAL FINANCE SYSTEMS

Two key emerging issues are affecting municipal finance systems in both developed and developing economies. The first is the progressive decentralization of the responsibility for infrastructure investment and the delivery of services to local governments, a trend that has increased their fiscal burden.

The second issue is the rapidly evolving local and regional fiscal relations. While there is a relatively smooth transition to complementary roles between regional and local authorities in the European Union (EU), the situation is far less clear in developing countries, with the exception of India where the state and provincial governments exercise a high degree of control over municipal finance.

Major challenges that must be addressed include:

- large numbers of smaller, financially weak municipalities;
- asymmetrical decentralization;
- retrenchment of central transfers;
- weakness of local revenue sources;
- lack of strong domestic capital markets;
- impediments to the development of municipal credit institutions;
- inadequate capacity and rules for sound financial management at the local level;
- lack of mechanisms to finance urban investments; and
- lack of funds for maintaining existing assets.

SOURCES OF MUNICIPAL FINANCE

Municipalities obtain their finance from a wide variety of sources, but the main categories consist of financial transfers from the central government and locally generated revenue, including debt finance. Central government transfers account for the bulk of local resources in most countries, particularly for capital investments, and are usually based on a redistribution of certain centrally collected revenues: a partial redistribution of the value added tax (VAT), entitlement grants for recurrent expenditures, and grants for specific projects. These transfers bridge the gap between the revenue-raising capacity of municipalities and mandatory local expenditures.

Locally generated revenues fall into three broad categories: taxes on property and on economic activities; user fees for the delivery of services and the improvement of infrastructure; and loans borrowed to finance long-term investments, generally infrastructure.

Taxes on property and businesses

Administration of the property tax demands a good real-estate valuation capability to perform periodic revaluations of all taxable property over a period of not more than about five years. Setting up a computerized system capable of maintaining property and valuation records greatly facilitates this task. Where these capabilities exist, it is possible to ensure that the assessed valuation of all properties is realistic relative to market conditions.

In many developing countries, property records are kept manually and valuation experts have a hard time keeping up with rapid urbanization. The tax yield from the real estate sector is low relative to the market value of the assets and the rate of appreciation of serviced and non-serviced land.

User fees

User fees form a significant part of municipal revenues, particularly in developed economies. Although widely used, their yield in developing countries has usually been less than the operating and amortization costs of infrastructure systems as many governments have set rates below their economic level in order to alleviate hardships on the poor. Balancing financial and social considerations, governments at all levels have instituted measures to alleviate the hardships suffered by the poor. The most commonly used are:

Recent debate over pricing of essential services has resulted in improved financial management of cities

Box 4 Linkage fees in Boston, US

In Boston, developers sign a Development Impact Project agreement with the Boston Redevelopment Authority for substantial real estate projects that require a zoning amendment. A linkage fee is levied on each additional square foot of floor space in excess of a 100,000 square feet upper limit. In 2004, linkage fees equalled US$8.62 per square foot, out of which US$7.18 subsidized affordable housing and US$1.44 job training. This rate can be adjusted every three years to follow inflation. The schedule of payments is spread out over 7 years for downtown projects and 12 years for projects in other areas, and the fees are deposited in a special fund for affordable housing and training. Alternatively, developers may choose to build affordable housing projects or create a job training programme. Between 1987 and 2004, US$79.6 million were generated for housing through linkage, adding 7604 units to the city's housing stock, 6116 of which were affordable. The programme generated US$15.2 million for job training and awarded US$12.9 million to 190 different job programmes, such as school-to-work initiatives, family literacy or workplace-based education, creating over 1000 jobs.

Source: Boston Housing Authority (2000, 2002, 2004) *Leading the Way* housing initiative reports, available at www.cityofboston.gov/dnd/D_Neighborhood_Housing_Reports.asp; Boston Municipal research Bureau (1998) *Boston's Linkage Program: A New Approach to Managing Linkage Funds for Housing and Job Training*, City of Boston, MA; Avault, J., Consalvo, R. and Lewis, G. (2000) *Survey of Linkage Programs in Other US Cities with Comparisons to Boston*, Boston Redevelopment Authority, Boston, MA

- allowing a minimum consumption level per capita or household free of charge, as in South Africa;
- subsidizing charges for lower-income populations; and
- establishing a pricing structure that is not discriminatory for small users.

Most recently, the debate over the pricing of essential services has acquired a new dimension because of the NGO-led movement to assert the legal 'right to the city'. This right includes access to urban land and urban services for all residents.

Betterment taxes and borrowing

In advanced economies, an array of impact fees and betterment taxes compensate local authorities for the additional expenditures incurred in extending urban infrastructure and services to new urban development projects or in upgrading services in the urbanized area. For example, since the mid 1980s, the proceeds of the linkage programme that mandates payments by developers of larger commercial development has financed both the construction of affordable housing and job training for residents of lower-income neighbourhoods in San Francisco and Boston, US (see Box 4).

Funding for capital expenditure requires access to long-term borrowing, broadly related to the working lives of assets to be financed. In situations of high inflation, economic recession, structural adjustment and other constraining factors, long-term borrowing is typically not available, although various methods have been devised to counter these constraints. The standard solution is to add the expected inflation rate to the real cost of money, adopt variable rates, or index either the principal or the annuity payments to the inflation rate. Alternatively, domestic loans are linked to a stable foreign currency, as has happened in many Latin American countries.

In the absence of long-term financing, local governments have tended to use short-term commercial debt where the option is available to them. Short-term borrowing by municipal governments is normally limited to covering capital investments. In many countries, attempts have sometimes been made to continuously roll over short-term debt used to finance capital expenditure. Debt has sometimes been used to cover recurrent budgetary deficits or for short-term cash-flow management.

Credit enhancement, access to financial institutions and capital markets

Local governments need sophisticated debt management capability to draw on the range of financial options and instruments to finance their capital investment needs. These capabilities are not currently prevalent among many local administrations in the developing world. In order to strengthen local finances and enhance municipal access to medium- and longer-term credit, shared revenues are regarded as part of the local resources available to service debt and can be pledged as collateral. Thus, shared revenues serve as loan guarantees and central governments can withhold them from municipal governments and authorize lenders to intercept the transfers in order to settle arrears of debt service obligations. This arrangement enhances the credit rating of municipalities.

International capital markets and multilateral financial institutions have focused upon East Asia's credit market in light of the strength of the regional economy, anchored by Japan and China, and the Asian countries' own performance rebounding from the 1997 financial crisis. In the Philippines, municipalities and provinces are authorized to issue bonds to finance self-liquidating, income-generating projects, enhancing the quality of life in the city. In India, the Ahmedabad Municipal Corporation became the first municipality to issue bonds on the capital market; but other municipalities have also used this method with the back-up of credit rating agencies.

Income-generating enterprises

Local governments can establish separate income-generating enterprises to enhance their overall revenue-generation capability. The advantage of using an income-generating enterprise is that its activities can be accounted for independently of general tax-borne activities. Typically, the role of revenue-earning enterprises is not to generate contributions to general public revenues, but to remove open-ended reliance upon such revenues.

In China, formal government budgets account for only half of local government financial activity due to the importance of off-budget finance. As they have no borrowing power, municipalities have resorted to the ingenious mechanism of creating independent wholly owned companies, whose activities are off-budget, to finance the capital financing of development projects, particularly infrastructure. These so-called special purpose vehicles (SPVs) are allowed to borrow on the capital markets and use their revenue to amortize their debt. They have become a key instrument in implementing large-scale urban development projects (see Box 5).

Municipal development funds

Many countries have established municipal development funds (MDFs) that provide regional and local governments with needed capital. The Public Works Loan Board (UK) and the Crédit Foncier (France) are among the oldest and have served as models for other countries. Typically, MDFs have been sponsored by central governments, with international

Box 5 The role of special purpose vehicles in China

In China, municipalities have no borrowing power and rely upon off-budget entities to obtain the capital they need for investment, primarily in infrastructure. These special purpose vehicles (SPVs) are wholly owned companies operating on a quasi-commercial basis. SPVs raise funds by borrowing from state-owned banks and undertake investments on behalf of provincial and municipal authorities. The Shanghai Urban Development Investment Corporation (UDIC), owned by the city, has directly issued bonds to finance infrastructure projects on the financial strength of the city authority. The implicit guarantee is that the city will not allow UDIC to fail. The bonds issued by a municipality are viewed as a contingent liability of the municipal authority and are usually backed by municipal assets transferred to the SPV or by the revenue stream of a self-sustaining project.

Local authorities are prohibited from guaranteeing loans to SPVs, and the extent of their indebtedness is a major concern as China restructures its domestic financial markets and plays an increasingly bigger role in the international capital markets.

Source: Serageldin, M., Jones, D., Vigier, F. and Solloso, E. with the assistance of Bassett, S., Menon, B. and Valenzuela, L. (2004) *Municipal Finance Conditions and Trends*, background paper for the main report, Center for Urban Development Studies, Harvard School of Design, Cambridge, MA

development organizations initially participating in the creation of these institutions. Some poorly managed MDFs have collapsed, while others have been sustained and continue to finance development projects. Yet others have managed to leverage local capital contributions and a few have evolved into such noteworthy institutions as Colombia's Financiera de Desarrollo Territorial (FINDETER), and the Development Bank of Southern Africa. An alternative approach has been for groups of municipalities to obtain pooled financing as members of specialized subnational entities, such as Sweden's Kommuninvest Corporation, or by virtue of their regional location – for instance, Virginia's Resources Authority in the US.

Other sources

There are other municipal finance sources, including social investment funds, environment funds and special funds financed by debt swaps. Social investment funds were introduced in several countries in Latin America, Asia and Africa over a decade ago to finance projects aimed at social development and poverty reduction.

Though still an exception, targeted funding of poverty reduction and environmental projects is growing in importance, particularly in Latin America. Funding tends to be either through external donations or through debt swaps under the Heavily Indebted Poor Countries (HIPC) initiative.

The Bolivian Strategy for Poverty Reduction, within the HIPC initiative, gives an important role to local authorities as a way of increasing the efficiency of services delivery to impoverished populations and to promote local development. It relies upon municipalities to develop and implement action plans to reduce poverty. An amount of approximately US$20 million annually is transferred to local authorities to invest within eight national priority sectors.

MUNICIPAL SPENDING PATTERNS

Local government budgeting

The lack of financial management skills at the local level often impedes the preparation of accurate and complete budgets. In many countries, local budgets are just lists of cash receipts and payments that are not usefully categorized. Often, there is no clear distinction between operating and capital expenditures. Budgets commonly respond to the mayor's priorities, requests by councillors, potential funding from higher levels of government and outside sources, and electoral promises.

Budgeting faces many challenges. First, estimates of grant and revenue-sharing allocations are hardly ever made available to local governments in adequate time for them to prepare their own annual budgets. Second, in most countries in Africa, Asia and Latin America, municipalities are not able to borrow long-term funds on the capital markets and have to rely upon targeted transfers for their capital investment. Third, most local capital budgets reflect immediate needs or political expediency rather than a long-term development strategy. Fourth, the efficient collection of taxes is a daunting problem, particularly in parts of the world that are experiencing rapid urbanization. The lack of up-to-date records, inadequately trained personnel and the prevalence of informal housing and of unstructured floating economic activities are major obstacles to an increased financial self-reliance of local governments.

■ Participatory budgeting

Democratic local governance has fuelled growing demands for accountability and transparency in municipal budgeting and financial management, particularly with regard to the allocation of scarce local resources and their utilization. Of particular interest is the transparency mandated by Brazilian legislation and the spread of participatory budgeting – first instituted by Porto Alegre – to municipalities in Brazil and other Latin American countries.

Multi-year capital budgeting

Capital investment budgets are a major undertaking for local governments. These budgets are often not well linked to development strategies and spatial plans, or such plans may not exist or may be mere wish lists of projects. An innovative approach is the rolling four-year capital investment programme of Szczecin in Poland. This allowed the city to improve its financial management standards to a level that enabled it to attract local and foreign investors, and to obtain a credit rating and borrow from commercial financial institutions (see Box 6).

■ Lack of funds for maintaining existing assets

In developing countries, asymmetrical decentralization has led to serious fiscal imbalances. In many such countries the funding provided barely allows for the delivery of services or coverage of settlements within the jurisdiction, thus undercutting shelter delivery. Because they immediately impact upon day-to-day activities, operating expenditures are

Box 6 Multi-year capital investment planning, Szczecin, Poland

During the transition towards a market economy, priority was placed on capital investments that structure and support the local economy and enhance local development, including road construction and maintenance; water supply and sewerage systems; revitalization of communal housing; and improving education and healthcare facilities. Szczecin was the first Polish city to link its city development strategy to a four-year capital investment programme (CIP). Approved by the city council in 1997, the CIP proved to be one of the most important instruments of financial management during the transition. It allowed the city to determine its financial and development capacity, and to prepare forecasts for local and foreign investors.

The first four-year CIP (1997–2000) coincided with the rapid expansion of the responsibilities of local governments as a result of devolution. In March 1998, the city council adopted a resolution detailing the principles governing the preparation of the CIP and established procedures and criteria for prioritizing and selecting projects to be funded. These included assessment of existing needs; linkages to the city development strategy; technical aspects of projects; implementation costs; financing capacity based on the city budget; and sources and conditions of potential external financing.

The programme identified each capital expenditure by year – disaggregated by project, programme and responsible department, and funding sources for each category – and proposed methods of financing. The rolling four-year CIP is submitted to the city council for annual approval. The first year's capital investment programme is integrated within the city budget.

Source: Center for Urban Development Studies (2000) *Housing Microfinance Initiatives*, Center for Urban Development Studies, Harvard School of Design, Cambridge, MA; Serageldin, M., Jones, D., Vigier, F. and Solloso, E. with the assistance of Bassett, S., Menon, B. and Valenzuela, L. (2004) *Municipal Finance Conditions and Trends*, background paper for the main report, Center for Urban Development Studies, Harvard School of Design, Cambridge, MA

almost always perceived as the most urgent. Priority operating expenditures and financial constraints frequently lead to deferment of expenditures on maintaining existing assets.

Managing municipal expenditures

As recurrent expenditures have increasingly dominated budgets, techniques for determining expenditures and measuring actual performance have been developed and incorporated within budgetary processes. Best practice demands that capital expenditure is budgeted and accounted for separately from recurrent operating expenditures; that operating expenditures be financed from fees, charges, regular taxes, regular shared revenues and recurrent government grants and not allowed to exceed these current revenues; and that borrowing, when permitted by law, be restricted to financing capital investments, with the possible exception of covering temporary cash-flow shortages. These principles of financial management are increasingly incorporated within legislation on national finance systems relating to state and local budgeting and provide a framework for financial management and assessment of performance, where local officials and elected representatives are held accountable for their own actions.

Accountability for performance is a cornerstone of good governance and a major tool in financial management. It requires some measurement of performance, and – since the mid 1980s – local governments in Western Europe, the UK and the US have started to measure the real costs of delivering public services (see Box 7). Accrual-based multi-year budgeting provides more or less robust indicators of performance and is becoming a more common alternative to the traditional cash flow-based local budgets. In developing countries, most municipalities lack the capacity and resources to implement sophisticated monitoring of financial performance. Nevertheless, publicizing even crude, quantitative and qualitative indicators enhances community understanding of urban management and development challenges and promotes citizen participation in local governance.

PRIVATIZATION OF MUNICIPAL SERVICES

Starting in the 1980s, 'privatization' became an international trend embraced by countries all over the world, prompted by international and bilateral development organizations advocating the greater use of private-sector entities as the means of improving the delivery of public services.

Privatization of local services entailed modifications in existing procedures and the introduction of new modalities of

Box 7 Accounting for the financial cost of urban services

For some public services (particularly, water supply, sewerage, drainage and transport), operation and maintenance costs represent small inputs in terms of economic resource use compared to the massive quantities of land, buildings, infrastructure and equipment that are in constant use to keep the systems functioning. Yet, despite this large input of fixed assets, there has been a great reluctance, all over the world, to account for their employment. Consequently, public service decisions, especially with regard to the pricing of services, are often made on the basis of cash-flow data for operating expenses.

Currently, more recognition is being given to the need for comprehensive cost analysis and accounting for fixed assets. Depreciation costs are charged in operating statements. The net worth of fixed assets is periodically revalued to its current value and the operating statements are charged with notional interest, reflecting the opportunity cost of capital invested. Reform of existing systems and the transition to newer financial systems usually take several years to implement. To prepare and update an inventory of fully recorded and valued fixed assets, the local government or other service delivery unit requires specialized personnel whom local governments may not necessarily have in house. They must either build this capacity or procure the services by contracting out.

Worldwide, progress is being made on the institution of more transparent systems in local financial management. For example, two of the world's largest countries, Russia and Indonesia, have very different cultures and histories. Yet, in each one, during the past few years, laws have been promulgated that will require the use of full accrual accounting in state and local governments. St Petersburg in Russia and a few other major cities began this reform during the 1990s. As housing and shelter are among Russia's most pressing social concerns, financing and budgeting for this sector need to undergo a complete overhaul. In Indonesia, capacity-building is helping local authorities to implement accrual-based budgeting; but progress is still slow.

Less ambitious trends have appeared in smaller countries. For example, in 2003 Macedonia conducted a series of national seminars sponsored by the United Nations Development Programme (UNDP) on 'Strengthening Local Self-governing Institutions in Macedonia, through Capital Development, Transparency and Financial Accountability', to build capacity as a first step in the reform of local financial systems. In the poorer countries, donor-sponsored fiscal decentralization includes the development and institutionalization of accounting reforms to ensure that the systems meet donor requirements. Capacity-building is extended to local governments to ensure proper implementation of the new systems, often starting with pilot initiatives.

Source: Serageldin, M. et al (2003) 'Assessment of participatory budgeting in Brazil', paper prepared for the Inter-American Development Bank, Cambridge, MA

supply and delivery of services, including the contracting out of all or part of individual services; public–private partnerships; franchises; and forcing internal service units to compete on a commercial basis, as happened in Eastern Europe. However, the scope for privatization at the local level was limited to a relatively small number of services. These included public transport; water supply; solid waste management; a number of activities including janitorial and cleaning services; information processing and accounting; landscaping; and vehicle and plant maintenance. The success of the outcomes depends upon the particularities of each situation and the viewpoints of key stakeholders.

It has become incumbent upon each locality to consider whether it should separately manage each of the services it delivers, or combine some services with one or more of its neighbouring units. Local authorities, separately or jointly, can outsource the management and delivery of one or more services to private operators, non-profit organizations or community groups. In Europe, there are strong incentives for inter-communal compacts; in transitional and developing countries, local authorities are reluctant to engage in joint action, which typically requires some delegation of powers and sharing of revenues. In Latin America, political affiliations create divisive forces that impede the development of joint activities. Many local authorities in developing countries have opted to establish separate operating units for some services with their own assets, staffing and management. These enterprises are managed by a 'board' or a committee in which the locality is represented.

The experience of formal privatization in many cities is that it has not benefited lower-income communities, pointing to the need for the public sector to have a role in delivering essential services, especially within slum areas. The abolition of social rates and other forms of subsidization of minimum consumption levels for basic services has worked against the urban poor.

Joint funding of infrastructure and urban services

In China, provincial and local authorities increasingly look to public–private partnerships as an option to fund or implement infrastructure and urban development projects. Partnerships with private investors range from the granting of concessions, to joint venture agreements, to build–operate–transfer (BOT) or build–own–operate–transfer (BOOT) schemes.

Of special interest to poorer countries are solutions based on partnerships between municipalities, NGOs and CBOs (community-based organizations). In these countries, integrating poorer communities within the city fabric and giving the poor access to basic services is hampered by the spread of chaotic urbanization, the mounting densities in the central zones, the obsolescence of existing conventional systems, and the lack of resources to maintain and upgrade existing systems.

To improve living conditions in the under-serviced communities, systems and networks using different technologies and serving different population groups and geographic areas must somehow be interlinked. Solid waste management is one of the services most affected by the need to merge traditional solutions with modern technologies. In West African cities, potable water supply could also benefit from this approach. Cotonou's (Benin) award-winning programmes demonstrate the importance of linking formal and informal service providers.

Recognizing the importance of home-based income-generating activities, particularly for women, microfinance institutions and community-based funds have started to offer loans for housing. They have progressively expanded their lending to help poor families access land and basic infrastructure services. Today, they have become key partners in municipal initiatives to improve the living conditions of poor households in both urban and rural areas.

PART II

SHELTER FINANCE: ASSESSMENT OF TRENDS

CHAPTER 4

MORTGAGE FINANCE: INSTITUTIONS AND MECHANISMS

The cost of a complete dwelling in the North is generally between 2.5 and 6 times the average annual salary. Indicative costs suggest very similar figures or higher figures for the South. For those planning and able to purchase property, it is very difficult to finance such costs without a loan and generally such loans will need to be long term (typically over 10 years and sometimes over 20 years). When the repayment period is to stretch for such a considerable period, a legal framework is required for lenders to be confident about the security of their finance. Hence the significance of mortgage finance in which the loan is secured on property.

The size of mortgage loans (given the cost of properties) and the requirement for a deposit or down-payment to cover a significant part of the cost means that most households accessing mortgage finance are those at the top or in the middle of the income scale. Low-income households may lack the finance for the down-payment and are likely to lack formal legal title deeds and hence are unlikely to be able to offer acceptable collateral. Despite such difficulties, one emerging global trend is the effort to reach mortgage finance down to lower-income groups, expanding the market for housing finance and increasing formal home ownership.

Chapter 4 first considers emerging trends in the provision of mortgage finance and summarizes present terms and conditions of such finance. Secondly, it looks particularly at the situation with regard to lower-income households that might be seeking mortgage finance and the affordability of such options for these households. Thirdly, it looks at emerging tensions and opportunities in current mortgage finance and assesses its potential contribution to addressing household needs for housing finance. Mortgage finance is generally provided by commercial companies and/or by the state through specialist housing finance organizations, mostly for the purchase of complete housing units that are legal.

RECENT TRENDS

General trends related to providers

In general, governments have sought to encourage home ownership and have, in many cases, provided preferential financing to influence consumer choice. There has been a general shift towards market-based mechanisms for the provision of housing, with attempts to reduce subsidies and deregulate markets. In part, this is due to the past ineffectiveness of housing strategies that have depended on the direct provision by the state. This trend is also consistent with the overall direction of macroeconomic strategies in recent decades.

In some countries, providers previously came solely from the government sector. New mortgage providers may be commercial financial institutions, or in some cases, mortgage companies (see Figure 3). Many Southern countries now have access to market-rate housing finance, which was not the case 20 years ago. Despite what is generally a pessimistic appraisal of the potential for direct state provision, a popular response to housing problems in the transition countries has been the establishment of national housing funds, in most cases orientated to the provision of low-income housing.

Sources of finance

The importance of deposits to the bank system is widely acknowledged. Deposits account for 62 per cent of the funding of all mortgage loans within the EU countries and this percentage is even higher in the transition countries. However, if the only source of finance available to the mortgage lenders is deposits, then, even if they can secure sufficient funds, lenders face a risk when committing long-term loans with short-term finance.

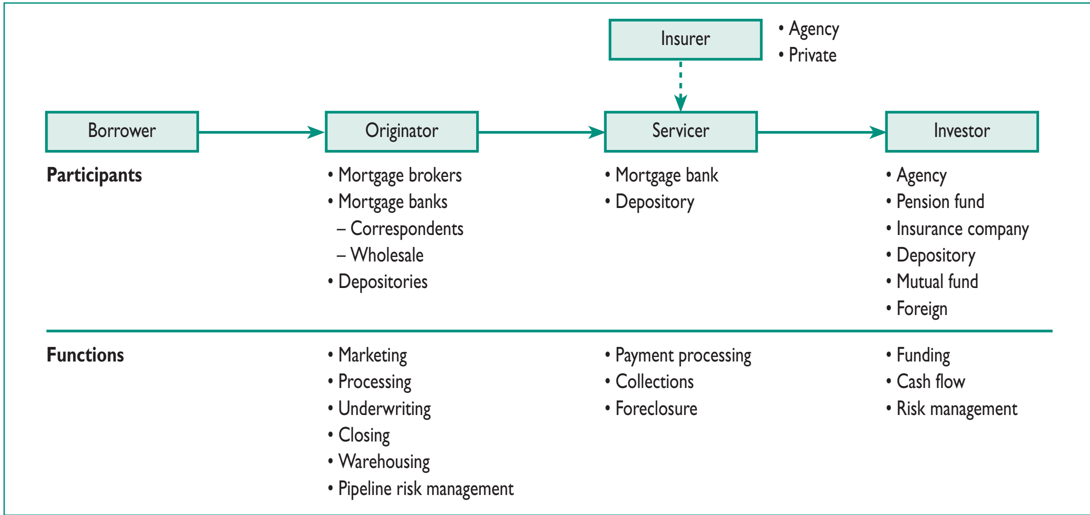


Figure 3

The unbundled mortgage delivery system

Source: Lea, M. (2000) 'The role of the primary mortgage market in the development of a successful secondary mortgage market', *Sustainable Development Department Technical Papers Series*, Inter-American Development Bank, Washington, DC

As an alternative to short-term deposits, there are several sources of longer-term finance. One source is the state itself and the direct contributions that it might make. A second source is private funds institutionalized for housing finance either through specialist saving schemes, such as those in Germany and Austria (and now some transition countries), and/or through the state establishing requirements for payroll deductions to capitalize housing funds. A third source is private commercial investment. Despite these multiple sources, the availability of long-term finance is limited in many countries.

Strengthening secondary markets

The secondary market in mortgage finance developed to cope with the risks associated with short-term deposits and longer-term loans. The US has led developments in secondary markets, which have become notably significant from the mid-1980s (see Box 8). For the last 25 years, there have been significant changes in mortgage finance with the growth of involvement by the capital markets; this began in the US and spread to Europe and, more recently, is being explored in Latin America and Asia.

The achievement in the US has been an elastic supply of long-run funding from the capital markets for mortgage finance. The major innovation has been the mortgage-backed security (MBS). Mortgage backed securities are less significant outside of the US, although in some Northern countries there is an emerging market.

A number of measures have been taken in Africa to strengthen secondary markets and specifically securitization. In Kenya, a recent draft national housing policy aims to create a secondary market to ensure additional capital from overseas and the reduction in the costs of borrowing. Generally speaking, mortgage bonds have not been widely used in sub-Saharan Africa, although there have been attempts in Ghana and more recently Kenya to raise finance in this way.

State support for housing finance

Despite frequent criticisms on the grounds of economic efficiency and ineffectual targeting, governments have over many decades intervened in housing markets with the intention of widening access to housing finance and they continue to have a major role in housing finance through the continued use of subsidies. In some cases, the scale of state support to higher- and middle-income households through measures to extend home-ownership (notably interest rate subsidies) may significantly exceed more direct strategies to support housing improvements for lower-income households.

There are several motivations for state involvement. With respect to the welfare of households, motivations are

Box 8 Strategies to strengthen secondary markets in the US

The rise in the secondary market in the US during the 1970s and 1980s came about largely because of standardization of pools of mortgages brought on by three government-sponsored agencies: the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae) and for government-insured loans, the Government National Mortgage Association (Ginnie Mae). Annual sales of mortgages to these three institutions have risen from US$69 billion in 1980 to more than US$700 billion in 1998; they now own or are responsible for about half of the outstanding stock of single-family mortgages. It is these agencies that purchase mortgages and package them into securities (or fund them with debt), thereby enabling them to be traded easily with minimal risk of default.

Freddie Mac was created in 1970 to be a secondary market for thrifts. At that time it dealt with thrifts and Fannie Mae with mortgage bankers; but now both institutions deal with the same mortgage originators. It initiated the first mortgage-backed securities programme in 1970.

Fannie Mae was established during the 1930s to provide a secondary market for government-insured loans to households. During the 1970s, it switched to providing secondary conventional mortgage loans.

Ginnie Mae was created as a successor to the old Fannie Mae. Its purpose is to handle Fannie Mae policy-related tasks and provide a secondary market for government-insured loans. It also guarantees issuer payments on mortgage-backed securities, providing an extra level of insurance.

Source: Van Order (2001) 'The structure and evolution of American secondary mortgage markets, with some implications for developing markets', *Housing Finance International* September, pp19–20

notably to promote home ownership as a whole and to specifically address the needs of those with inadequate housing. The state may also have systemic interests to ensure that the financial markets for housing are stable.

The common strategies to increase home-ownership through the enhanced provision of finance are:

- mortgage interest relief;
- interest rate subsidies;
- housing-savings scheme;
- guarantees;
- subsidies for 'key' public sector workers; and
- intermediate tenures.

A more recent shift has been subsidies designed to augment the payment capacity of the poor (direct demand subsidies).

Direct construction and loans

One of the most far-reaching systems of state intervention through direct construction has been used in the case of Singapore, where 96 per cent of the households are currently living in home-ownership apartments. The strategy has been based on the provision of subsidized mortgage finance (primarily through the interest rate), combined with a dedicated supply of funds through already existing provident/pension funds. However, there are many examples of failed public housing policies. One example is the National Housing Corporation in Kenya, whose production was well below need, with only several thousand units a year. Two parastatals in the Côte d'Ivoire together constructed only 41,000 units between 1960 and the 1980s before being wound up.

Taxation-related incentives

In many West European countries, mortgage interest payments are to some extent tax deductible. Interest rate subsidies have been a popular way of enhancing housing finance affordability. Sometimes this policy has been criticized as acting as a substitute for prudent macroeconomic management. Interest rate subsidies in some countries in Europe may be associated with savings schemes for housing investments, the best known of which is the German *Bauspar* system.

The case against interest rate subsidies has been strongly made. Such subsidies inevitably favour those that can afford loans and larger subsidies go to those able to afford larger loans. It has been argued that direct subsidies are a preferred way of offering assistance with housing costs as they can be more precisely targeted on those in need. Despite such arguments, interest rate subsidies appear to continue to be widely used.

Securing stability – insurance and guarantees

In addition to direct assistance to households to increase the affordability of housing finance, governments have sought to ensure the stability of the system and to reduce the risks for lending institutions when they extend services to lower-income households. As the greater availability of finance has been reflected in growing levels of ownership occupation, risks have increased.

Mortgage insurance is provided in English-speaking countries in the North by a variety of sources and, notably, insurance paid for by borrowers and/or investors (via the state). Governments may specifically provide guarantees in order to extend mortgage lending. While most loan insurance has been intended to protect lenders (allowing them to make loans to higher risk groups), new products are being developed to enable borrowers to insure against falls in value and loss of income.

In the United States and Canada, governments have developed complex systems of insurance that have supported financial flows into a system for housing based around mortgage finance. Hence, for example, the Government National Mortgage Association (Ginnie Mae) established in 1968 guarantees the payments from a number of mortgage providers so that their loans can be securitized and sold on, thereby returning cash to the housing finance system.

Mortgage insurance has been generally thought to be too risky in the transition countries, although a self-managing guarantee fund was established in Estonia in 2000. Loan guarantees are being developed in Estonia, Lithuania and the Slovak Republic.

Effective housing finance institutions have helped to raise home-ownership in many cites, especially in developed countries

RECENT REGIONAL TRENDS

Developed countries

Home-ownership is now the majority tenure across Western Europe, with only a few exceptions – notably in Germany. Nevertheless, levels of owner-occupation vary considerably, being highest among some of the southern European countries (Spain and Italy) where home-ownership can be described as being 'dominant'. Home-ownership is relatively high in several other countries, notably the UK, at around 70 per cent. In a cluster of countries, such as France, the Netherlands, Denmark and Sweden, home-ownership has been established as the 'majority' tenure, without being especially high or dominant. There is little evidence of convergence in home-ownership levels, either in the sense that they are moving in the same *direction*, or that they are converging towards similar *levels*.

It is difficult to detect a consistent trend in mortgage lending, despite a convergence in mortgage rates both within the Eurozone and outside it. In general, strong growth in mortgage lending has been experienced, but there is little consistency between these countries. The Netherlands stands out as having experienced a huge rise in mortgage lending, linked to deregulation in the mortgage market in the 1990s; this took place somewhat later than in Scandinavia and the UK, while arguably it has still to occur fully in Germany, France and Italy (see Table 4).

In 2003, the European market as a whole continued to grow with the total value of residential mortgage debt increasing by 7.4 per cent, a little below the ten-year average of 8 per cent. The total volume of mortgage loans in Europe at the end of 2003 was US$3.4 trillion. This figure has grown rapidly and it now accounts for 42 per cent of EU GDP (see Table 5). This rapid expansion in lending has been encouraged by lower interest rates. However, it should be remembered that the rise in the volume of lending is not necessarily associated with increasing access, as one further trend has been rising house prices, with capital gains for current home-owners and increasing difficulties for those seeking to become home-owners for the first time. In the United States, home-ownership grew on average, as did income, throughout the largely prosperous 1990s, and now stands at a record high.

Countries with economies in transition

The transition countries face a particular problem in that commercial housing finance markets were previously non-existent. The shift in political systems resulted in

	Mortgage debt (percentage of GDP)		
Country	**1990**	**2003**	**Change**
Dominant			
Spain	11	42	+31
Italy	4	13	+9
High			
UK	53	64	+11
Finland	32 (1995)	32	0
Majority			
Netherlands	40	100	+60
Sweden	60 (1995)	50	-5
Denmark	59 (1995)	74	+15
France	20	25	+5
Low			
Germany	43	54	+11

Source: Stephens, M. (2004) *Housing Finance, 'Reach' and Access to Owner-Occupation in Western Europe*, mimeo, York

Table 4

Trends in mortgage lending in Western Europe, 1990–2003

considerable and continuing housing problems, with very low levels of housing construction and, in some cases, deliberate attempts to encourage building.

There has been state support to the development of housing finance systems, with the expectation that the commercial sector will become an increasingly significant provider. Unfortunately, much of this support has been to the benefit of higher income groups who are the only ones able to afford such finance. The Slovak and Czech Republic governments pay 30 to 50 per cent of their budget subsidies to the Bausparkasse institution supporting middle-class savings. Tax incentives have also been used to encourage home ownership in the transition countries. In the Czech Republic, Hungary, Poland and Slovakia, the German and Austrian Bausparkassen model was used with interest rate subsidies.Volumes of housing loans are low in the transition countries. However, there are indications that housing loan markets are growing rapidly; for example, in Estonia the scale of housing loans doubled between 1997 and 2000 and in the Czech Republic the scale of loans grew more than six fold during the same period. In 2002 and 2003 mortgage lending

Argentina [i]	4.0	2002
Austria	26.4	2003
Belgium	28.5	2003
Bolivia [ii]	8.5	2004
Brazil [i]	2.0	2002
Chile [i]	12.0	2002
Colombia [i]	7.0	2002
Czech Republic	4.5	2003
Denmark	87.5	2003
Estonia	5.0	2001
Finland	35.6	2003
France	24.7	2003
Germany	54.3	2003
Greece	17.4	2003
Hong Kong [iv]	31.0	1998
Hungary	7.8	2003
Ireland	45.0	2003
Italy	13.3	2003
Latvia	8.3	2003
Luxembourg	33.4	2003
Mexico [i]	4.0	2002
Panama [ii]	24.4	2004
Peru [i]	2.0	2002
Poland	4.7	2003
Portugal	50.6	2003
Slovenia	3.0	2001
Slovakia	3.0	2001
South Korea [iii]	13.4	2001
Spain	42.1	2003
Sweden	50.0	2003
UK	70.4	2003
US	71.0	2003
Uruguay	7.0	2004

Notes: i Forero, E. (2004) 'Evolution of the mortgage system in Colombia: From the UPAC to the UVR system', *Housing Finance International*, March, p32
ii Rojas, E. (2004) 'Housing finance in Latin America', Presentation to the 25th World Congress, International Union for Housing Finance, Brussels, June; this is mortgage lending, not residential debt.
iii Mortgage debt to gross national product (GNP); Lee, J. (2003) 'Mortgage securitization in Korea', *Housing Finance International*, March, p24
iv Lamoreaux, P. (1998) 'Housing finance and capital markets: The Hong Kong experience' in M. Watanabe (ed) *New Directions in Asian Housing Finance*, International Finance Corporation, Washington, DC, p51
Data for Austria and the Czech Republic includes non-residential mortgage loans and Portugal includes loans to individuals for housing purchase only.

Sources: Yasui, T. (2002) 'Housing finance in transition economies' in *Housing Finance in Transition Economies*, OECD, Paris, p18; European Mortgage Federation (2004) *Hypostat 2003: European Housing Finance Review*, EMF, Brussels, p7

Table 5

Residential debt as a percentage of GDP

grew particularly strongly in Hungary, Poland and Lativa, i.e. by more than 85 per cent.

There are two distinct housing finance systems that are developing – one which is similar to southern European countries and one which shares characteristics with the German system. The first system is associated with high levels of home ownership with a housing finance system that has yet to develop. Countries in this group include Hungary, Slovenia and Lithuania. The second group includes the Czech Republic, Poland, Slovakia, Estonia and Latvia, all of which have adopted legislation to support mortgage bonds.

The privatization process that took place resulted in the transfer of significant numbers of dwellings into private hands. Owner occupation is now close to or above 90 per cent in Hungary, Bulgaria, Estonia and Romania, while in Poland, Slovakia and Slovenia it is above 70 per cent. However, despite this increase in home-ownership, the financial systems needed for such ownership have not developed fast enough.

Developing countries

The problems of affordability in developing countries are considerable. High levels of home-ownership can be misleading because, while many own their homes, their ownership is illegal and/or informal. The house price to average income ratio in Southern countries is considerably worse than in the North. While house prices are four times average incomes in the developed world, the ratio is just under six in Latin America and the Caribbean, seven in oriental Asia, almost ten in the rest of Asia and more than ten in Africa.

The supply of mortgages in Southern countries has been limited by a large number of factors. First, in general there is a lack of supply of long-term funding, even in those Southern countries in which financial markets are beginning to 'emerge'. This is related to many factors, including low incomes that barely cover subsistence needs for a considerable proportion of the population, a lack of formal financial institutions that can capture people's savings, as well as macroeconomic instability that deters households from holding savings with institutions such as pension funds that have a particular interest in long-term finance. The recent financial crises have had negative impacts on the formal housing finance systems in a number of countries and have particularly deterred commercial provision of mortgage finance. However, there are signs of a recovery in lending in both Asian and Latin American countries.

Furthermore, urban land and property development and urban livelihoods (labour markets) are associated with a high degree of informality that does not fit easily with the requirements of mortgage finance. As a consequence of this, there has been a greater interest in titling in recent years. However, the findings from Peru clearly indicate that legal title alone is unlikely to secure large-scale lending (see Box 9).

In spite of these obstacles, mortgage growth has been notable in some Asian countries, including Thailand and the Republic of Korea, as well as some lower-income Asian countries such as Indonesia and India. However, this somewhat optimistic picture is not replicated everywhere. Mortgage finance has been slow to emerge in Pakistan. In the Philippines, the government does appear to have been somewhat successful in extending subsidized loans to middle and lower-middle income groups employed in the formal sector, principally through government-controlled pension and provident funds.

In China, the system of housing finance has been significantly redeveloped. The previous system was one in which dwellings were primarily provided through work units that housed employees in return for a nominal rent. During the 1980s, an alternative system began to emerge in which the state sought to privatize and commercialize housing, shifting responsibility away from work units. Key to such a shift was a significant reduction in state housing subsidies across urban China. In 1995, the government introduced two major programmes to encourage home purchase, the National Comfortable Housing Project and the Housing Provident Fund.

In Latin America, less than 30 per cent of dwellings are produced by the formal housing market. Residential debt is in general a fairly low percentage of GDP, indicating that mortgage lending is not extensive. Significant difficulties of foreclosure, with long foreclosure periods taking over one year, are just one set of the problems that have reduced the attractiveness of mortgage finance in this region. During the last decade, the core issues facing governments in Latin America appear to be the long-standing problems of macroeconomic performance and notably inflation, the specific economic difficulties of the late 1990s and the need to extend finance to those with lower incomes. The related strategies have been titling, direct demand subsidies, the use of specially defined units for housing investment and the expansion of capital into the system through strengthening of the secondary market.

While there are continuing problems of under-developed housing finance systems, in part as a result of the economic difficulties of recent decades, there are some positive trends in Chile, Costa Rica, Panama, Mexico and Peru, with uneven progress in Colombia, Bolivia and

Box 9 Land titles and mortgage finance in Peru

The policy to legalize property was established by the Peruvian government in 1996 through the Urban Property Rights Programme. A commission to legalize informal property was created and more than 1 million title deeds were distributed by 2000. The assumption was that this would enable the poor to access loans and thereby improve their standard of living. In order to maximize the potential, the commission established an information centre and offered training workshops in the use of credit for microenterprise development (although it should be noted that the government had previously legalized squatter settlements and the commission was speeding up rather than initiating a process).

There are a number of categories of insecure tenure and inadequate titles in the country. Clearly, not everyone was entitled to receive a land title. Generally, owners of unauthorized housing (those in public housing but who have not yet been given title deeds) and those living in low-income settlements which either began life as squatter settlements and which are in the process of regularization, or those which are illegal subdivisions (from agricultural land) are entitled to benefit from this policy. In the case of squatting on private land, the granting of title deeds takes longer because the commission seeks an agreement for the purchase of the land between the squatters and owners.

Taking into account all of those able to claim a land title, between 1996 and 2002, 1,269,194 title deeds were awarded, almost half of which were in metropolitan Lima. However, many of those living in squatter settlements who are in the process of improving their settlements were already reasonably confident of their tenure security. While they did not have effective possession of a title deed, improvements (both self-help and investments from service providers) had not waited on such a legal title. Perhaps as a consequence, there was very little take-up of mortgage finance. Up to 2002, 17,324 families in Peru who had obtained title deeds from the commission had gained access to mortgage loans, some 1.3 per cent of the total title deeds allocated during the process. This evidence suggests that the poor are as scared of borrowing from the banks as the banks are reluctant to lend to the poor.

Source: Calderón, J. (2004) 'The formalisation of property in Peru 2001–2002: The case of Lima', *Habitat International* **28**, pp289–300

Ecuador. These improvements include financial sector reforms to facilitate the expansion of mortgage financing, judiciary reform to facilitate the recovery of collateral and increase in housing production/finance in the private sector. They also involve attempts to have public housing agencies working more effectively with the treasuries, private banks and developers to address housing needs of beneficiaries.

The situation in sub-Saharan Africa divides between South Africa (and to a lesser extent Namibia and, until recently, Zimbabwe) where the commercial banking sector is significantly involved in mortgage lending, and the rest of the continent. South Africa's mortgage market is about 198 billion rand (US$30.7 billion). Most of its housing finance is provided through bank mortgages. Despite this scale of finance, there is evidence to suggest that the lower-income households remain excluded from the market. While those who are in formal employment can use their provident funds to guarantee housing loans, many work in the informal sector. Moreover, mortgage finance is unaffordable to many.

The lack of market development in much of the rest of sub-Saharan Africa is related to similar reasons for the exclusion of many poor South Africans from formal mortgage markets. Further problems include macroeconomic instability and problems around tenure insecurity. As a result of such factors, commercial housing markets remain minimal in many African cities. The housing finance sector is dominated by those institutions which are state-owned, receive financial support from the state, often offer subsidized loans and have poor repayment records.

The original conceptualization after political independence was that the private sector would provide for higher income groups and hence the focus of government should be on the middle and lower income groups. Many sub-Saharan African governments established national housing agencies to directly develop houses, offer loans and establish financial systems. However, the experiences were not successful.

While state housing finance institutions have continued in some cases, the greater emphasis on cost recovery and operating efficiency in the 1990s has given them considerable problems in securing finance. Generally speaking, those that do exist have been heavily regulated and have also been seen as social instruments, rather than financial mechanisms. More recently, the state has withdrawn

Affordability is a major constraint for shelter sector development and maintenance

from this area and some housing finance institutions have withdrawn as well. A particular and continuing problem faced in Africa has been a lack of effective institutions and instruments to mobilize savings and channel them into housing investment. For the most part, housing finance institutions have remained dependent on deposits and have not been able to secure long-term finance.

TERMS AND CONDITIONS

Mortgage lending is associated with a standard package of terms and conditions which specify the contribution of deposits, on some occasions the period of savings, the interest rate to be charged on the loan (and if it is fixed or variable), the period of the loan (potentially with penalties for early and late repayment) and loan to value ratios (i.e. the maximum percentage of the loan against a verified value of the dwelling). A further important factor is the amount that

There are increasing attempts to extend the reach of housing finance institutions down the income scale

the loan institution is willing to lend in relation to the borrowers' income(s).

Longer loan periods reduce monthly repayments and higher loan to value ratios reduce the scale of the deposit that has to be saved. Higher loan to value ratios are associated with longer repayment periods. However, risk is an important factor in addition to affordability and it is notable that shorter repayment periods prevail in a number of transitional and Southern countries.

The increased diversification of housing loan suppliers has reduced the general significance of savings activities that are specifically linked to housing, but some form of saving remains essential if mortgage loans are offered for less than the full cost of the property.

A significant refinement of more traditional savings practices that remains important in some countries is contractual savings for housing, or *Bausparkassen*. This institution has been popular in Germany and Austria and has more recently spread to other countries, particularly the transition countries. Such institutions were introduced in Slovakia (1993), Czech Republic (approximately 1994), Hungary (1997) and Croatia (2000).

Interest rates can be particularly problematic for affordability during periods of high inflation. High nominal interest rates tend to worsen the so-called 'front-end loading' problem whereby the real burden of interest payments fall very heavily in the early years of the mortgage. High interest rates considerably increase the cost of borrowing and make housing investments unaffordable for many families. In the North, there appears to have been a shift to flexible, variable rates, which pass more of the risks from the provider of the loan to the borrower. In developing countries, interest rates are relatively high, reflecting two state policies not unusual in these countries: the government wishes to encourage capital inflows to strengthen the currency and secondly it wishes to encourage saving.

HOUSING FINANCE, AFFORDABILITY AND LOWER-INCOME HOUSEHOLDS

Considerable effort has been made to extend opportunities to secure housing finance in recent years. This is the product of two related factors. On the one hand, the housing finance market has become more competitive as new providers have been encouraged to enter the market. Such providers have been seeking new customers to extend their activities. On

the other hand, the state has been looking to the market to address housing need. Faced with considerable housing problems and seeking to reduce public expenditure, governments have sought to encourage the market to address needs were possible.

As noted earlier, affordability is not just about access to and the cost of housing finance, it is also critically about the price of housing. One of the most important trends in housing finance in Western Europe has been the widening 'gap' between incomes and house prices, as the latter have risen relative to the former in many countries. House prices have risen particularly since 1997, and notably in Australia, Ireland, Spain and the UK. In 2003, the European Mortgage Federation noted particularly strong price increases in Latvia, Portugal, Spain, the UK and Ireland (see Table 6).

In a number of countries housing supply appears to be inelastic, i.e. to respond only slowly to increases in housing demand expressed through rising prices. Research has shown that local regulations that prevent housing construction are a significant cause of high house prices in the US and UK cities, as well as in Malaysia, South Korea, Tanzania and New Zealand.

In a context of rising house prices, housing finance systems have a greater job to do in bridging the gap between incomes and prices. Young people have particular difficulties in purchasing dwellings, as they have had less time to save for a down-payment (deposit) and earnings are lower for those who have recently entered the labour market.

In the UK, the decline in home ownership among young households is very striking. The proportion of first time buyers in the UK has fallen and their age risen – from 27 years in the 1980s to 34 years today. A similar picture emerges in Spain, New Zealand and Japan.

Turning to more general problems of affordability, US data for 2004 indicates that there are some 6 million households living in owner-occupied dwellings who fall below the poverty line. This is not that much less than the 7.9 million households below the poverty line who are living in rental accommodation. In the transition countries, there are real problems with affordability due to generally low levels of income. For example, only 10 to 20 per cent of the population in Estonia and Latvia is considered to be eligible for housing loans. In the South, the numbers of people able to afford formal housing with the associated financing costs are limited. As indicated earlier, the clear emerging trend in a number of countries is that of the extension of mortgage finance. However, it is very difficult to assess how successful this has been.

In several Northern countries such as the UK and New Zealand, it has become cheaper to borrow but harder to get through the admission requirements. Despite attempts to reach those with lower incomes with affordable housing finance, many households living in the South, and at least some in the North, are not able to secure such finance. This

Most of the housing in formal parts of developing country cities is unaffordable for the majority of low-income residents

Country	2004 [i]	2003 [ii]	1997–2004
Australia	8.2	17.6	112
Belgium	9.3	5.5	50
Canada	6.7	6.5	43
China	9.9	4.1	no data
Denmark	7.3	3.4	50
France	14.7	11.5	76
Germany	–1.7 [iii]	–4.5	–3
Hong Kong, SAR of China	31.2	–13.6	–49
Ireland	10.8	14.8	187
Italy	9.7	10.6	69
Japan	–6.4	–4.8	–24
The Netherlands	3.3	1.9	76
New Zealand	16.4	21.2	56
South Africa	35.1	20.9	227
Spain	17.2	16.5	149
Singapore	nil	–2.3	no data
Sweden	9.8	5.5	81
Switzerland	2.2	2.4	12
UK	13.8	11	139
United States	13	6	65

Notes: i Third quarter, or 2004 latest.
ii Third quarter.
iii Second half of 2003.

Source: The Economist, (2004) 'The global housing market: flimsy foundations', 11 December, pp77–78

Table 6

House price changes

Box 10 Mortgage finance: problems with down-marketing in South Africa

The preconditions for the mortgage model are that houses have exchange value and are easily traded, so banks can use them as security for a high-value, long-term mortgage, and that borrowers can make regular repayments out of a predictable income stream. These conditions, however, do not hold for South Africa's low-income majority. South African banks are undeniably correct that they cannot extend mortgage finance to the informally employed, low-income majority, most of whom do not even have bank accounts. What is only beginning to be understood is that mortgage lending at the bottom end of a 'developing country' market – which is what South Africa really is – is risky not only for banks, but also for potential low-income borrowers. Even though they can repay small loans (as some South African microfinance institutions have proved), most low-income households cannot maintain the rigid repayment schedule required by a mortgage. Moreover, South Africa's 'township' housing markets are institutionally weak, and it is very difficult to sell a house, either to move up/down the housing ladder, or in execution. To make matters worse, South African formal-sector wage employment has actually declined in absolute terms since 1994, especially in the low middle-income bracket. As a result, when they do manage to get a mortgage, many low-income black South Africans lose their houses due to factors such as income instability and retrenchment.

Source: Baumann, T. (2004) *Housing Finance in South Africa*, mimeo

is not just an issue of affordability, but also of the reluctance of formal sector financial institutions to lend to those working in the informal sector (see Box 10).

In the US and UK, there have been problems with housing market 'booms and busts'. Policy changes in the UK have shifted risks from institutions to borrowers. Increasing interest rates and very high loan to value ratios resulted in a crisis in the late 1980s, with a significant increase in foreclosures. A related problem to 'boom and bust' house prices combined with high loan to value ratios is negative equity, that is when the value of the remaining loan exceeds the price of the house (for example, following a fall in prices). The fall in the Japanese market in the early 1990s offers an illustration of the potential scale of this problem: The total amount of negative equity for the whole of the Tokyo area was estimated to be about UK£7 billion in 1995. The message is that in addition to assessing the effectiveness of extending mortgage finance for their poverty reduction goals, governments also need to consider the implications and risks for housing market stability.

CHAPTER 5

FINANCING FOR SOCIAL AND RENTAL HOUSING

As already indicated in the discussion of subsidies within Chapter 4 on mortgage finance, there is a widespread acceptance of the need for subsidies. The willingness of governments to consider housing subsidies reflects the significance of shelter and a home to citizens, the recognized importance of this to society, and the importance of residential construction for the economy. More specifically, a number of reasons can be identified to explain the prevalence of state subsidies for shelter (which explicitly includes services and the dwelling):

- improving public health and more specifically ensuring that living conditions do not cause outbreaks of diseases;
- improving fairness, justice and social stability;
- providing some aspects of housing considered to be a 'public good' that are not adequately coped with by the private market;
- overcoming market inefficiencies that may result in: monopoly profits and undersupply by developers, poor housing quality, or an insufficient volume of construction, particularly of low-income housing;
- reducing housing costs; and
- stimulating economic growth, as the construction industry is such an important sector.

While a narrow definition of housing finance may focus only on the provision of credit, the scale and significance of housing finance subsidies primarily through rental housing, subsidized loan finance and direct demand (capital) subsidies makes this component difficult to ignore. An understanding of how the financing of social housing can fit within a broader system of housing financing is needed. This chapter looks specifically at some strategies that have recently been used to provide financial subsidies.

Financial subsidies seek to provide incentives to enable and persuade a certain class of producers or consumers to do something they would not otherwise do by lowering the opportunity cost or otherwise increasing the potential benefit of doing so. Some argue that such financial subsidies are best avoided and should be a policy of last resort. Such concerns focus on the potential distortion of markets and are often accomplished by recommendations on institutional and regulatory reforms (see Box 11). In addition, subsidies, especially those offered on interest rates, may have a huge hidden cost.

While subsidies tend to be criticized by economists seeking to encourage a greater realization of the potential effectiveness of markets, they remain popular with governments. The interest in subsidies has resulted in multiple approaches to their delivery, which notably include: direct interest rates reductions; allowing mortgage interest to be deducted from income taxes; support for housing savings; support for insurance in the primary market; support for insurance in secondary markets; and direct grants. However, concerns remain, notably that such subsidies rarely reach the poor. This chapter examines financial subsidies that have particularly sought to reach the poor and provide them with access to a complete dwelling. Governments in the North and the South have primarily used two financing strategies to assist families to obtain housing: assistance for ownership and/or the assistance to afford adequate rental accommodation.

Three specific trends are well established in a number of countries:

Subsidized urban rental housing continues to be important in some countries

Box 11 Regulations, policies or subsidies?

Subsidy should be used as a policy of last resort or, more precisely, should only be used in conjunction with other policy steps. The hierarchy of complementary government actions needed to improve the housing conditions for the majority of housing in an economy are as follows:

- Develop or reform institutions and policies to facilitate the role of private and non-profit lenders and developers in expanding the moderate-/low-income housing supply, and provide education and training to consumers and producers to improve the operation of the housing finance industry;
- Improve the regulatory system in the different supply markets (land, finance and infrastructure) to allow more households to acquire authorized and healthful housing;
- Provide subsidies to address well-defined objectives.

Simply put, if government does not do what is necessary to encourage housing construction and finance industries to function efficiently, housing supply cannot respond to price signals, and higher incomes or subsidies will not translate into better housing.

Source: Hoek-Smit and Grigsby, cited in Hoek-Smit, M. C. and D. B. Diamond (2003) 'Subsidies for housing finance', *Housing Finance International* **17**(3), p5

- Governments have shifted away from the direct construction and management of public housing. They have used several strategies to reduce their stocks with large-scale transfers to occupiers in some cases.
- There is increasing assistance for home-ownership through direct demand (capital) subsidies.
- Consistent with the two trends above is the greater use of housing allowances (rather than direct provision) to assist low-income families renting accommodation in the private or non-profit sectors.

Despite their focus on lower-income households, funding for direct subsidies is often smaller in scale than interest rate subsidies when the full costs of the latter over the life of the loan are considered.

CONDITIONS AND TRENDS

State rental housing in developed countries

Although in developed countries the state is generally playing a less direct role in economic intervention, this is not necessarily the case in housing. Despite the shift to income-related support, the social rented sector (defined as housing let at below market prices and allocated administratively on the basis of housing need, rather than on the ability to pay) remains a significant tenure in several EU-15 states, including the UK, France, Denmark, Finland, Sweden and the Netherlands. However, there have been significant changes in policy and the nature of housing support has shifted in Western Europe: Support systems with large, general interest subsidies for new construction and rehabilitation have been phased out. Targeted, income-related, subsidies have become relatively more important, as have subsidies to depressed housing areas.

However, what is also evident is that, despite a commonality of trends in respect of more limited funding, considerable diversity continues within Europe and there is no single approach to addressing housing need.

In the United States, the direct provision of social housing in 2002 has not been a popular strategy, with just 1.7 per cent of the population living in public housing. Just over half of the funding to support low-income housing from the Housing and Urban Development Department goes to the Section 8 Housing Choice Voucher Programme, which initially focused on rental housing, but which has now been extended to enable support for ownership occupiers. There is also limited assistance, such as tax credits for private sector

Box 12 Funding social housing in the European Union (EU)

At the highest level of generality, European Union (EU) social providers (particularly not-for-profit providers) typically raise private-sector loans collateralized on the housing stock (although the UK still uses extensive capital grants). The financial basis of the funding is supervised by local authorities or dedicated public agencies and by the financial supervisors who follow lenders' practices. Unlike the constraints facing mortgage markets, there is some evidence of a European-wide market for social housing finance.

The classic model of social housing finance in Western Europe involved significant public commitments to underpin, insure, subsidize or provide public loans (or some combination of the above). This meant that providers could repay loans at below-market terms or have to fund investment on only a proportion of the capital value (rather than the private-sector provider who needs to raise market finance on the entire capital value). The growth in the use of market instruments, buttressed by housing allowances and some subsidy in the form of capital grants, has many important consequences:

- the opening up of the source of social housing funds to the global capital market and to a diverse range of social instruments;
- 'professionalizing' the voluntary housing sector (arguably to the detriment of tenant participation);
- expecting most providers in EU countries to use their own funds (reserves), which can be as large as 33 per cent of funding;
- the fact that, despite the growth in private funding, public funding remains important in the UK, Germany, Belgium, the Netherlands, France and the Nordic countries; and
- the diversity of the sources of private funding, with an increase in risk.

Source: Gibb, K. (2002) 'Trends and change in social housing finance and provision within the European Union', *Housing Studies* **17**(2), p331

developers building rental housing for low- and moderate-income housing.

There has been a general marked decline in the levels of new housing units in this sector. As the numbers of designated social housing and/or public properties fall, there are concerns that the scale of social disadvantages associated with such accommodation will rise. It is feared that this will result in a high concentration of social disadvantage, thereby exacerbating social exclusion, reducing mobility and creating greater marginalization for tenants. One further concern is that the growth of means-tested housing allowances (also encouraged by use of private finance) has resulted in higher rents. However, these are considered to offer better incentives in terms of labour mobility and to enable more effective targeting.

One of the most significant developments in social rented housing has been the increased use made of private finance for social rented housing in much of Western Europe (see Box 12). Despite this use, there has been limited private equity investment, although there is some evidence of greater interest in the UK. Another key trend in recent years has been the emergence of surpluses in the social rented sector as a whole in many countries. Declining debt burdens arising from lower levels of construction and the repayment of older debt have coincided with rising rents to create these surpluses. Several countries have attempted to establish 'revolving door' systems of finance whereby surpluses are reinvested in the sector. However, it seems that revolving door finance alone does not stimulate increased construction, either because funds are inadequate or incentives are absent.

State rental housing in countries with economies in transition

Prior to transition, in most Eastern European countries housing was provided by state institutions (workplace, local government and/or housing co-operatives). Essentially, the system was one in which state-provided social rental systems dominated, with low rents and administrative allocation systems.

The transition phase included the transfer of some of these dwellings to their occupants under privatization programmes. In some countries, more than 90 per cent of the stock was sold, while in others the percentage was a low as 6 per cent. However, housing markets were very limited. Even where people own their dwellings, it appears to have been difficult to trade them.

By the end of the 1990s, there was some interest in reinvestment in rental housing, for example in Poland,

Slovakia, the Czech Republic and Hungary. A significant scale is planned – between 10 and 30 per cent of new construction in Poland, Romania and Hungary. However, a considerable problem remains, which is that the institutional strategies for addressing the housing needs of the poorest have collapsed, with no alternative being developed.

Rental housing in the developing countries

Large-scale public housing has not been that significant in the South, despite exceptions such as Hong Kong. While many countries have experimented on a minor scale, in general the scale of provision reflects the limited funds available to invest in public housing initiatives and the high standards that are required. In general, public rental housing has not been allocated to the poor, nor would it necessarily have been affordable even if it had been allocated. In some cases, these properties have now been privatized following the increased emphasis on market provision. As with the transition countries in Europe, China has relatively recently begun a policy to transfer to home-ownership dwellings that had previously been rented from state-owned enterprises and from other state housing providers.

Despite a general trend against direct provision in the South as well as the North, there is some continuing support for rental housing in a number of countries. In Hong Kong, the Housing Authority actually increased its stock by 18,000 units between 1991 and 2001. In the Republic of Korea, there has been (since 1989) a growing interest in a permanent rental dwelling programme for those on low incomes. In South Africa, there has also been a policy (albeit as a secondary strategy subsidiary to the main emphasis on home-ownership) to support the development of a social housing sector and, more specifically, to encourage the development of housing associations to manage low-income estates and rental accommodation.

The majority of renters in developing country cities are in the informal housing sector. In some parts of West Africa and Asia, the incidence of renting is very high. It is estimated that 80 per cent of households in Abidjan, Côte d'Ivoire, were tenants in the 1980s and that 88 per cent were tenants in Port Harcourt, Nigeria, in 1984. Comparable percentages in 1981 for Calcutta and Madras, India, were 76 and 68, respectively. In spite of this reality, most low-income shelter policies, programmes and projects have tended to promote home-ownership and have paid little attention to rental housing, either in terms of understanding and addressing the needs of tenants, or encouraging the development of this type of housing. However, there is now increasing recognition of the significant role of rental housing in meeting the shelter needs of the many urban poor households who cannot afford home-ownership.

Social housing and home ownership

In practice, the high costs of construction of rental public housing and the ongoing costs of maintenance, often in a context in which rents remain very low and national housing budgets very limited, has resulted in large-scale rental programmes being considered impossible in many Southern countries. Despite these problems, there are some governments that have sought to introduce subsidy programmes of a significant scale.

In some cases, they have chosen to use limited funds to support small loan programmes that enhance the process of incremental housing development. In other cases, governments have chosen to subsidize a minimum complete dwelling. In yet other cases, effective capital subsidies have been given through supposed low-interest loans. The limited resources that exist for housing finance mean that allocations may be made as political favours rather than universal entitlements.

In other strategies, there has been a greater emphasis on grant finance and one alternative has been the direct demand subsidies that are associated particularly with the Chilean and, more recently, the South African housing subsidy systems (see Box 13). Capital grant subsidies have also been offered in a number of other countries, although at a smaller scale. By 1999, five Latin American countries had introduced owner-orientated direct demand subsidies: Costa Rica (1986), Colombia, El Salvador, Paraguay and Uruguay (all in 1991).

Despite the initial political commitment, the Chilean, Colombian and South African governments have not put large-scale funding into this process. The percentage of state expenditure for these three countries does not exceed 1.25 per cent, while 2 per cent has been considered typical in the South.

Arguably, the strong focus on capital subsidies has tended to respond to the needs of the construction industry. The construction companies in Chile appear to have favoured higher standards and been opposed to self-help housing. In South Africa, while the focus on housing reflected political priorities, the strategy for addressing housing need emerged from the business representatives and consultants who dominated the National Housing Forum between 1992 and 1994. The Forum saw low-income housing finance in terms of a new capital subsidy deployed by private developers in large-scale construction projects.

Box 13 The Chilean approach to housing subsidies

Since the mid 1980s, housing policy in Chile has been orientated towards subsidizing demand for housing. There are now a number of different housing programmes; but the financial principle is the same in each, with finance being based on three components: beneficiaries' savings, government subsidy and loans. The proportion of these three components varies according to the cost of the house and according to each housing programme. The lower the price of the housing, the higher the proportion provided by the subsidy – although the actual subsidy per housing unit could be almost the same amount. One of the most important aspects of Chilean housing policy is its continuity. It has been based on this approach for almost 20 years, and during the last 15 years the average number of subsidies provided has been nearly 100,000 per year.

In most programmes, people apply through the regional office of the Chilean Ministry of Housing or through the local government. Each programme has its own regulations that are primarily related to who can apply, what they will need to submit in order to be eligible for financial support and what they obtain. The process of selection of the applicants is a very important part of the housing process. One of the reasons for the success of the Chilean model is that almost everyone believes that the process is transparent. This process is computerized and, in general terms, people know what the criteria are according to which they will be selected (for example, level of poverty as indicated by a socio-economic survey of each family and the amount of initial saving). The result of this selection is published in a local and/or a national newspaper so that people can be informed.

There are basically two types of programmes:

1. *Modalidad SERVIU (SERVIU way)*: the regional government will contract the construction of a housing scheme to a private contractor (usually through a process of tendering) and then sell the units to the applicants who have subsidy certificates.
2. *Modalidad privada (private way)*: each applicant manages the construction of the housing themselves or purchases an existing unit in the market. Each person receives the subsidy certificate for a specified amount of money (typically the equivalent of around US$4500). For those who are building new units, they will need to hire a building enterprise (it is difficult for those who would like to do self-build to get this funded).

All programmes require the families (even the poorest) to have a certain amount of savings. This is to make people feel that they have made an effort and that they are not wholly dependent upon the state. At the same time, most programmes included a credit system or support for a loan system (private mortgage). This has meant that it is very important to make the terms and conditions of the loan clear. If the government considers that a certain housing programme is orientated towards the poorest families, it may decide that it is better that the programme does not include a loan component.

The Solidarity Fund for Low-income Housing is a programme that has no loan component as it seeks to reach the poorest households. It is based only on family savings and a subsidy that varies regionally. The housing programme generally restricts the proportion of the subsidy that can go on land to below 30 per cent – largely because a certain level of quality for the house is considered necessary (in terms of size, building materials, etc.). Most applicants are families; but people living on their own can apply if they are older than 60 years or if they are disabled (and registered with the National Disabled Register) or are indigenous people (registered with the National Register of Indigenous Peoples). Single-person households cannot be more than 30 per cent of the families in the whole group. Groups need to be organized in at least ten families. The organization of the group is managed by an external institution that could be the municipality, a non-governmental organization (NGO), the regional housing office, a housing co-operative or a housing foundation, among others; this institution must be registered with the Ministry of Housing. This institution will prepare the housing project as it is requested. Each project needs the approval of the municipality (in terms of urban planning regulations) and the feasibility of urban infrastructure/services (such as water, sewerage and electricity). If the group is buying the land, it will need to show the ownership as a group or the fact that the site is owned by the institution in charge.

Source: Fernandez, V. (2004) *Housing Finance – the Case of Chile*, mimeo

Box 14 An assessment of direct-demand subsidies by the World Bank

Direct-demand subsidies have proved the most efficient type of home-ownership subvention for moderate- and middle-income households in Latin America. Essentially, direct-demand subsidies are portable vouchers that bridge the gap between the amount that households can afford (by joining an affordable mortgage, a down payment and the subsidy) and a housing solution. This form of subvention most effectively stimulates competition among supply agents (developers and financial institutions) and furthers development of the financial sector. Securitization of accompanying market-rate home credit becomes feasible, although it is generally unviable when subvention takes the form of below-market interest rates. Once subsidy programmes reach a significant size and continuity, they develop important economies of scale necessary for the systemic improvement of housing conditions. However, developers, financial institutions and other formal-sector institutions often find serving low-income groups uneconomic if they have other options, even with families obtaining direct-demand subsidies.

As a result, there is a need to supplement these programmes with other policy changes. Supply bottlenecks, such as a lack of lending institutions and land development standards, need to be addressed.

Source: World Bank (2004) *IBRD Program Document for a Proposed Programmatic Loan to the Amount of US$100 million to the United Mexican States for Affordable Housing and Urban Poverty Sector Adjustment Loan*, Report no 27627–MX, World Bank, Washington, DC

For the most part, such large subsidy programmes have been driven by state agencies and state funds. In some cases, such as in Chile and Ecuador, NGOs may play a role in the programme, for example, to assist groups and individuals to access capital grant susdidies.

CHALLENGES

Despite the widespread recognition that has been given to the subsidy approaches above, their limitations should also be recognized (see Box 14). Despite intentions, the evidence from Chile and Colombia is that such programmes have struggled to reach the lowest-income households. Other problems include the small size of the housing units and the poor quality of housing construction. The remote location of the land has resulted in isolation and costly access to jobs and services for lower-income families. One problem in South Africa is that some households are beginning to abandon their subsidy houses, partly because of their poor quality and location, but also because households are now liable for rates and other service charges.

Access to basic services, such as water supply, is an essential component of adequate housing

It is not clear that capital subsidies are the way to go for the poorest households. A more effective strategy might be to ensure access to serviced plots in well-located areas where the poor choose to live and then to provide small loans to finance incremental housing. There are those who believe that such programmes are unaffordable to the poor in Latin America, given that there are millions of indigent poor families that cannot provide themselves with enough to eat, let alone save for housing.

The potential scale of such strategies for financing housing appears to be limited by the high and explicit costs and generally these strategies lead to small and insignificant programmes. In Chile, Colombia and South Africa, the intention was that the commercial banks would be involved in providing credit (small loans) to supplement the subsidies but, unfortunately, convincing the banks to lend to the poor has been difficult.

There are concerns in respect of social housing (including both Northern rental and Southern direct demand subsidy options) about the concentration of the poor in specific spatial areas. It is recognized that remote location can add to problems of social exclusion, while a high concentration of very poor households can increase some of the problems of poverty.

CHAPTER 6

SMALL LOANS: SHELTER MICROFINANCE

Shelter has become a commodity for increasing numbers of low-income households, especially those living in urban areas of developing countries. Those who build incrementally (or progressively) are a very significant group in many countries in the South. However, loan finance for shelter-related investments in incremental dwellings made by low-income households whose income comes from the informal economy is rarely available through the formal commercial financial sector. Households seeking to invest in their shelter (land, infrastructure and housing) have been forced to use their own limited income, seek additional resources from family and friends, borrow from informal credit markets or, in some cases, from groups like credit unions.

There have been several institutional efforts to assist these households secure access to some kind of loan finance. In particular, shelter microfinance and community finance mechanisms have grown considerably in recent decades. Based predominantly in Asia and Latin America, there have been multiple explorations and innovations over the last 20 years. Initial activities were developed by NGOs working in housing and urban development, and by microfinance organizations interested in supporting housing investment. Agencies responsible for these activities now span the voluntary and public sectors.

Chapter 6 discusses the use of microfinance approaches to shelter lending. The loans are almost universally to individuals, generally those with some security of tenure, for investment (construction, improvement and extension) in housing. There are now a few larger programmes that involve multi-sectoral initiatives, with some also having a role for the private sector. Some innovative state programmes have sought to replicate shelter microfinance approaches, albeit within different structures and systems.

SMALL LOAN CHALLENGES AND CHARACTERISTICS

For individuals or households with limited incomes, the only possibility of home ownership (even in an illegal settlement) is through shelter investment made in several stages. Land purchase, service installation and upgrading, and house construction, consolidation and expansion are all made at separate times. An estimated 70 per cent of housing investment in developing countries occurs through such progressive building. Such incremental shelters, often initially built of temporary materials, often require frequent repairs because of damage (for example, from natural forces).

Despite its significance, incremental development is often discouraged by more formal housing finance agencies. In general, this resistance to incremental housing by formal finance companies is because of the risks associated with the building processes (particularly potential illegality) and because of uncertainty about house value and hence problems of mortgage valuation.

Research and practice during the early 1990s emphasized that the quality of self-help investment could be enhanced by financial institutions that enabled the accumulation of savings and/or offered small loans. However, little finance is available for the poor in the South. Several examples from different countries all point to the high dependency of the poor on non-mortgage sources of housing finance. In India, according to the National Statistical Survey's (NSS) 44th round survey, more than 80 per cent of housing finance comes from private savings, sale of assets and non-formal sources of credit.

Microfinance for shelter offers small loans suitable for significant housing improvements. Loan sizes are between US$1000 and $5000, although they may be smaller in some

	Mortgage finance	Microenterprise finance	Shelter microfinance	Community funds
Objective	Provide long-term housing finance	Provide investment finance for enterprise development and enable income growth	Provide housing improvement and improve well-being	Enable the poor to secure shelter assets, particularly land and infrastructure
Borrowers	Upper- and middle-income households	Micro- and small entrepreneurs	Those with land who need to improve the dwelling	Those without secure tenure, basic services and adequate housing
Use of loan funds	Acquisition of property	Development of business	Housing improvement	Land, infrastructure and occasionally housing improvement
Role of savings	Deposit required; savings process not important	May be required	Savings may be required; deposit may be required	Savings generally essential; deposit may be required
Additional support	Irrelevant	Generally not	Possible	Nearly always considered necessary because of complexities of land development
Attitude to the very poor	Avoid	Generally avoid; some specialist programmes	Depends upon orientation; but requirement for land likely to exclude the poorest	Generally seeks to help the very poor if they are residentially stable
Purpose of the collective (community organization)	None	May be used as guarantor	May be used as guarantor; sometimes additional community support is a part of the process	Lending is collective and the role of the group is seen as essential to address the exclusion of the poor
Amount	Generally over US$10,000	Generally under US$500	Generally between US$100–$5000	Generally under US$1000
Interest rate	Inflation plus a margin of 8–15%	Inflation plus a margin of 15–45%	Inflation plus a margin to cover costs of 10–20%	Inflation plus administration
Term	15–30 years	Less than 1 year	1–8 years	3–20 years (generally shorter)
Collateral	Mortgage	Personal guarantees, goods, co-signers	Personal guarantees, goods, co-signers, mortgage	Can be title deeds but emphasis placed on collective loan management
Financial sustainability	Generally considered essential, but may be state subsidies	Desired – support for product development	Desired – support for product development; occasionally integrated with subsidies for land development	Seek state support to offer subsidies for land development and services in order to include lower-income families
Linking role	None	To other financial institutions	To other financial institutions; may involve the municipality in slum upgrading programme	To state and municipality

Source: adapted from Asian Coalition for Housing Rights (2002) *ACHR Newsletter*, Special Issue on Community Development Funds, 14, February, Bangkok, p6, and Ferguson, B. (2004) 'Scaling up housing micro-finance: A guide to practice' *Housing Finance International*, September, p5.

Table 7

Lending strategies for housing development

countries where construction costs are lower and/or building standards do not prevent low-cost housing options. Loan terms are generally between one and eight years, although in most cases they are at the shorter end of this range. Hence, although these loans are often given by existing microfinance lenders and are seen as falling within this category of financial services, they are often considerably larger than enterprise loans (especially those taken by new borrowers when entering this market).

Security conditions vary considerably depending on local circumstances. In some cases they are similar to those required for enterprise development, i.e. group guarantees and co-signers. In other cases, they involve holding the paralegal documents to the property, and other non-mortgage collateral. Some shelter microfinance lenders follow a similar process to that of a conventional mortgage for larger loans.

Loans are generally taken to build additional rooms (often turning space constructed using wood and traditional materials into brick- or concrete-built structures), improve roofs and floors and add kitchens and toilets. There is a vibrant rental market in many low-income settlements in most developing country cities. In some cases, microfinance loans are used by the landlords to construct additional rooms for rent. In a few cases, small loan programmes have been orientated to the landlord sector to improve the living conditions of tenants. However, there are relatively few intentional initiatives of this kind (see Table 7).

THE GROWTH OF MICROFINANCE FOR SHELTER

The growth of microfinance agencies since their inception in the 1980s has been considerable and there are now many such organizations. To exemplify the situation in one country, in India the number of such grassroots level organizations engaged in mobilizing savings and providing microloan services to the poor is estimated to be in the range of 400–500 organizations.

Early and continuing evaluations of microfinance organizations demonstrated that, whatever the loans were taken for, a proportion as large as 25 per cent could be diverted for shelter investments. Findings such as these have encouraged the exploration of microfinance lending specifically for shelter.

There are a considerable number of NGOs that have been working with housing issues, generally for lower income groups, and that have been drawn into loan financing in order to scale up their activities and/or to provide assistance to residents who have been successful in acquiring land. Shelter NGOs looked to the examples of microfinance agencies seeking to bring financial markets to those who traditionally had been excluded from opportunities for savings and credit (see Box 15).

There are two distinct groups of such NGOs working in housing finance. The first group is professional urban development NGOs that have primarily been drawn into finance programmes to influence state policies and the demands of low-income communities. The second group are humanitarian agencies that have worked to improve housing conditions in low-income areas. Recognizing that families are able and willing to invest in their own dwellings, they have directly developed small loan programmes at scale.

During the 1980s, some programmes had the explicit intention of preparing their clients for entry into formal housing finance either in the short or the longer term. There was an underlying expectation that the poor could borrow from the formal financial systems once appropriate modifications had been identified and implemented. Examples include the Central American programmes supported by the Swedish International Development Agency (SIDA). However, in practice, it has proved difficult to convince such formal financial institutions that they should participate in direct lending; in part this is due to the small loan size and associated high administration costs.

There remains the tradition of guarantee funds, although their use is somewhat limited to a few specific examples and scaling up such examples into regular practice appears difficult. A number of NGOs have specifically sought to use guarantee fund strategies to release financial capital from the formal (mainly commercial) financial sector. Examples of guarantee funds include SELAVIP (Servicio Latinamericano y Asiatico de Vivienda Popular), SPARC (the Society for the Promotion of Area Resource Centres), Homeless International and a number of other Southern NGOs.

Box 15 Launching a housing microfinance product: Mibanco, Peru

With 70,000 active borrowers, Mibanco in Peru is one of the largest microfinance institutions (MFIs) in Latin America. The organization started as a non-governmental organization (NGO), but became a commercial bank in 1998. The conversion into a deposit-taking institution gave Mibanco the funding necessary to expand from microenterprise lending into other areas. During mid 2000, Mibanco added a housing product, Micasa, in the form of a loan for improvement, expansion, subdivision, or rebuilding or replacement of existing housing.

After 12 months of operation, Micasa had 3000 clients, with portfolio at risk greater than 30 days of 0.6 per cent and a return on loan portfolio of 7 to 9 per cent. Loan size ranged from US$250–$4000, and averaged US$916. Interest rates were 50 to 70 per cent per annum. These rates are less than those Mibanco charges on microenterprise loans. Loan periods were as much as up to 36 months; but most households preferred loans of 6 to 12 months, and the average loan period was 11 months. Mibanco uses its analysis of repayment potential and household assets to guarantee most loans. Mortgage liens are sometimes taken, but only on larger loans (those above US$4000) if the client already has clear legal title. In total, mortgage liens secure only 7 per cent of Mibanco's home loans. The housing loan product has strong profitability and demand, and Mibanco expects such loans to represent half of its portfolio within three years.

Source: Ferguson, B. (2003) 'Housing microfinance – a key to improving habitat and the sustainability of microfinance institutions', *Small Enterprise Development* **14**(1), pp21–31

Many housing microfinance institutions are led by women and fully recognize women's housing rights

In addition to NGO initiatives, there has been considerable interest in housing lending shown by the microfinance sector. Microfinance agencies appear to be diversifying rapidly into housing microcredit in at least some regions. One study funded by the International Finance Corporation (IFC) identifies 141 institutions providing shelter finance loan products to the poor. Another, focusing on Latin America, identifies 57 microfinance agencies as offering housing loans, just under 30 per cent of the total number of such institutions. Of these agencies, about 18 per cent of their total loan portfolio is related to housing loans, amounting to about US$160 million. The speed with which housing loans have been integrated into such agencies appears to have been facilitated by the similarity of lending practice.

Shelter microfinance can play an important role in slum upgrading programmes

One reason for the diversification of microfinance agencies into housing is commercial advantages. Such diversification may increase the financial stability of their loan portfolio, enable them to take advantage of opportunities for growth, and avoid losing clients to other microfinance agencies that provide housing loans. A further notable advantage is that the longer repayment period associated with housing loans helps to draw the borrowers into a longer-term relationship with the lending agency and increases the likelihood that further loans will be taken (for example, for enterprise development).

It appears likely that there is considerable scope for expansion, at least in most of Latin America and Asia. Given the scale of housing need, microfinance for shelter remains significantly under-developed in many countries in which market conditions appear favourable, such as Mexico and Brazil. The market may also be significant in Africa, but it is likely that the income group will be different. In Africa, where many of the middle class may not be able to access formal loans due to land title problems, microfinance may not reach down so far the income groups and scale may be smaller but still valuable.

NEIGHBOURHOOD IMPROVEMENT (SLUM UPGRADING)

A further potential role for shelter microfinance is within more comprehensive slum upgrading programmes. There appears to be a growing interest in using microfinance agencies to provide specialist financial services within more comprehensive neighbourhood improvement and poverty reduction programmes. Within this strategy, the development agency, central government and/or municipality finances a process to upgrade the low-income area with components to regularize tenure and provide and/or upgrade infrastructure and services. The upgrading programme then contracts with an organization to offer small-scale housing loans for those that wish to upgrade their homes.

A good example is the Local Development Programme (PRODEL) in Nicaragua that was set up to enhance development in smaller towns and cities with a number of components, including infrastructure improvements, housing loans and loans for microenterprises. A more focused (and smaller-scale) approach is illustrated in Ahmedabad (India) where the Slum Networking Project (undertaken within the municipality) wished to include a credit component to help households afford to contribute to infrastructure improvements.

Box 16 Community-led Infrastructure Financing Facility (CLIFF) and bottom-up neighbourhood development

The Community-led Infrastructure Financing Facility (CLIFF) is an urban poor fund capitalized by donors that has been designed to act as a catalyst in slum upgrading through providing strategic support for community-initiated housing and infrastructure projects that have the potential for scaling up. The overall goal is to reduce urban poverty by increasing the access of poor urban communities to commercial and public-sector finance for medium- to large-scale infrastructure and housing initiatives. The first initiative is in India with the Society for the Promotion of Area Resource Centres (SPARC), the National Slum Dwellers Federation (NSDF) and Mahila Milan.

Scaling up citywide requires an engagement with the formal development process and the establishment of working relationships with formal-sector institutions. This is usually problematic, largely because public-sector financing is severely constrained and has a proven record of being reluctant to lend to the poor. A further problem is that the formal sector has continued to be unable to adapt their systems to accommodate non-formal investment processes. In December 2002, Cities Alliance approved a proposal to establish CLIFF with a seed capital of US$10 million from the UK Department for International Development (DFID) and an additional US$2 million from the Swedish government. Homeless International (a UK NGO) is the implementing agent and works with Samudaya Nirman Sahayak. The main function of CLIFF is to:

- provide bridging loans, guarantees and technical assistance;
- initiate medium-scale urban rehabilitation in cities in the South;
- work in partnership with community-based organizations (CBOs)/and non-governmental organizations (NGOs) who have or can be assisted to develop a track record in delivering urban rehabilitation;
- seek to attract commercial, local and public-sector finance for further schemes, thus accelerating or scaling up the response to the challenge of urban renewal; and
- establish local CLIFF agencies that can operate as lasting local institutions.

While most slum upgrading initiatives have been led by the state, an alternative approach is that developed from an Indian alliance of SPARC (an NGO), the National Slum Dwellers Federation and Mahila Milan (a network of women's collectives). Their strategy is to develop the capacity of local communities to manage a comprehensive upgrading and redevelopment process which is financed primarily by the state (through subsidies) with additional monies through loans taken by communities and repaid by individual members. Through a not-for-profit company, Samudhaya Nirman Sahayak, communities draw down the funds they need to pre-finance land, infrastructure and housing development. The scale of activities has resulted in additional donor finance being drawn into the process through the Community Led Infrastructure Financing Facility (CLIFF) (see Box 16).

Combined land development and housing loans

A further model offering a more comprehensive development strategy than shelter microfinance is the strategy of combining small loans for housing improvement with land development. One illustration is the case of El Salvador where low-cost subdivision regulations established in the early 1990s have helped stimulate a low-income land development industry of 200 firms. After developing the area and selling the household a serviced plot, many of these developers offer a small loan (often around US$1000) to build an initial core unit. It appears this strategy has resulted in affordable secure tenure over the last decade, and – with greater supply – has lowered real estate prices in real terms.

The discussion above highlights the growing diversity of approaches that are grouped together within shelter microfinance. The neighbourhood development (slum upgrading) together with the servicing of greenfield sites approaches suggest a number of distinct neighbourhood and housing strategies that include a role for small-scale housing loans:

- improvements of existing housing units (the dominant approach at present within shelter microfinance);
- linked land purchase and housing loan developments;
- linked land development and/or upgrading paid for with a capital subsidy and housing loan; and
- linked settlement upgrading and housing loan.

OTHER PROVIDERS AND SOURCES OF FINANCE

In addition to NGOs and microfinance agencies, there are also numerous sources of finance for small loans, although few large programmes offering opportunities to finance incremental housing development at scale. While the microfinance agencies and NGOs discussed above both receive external development assistance, many of the other providers considered below have had no external source of finance.

Many small loans are offered by less formal financial markets and they may have a number of characteristics that differ from formal financial markets. Access to finance may depend on social networks based on religion or ethnicity. Other forms of housing finance that have emerged include lines of credit from building materials suppliers and hire purchase of individual items like sanitary ware. In Chile, companies such as Easy, Homecenter and Home Depot provide people with building materials and have credit systems to which it is very easy to have access, providing that proof of income can be offered.

While remittances are not a provider, as such, of small-scale investments in housing finance, they are emerging as a significant source of finance for housing investment. Their current scale is estimated to be US$200 billion a year; official figures are somewhat less, placing remittances as the second largest inflow to the South after foreign direct investment. The largest receivers of remittance income are India, Mexico, the Philippines, Morocco and Egypt. Their growing scale has resulted in a number of institutional innovations to capture these financial flows and more efficiently enable housing investment.

State programmes offering small loans are potentially important, although they have not featured much in the development of the sector. In general, there has not been large-scale state finance for small-scale lending to support incremental housing development. However, governments have sometimes sought to provide capital for NGOs interested in providing small loans for housing development. In India, the government has sought to provide capital through HUDCO from the early 1990s. The Colombian government has recently taken a loan from the Inter-America Development Bank which includes financing for 10,000 microloans for housing improvement. In Peru, the state housing authority is channelling housing funds to microfinance agencies, municipal savings and loan cooperatives and some microfinance banks in an effort to provide appropriate finance.

There is a range of voluntary sector agencies, such as co-operatives and credit unions, that seek to extend credit to their membership and that may offer small loans for housing. These may also include less formal rotating savings and credit associations (ROSCAs). In general, the loans offered by such providers are not intended for housing improvements but in some cases they are used for this purpose. Housing and/or savings and loan co-operatives and mutuals are a further source of loans in Latin America. Also notable are the housing and mutual aid co-operatives of Chile (FUCVAM), which provide loans and assist with construction.

Sources of capital finance

How do microfinance agencies secure capital for their lending? Some providers draw on their own capital, notably the private sector and for the most part the small-scale voluntary organizations such as credit unions. However, most agencies that wish to expand their lending have to find significant sources of capital.

NGOs and other microfinance agencies have four sources of capital finance: deposits, development assistance, governments (already described above) and the private sector. The problem of lack of capital remains even in countries with a well-development microfinance sector, such as Bangladesh.

While many agencies encourage deposits and, as in the case of the Self-employed Women's Association (SEWA), these savings may provide 80 per cent of capital, availability of medium-term capital is recognized to be a constraint. Some bilateral donors, including the Swedish International Development Agency (SIDA) and the US Agency for International Development (USAID), have funded shelter microfinance activities for a considerable period (almost twenty years) (see Box 17). However, the multilateral donors – such as the International Development Bank and the World Bank – have only begun to learn about and develop programmes in this area over the last few years. In their absence, Northern NGOs have played a very significant role in supporting such initiatives. These NGOs have included Misereor (Germany) and Cordaid (the Netherlands), as well as specialist housing and urban development groups such as SELAVIP (Belgium) and Homeless International (the UK).

Shelter microfinance and subsidies

There is a difference of opinion between microfinance agencies about the need for housing subsidies. On the one hand, there is a belief that subsidies are needed both because of the traditional association between subsidies and low-

Box 17 Swedish International Development Agency (SIDA) assistance to low-income housing in Central America

Since 1988, the Swedish International Development Agency (SIDA) has financed housing and local development programmes in Central America with total resources of US$50 million. By the end of 2003, the programmes had helped approximately 80,000 low-income families, or about 400,000 people, in the main urban areas of the region to improve their habitat conditions. The resources from SIDA have been channelled through different institutions and programmes – namely, the Foundation for Housing Promotion (FUPROVI) in Costa Rica, the Local Development Programme (PRODEL) in Nicaragua, the Salvadoran Integral Assistance Foundation (FUSAI) in El Salvador, the Urban and Rural Social Housing Development Foundation (FUNDEVI) in Honduras and the Local Development Trust Fund (FDLG) in Guatemala.

SIDA's policy throughout the region has been that housing subsidies are primarily the responsibility of national governments, who act as counterparts to the international agency. That is why most of the funds allocated by SIDA have been channelled to finance three main components of these programmes: loans (including microloans for housing improvements and new housing), technical assistance (both to executing agencies and the target population) and institutional development, especially of those institutions that manage the Swedish funds.

Source: Stein, A. with L. Castillo (2005) 'Innovative financing for low-income housing improvement: Lessons from programmes in Central America', *Environment and Urbanization* **17**(1), pp25–39

income housing and because of the larger size of housing loans. On the other, it is widely accepted that microfinance needs to perform without subsidy finance in order to be able to expand as market conditions permit.

In situations in which there is no state support, there appears to be an effective cross-subsidy from enterprise to shelter lending, as the interest rates are lower in the latter. In some countries, particularly in Asia, subsidies are available through reduced interest rates, and microfinance agencies have become a conduit to deliver state support to the poor. In some cases, the subsidy is provided in the form of an interest rate reduction. Grameen Bank and SEWA have both accessed low-interest sources of funds and pass on this subsidy.

TERMS AND CONDITIONS

There is a considerable diversity in the nature of shelter microfinance as provided by the many different organizations that are active in this sector.

The link between housing investment and savings extends well beyond the microfinance sector. In the North, traditionally families have saved for several years simply to access conventional mortgage finance. Similarly, many microfinance programmes for housing, particularly in Asia and Africa, have savings requirements. Savings, as a strategy, has a place in microfinance for many reasons. It is a strategy to assist with repayments in which borrowers have to demonstrate a capacity to make regular payments and accumulate sufficient funds for the required down-payment or deposit.

Collateral is an asset pledged to a lender until the borrower pays back the debt. Its major role is in reducing lender risk and it is widely recognized that a key challenge for shelter microfinance is that of loan security. Many microfinance agencies seek to minimize the need for collateral by using existing client history (i.e. enterprise lending). A further strategy used for lending for income generation is small repeat loans as a way of building up repayment skills and capacities and providing an incentive for repayment. However, the larger size of shelter microfinance makes this strategy more difficult to follow.

Another strategy used by microenterprise lenders is that of group guarantees. However, this strategy has been found to be problematic for housing loans, again because of the bigger loans and longer loan period.

In the absence of such strategies, a wide range of collaterals are used, including mortgages, personal guarantees, group guarantees, fixed assets and/or pension/provident fund guarantees. Pension fund collateral is used particularly in South Africa and Bangladesh, and more recently in Namibia. In a recent study of microfinance agencies' practices, the following are identified as collateral:

- land title and buildings;
- chattel mortgage/lien on assets;
- obligatory savings;
- assignment of future income (wages);
- personal guarantees (co-signers);
- joint liability and group guarantees (character-based lending); and

Box 18 Self-employed Women's Association (SEWA) interest rates for housing, India

When the Self-employed Women's Association (SEWA) first started lending for housing in India, it did not differentiate between housing and enterprise loans (in practice, the housing loans were bigger and were often the third or fourth loan that was taken). However, due to the size of housing loans (and the fact that they did not necessarily generate an instant higher income flow), they have been differentiated as a separate loan product since 1999, since which time they attract a lower interest rate of 14.5 per cent. Income-generation loans – which typically account for 50 per cent of SEWA Bank's total loan portfolio and are usually of a lower loan amount and generate faster returns, charge interest at 17 per cent, thus partially cross-subsidizing the housing loan portfolio. SEWA's average cost of capital is 8 per cent and this primarily reflects the interest that it pays on members' savings. To secure housing loans, clients must have a regular savings record of at least one year. SEWA's experience is that a strong savings record correlates to good repayments and the regularity of payments is more important than the amount.

Source: Biswas, S. (2003) 'Housing is a productive asset – housing finance for self-employed women in India', *Small Enterprise Development* **14**(1), pp49–55

- other financial assets (for example, life insurance policies and pension funds).

One difficult area is the extent to which legal title is a requirement of lending. Despite an emphasis on land ownership, the use of title deeds as collateral for microfinance loans is limited and one study of 80 such organizations found that only one quarter use it.

Some microfinance institutions make borrowing for business a precondition for housing loans

In many cases, interest rates for shelter loans are lower than those for enterprise development, even when offered by the same agency (see Box 18). In most cases the rates are fixed, as the loans are for relatively short periods and it is very difficult for low-income households to cope with the uncertainty of variable rates. Interest rates must be acceptable to borrowers and experience suggests that interest rates have to match (even if they are not identical to) mortgage rates. Most agencies seek to at least cover the cost of inflation and administration, with an allowance for defaults and bad loans. An alternative approach used by Habitat for Humanity in Africa and the Middle East is to use a variable inflation index on the loan which is pegged to the price of a bag of cement. This allows repayments to maintain their real value.

With regard to loan periods, there is a very significant difference between shelter microfinance programmes. One recent survey of 15 agencies offering small loans for shelter found that the loan periods ranged from 20 months to 15 years.

Many of those lending for shelter microfinance seek to provide assistance in construction activities. For example: FUSAI, an NGO in El Salvador; Proa, a Bolivian NGO; SEWA; and Funhavi (Mexico). Opinions differ about the viability of such services for microfinance agencies. One argument is that the more developed microfinance agencies do not offer such services. However, groups such as the Cooperative Housing Foundation argue that it is a necessary service and the content helps reduce default rates.

There is an emerging preference for lending to women in many of these institutions-based on the reliability of repayment. Women borrowers are 'current good practice' and there is a particularly strong predisposition towards lending

to women in Asia. The Grameen Bank, for example, argues that the title to the house constructed with loan finance is vested with the borrower and in 95 per cent of cases this is the woman. In the case of Funhavi (Mexico) 38 per cent of the clients are women. In Kuyasa (South Africa) women are 72 per cent of the borrowers. In the case of PRODEL (Nicaragua), more than 60 per cent of the housing improvement loan recipients and 70 per cent of the microentrepreneurs are women.

While the primary focus of the initiatives discussed above is on savings and lending for shelter improvement, some of these programmes recognize the evident links between shelter and livelihoods. There are a number of ways in which these programmes are linked to enterprise lending. The first is through lending for income-generation, the justification being that successful income-generation is needed to be able to afford housing investment and related loan repayments. In many cases, shelter microfinance is offered along with income generation loans. In some cases, it is a condition of the lending organization that income generation loans are taken first, in other cases, one or other might be taken.

In addition, housing investments are more directly linked to income generation in two main ways. First, housing construction activities may be for the purpose of improving a selling or production area, such as a workroom or small shop. Second, housing construction activities may be for the purpose of providing a room or rooms to rent in order to generate extra income for the household.

FORESEEN CHALLENGES

While shelter microfinance might not be effective in every context, there is now widespread experience and understanding of the process and considerable appreciation of the approach in many countries. There are two notable challenges facing the shelter microfinance sector. The first is the nature of the beneficiary group and the difficulties faced by very poor households due to problems of affordability and lack of secure tenure. The second is sources of funding.

Shelter microfinance programmes appear, in general, to reach the income groups served by microfinance agencies lending for enterprise development and families with similar incomes in the formal sector. The bias of microfinance agencies towards the somewhat higher income groups has been recognized for some time. This bias reflects the need of the agencies to secure high levels of repayments and give out larger loans (with the administration costs therefore being a smaller proportion of the loan). Many shelter microfinance programmes appear to be targeted at the ‘higher-income’ urban poor, sometimes those with formal employment (at least one member of the family) and often those with diversified household livelihood strategies.

In some cases, shelter microfinance is linked to state subsidy programmes (notably in Latin America) and this may extend its reach downwards towards lower income groups. The use of other mechanisms and, notably, the requirement for secure tenure, may further define the client group as being the poor but not so poor. It might be argued that any household able to afford a loan is not going to be the very poorest, and hence shelter microfinance programmes will inherently struggle to reach down to those with lower-incomes.

Lack of capital emerges as being a very significant constraint on expansion. This is a general constraint on the microfinance sector as a whole and in general does not appear to be specifically related to housing lending. Microfinance agencies face an issue of scale. To be profitable they have to increase the quantity of lending. There is evidence that this is driving their expansion into shelter microfinance, but for the smaller agencies, lack of capital to expand operations appears to be a significant constraint. Raising funds for shelter microfinance is more complicated than for enterprise lending because of the longer loan periods.

However, shelter microfinance products continue to be developed and there are reasons to believe that more agencies are entering this area and that those that are already there are expanding their activities.

CHAPTER 7

COMMUNITY FUNDS

Community funds are of growing significance in assisting the poor to address their shelter needs. As the role of the state has diminished, increased emphasis has been placed on alternative strategies to support secure tenure, access to basic services and improved dwellings. Community funds offer small loans to households but route these loans through community organizations. The emphasis on collective loans is for many reasons, but one is that the loans support investments in land and infrastructure which are necessarily made by a group working together. This chapter describes community funds, identifying their key characteristics, and discusses trends within this sector. It looks specifically at a number of key challenges, notably the affordability of their strategies and sources of funds.

WHAT ARE COMMUNITY FUNDS?

Community funds are financial mechanisms that encourage savings through establishing and strengthening local savings groups, and provide collective finance for shelter improvement. This may include any one or more of the following activities: land purchase, land preparation, infrastructure installation, service provision, and housing construction, extension and improvement. Their most distinguishing characteristic is the way in which funding is perceived – rather than the mechanisms of the financing process. Community funds use savings and loans to trigger a development process – not simply to increase the access of the poor to financial markets. They seek to strengthen the social bonds between community members (building social capital), so that existing finance within the community can be used more effectively and external finance can be integrated within community development strategies. Community funds are targeted at group borrowing and therefore may include those with lower incomes.

One approach common to some of the programmes is an emphasis on savings for shelter improvement and the use of collective strategies, both to reduce the risks for the individuals involved and to build relations between low-income citizens and development agencies and/or the state.

As with many such development trends, there is no single source for the innovations around community funds and the approach has emerged from a combination of factors. One of these has been the recognition by housing professionals of the inefficiencies in housing investment that arise from a lack of access to loan capital. Other factors of notable importance have been:

- NGOs seeking to use donor monies more effectively together with a recognition of people's willingness to invest in their own neighbourhood;
- state agencies seeking to find more effective ways of addressing housing need and building on their experience of what has not worked in the past;
- a growing expertise in poverty reduction and a greater awareness of the role of assets in securing improved livelihoods; and
- more recently, there has been an awareness of the scale of differentiation within low-income groups, and as the importance of reaching the poorest has grown within development, so has a willingness to look at new methods that might be effective in securing inclusion.

Many microfinance enterprise initiatives are premised on the understanding that increasing incomes is an effective strategy to reduce poverty (see Box 19). Shelter lending is in part

consistent with that strategy but also seeks to enable households to reduce expenditure, using their monies more effectively to achieve their goals.

The relationship between microfinance and community funds can best be represented as a continuum. At one extreme are agencies that seek to operate according to the criteria of financial markets, at the other are those that offer highly subsidized loan programmes with a premium being placed on the inclusion of those most in need. In practice, there is considerable overlap of interest between community funds and microfinance.

Community funds are particularly appropriate for the comprehensive upgrading of slum neighbourhoods

TRENDS

The small scale of traditional housing programmes for the poor has led to a search for more effective ways to improve housing and address the shelter needs of the poorest at scale. The challenge has been to use the relatively small amount of funds effectively and to ensure that those benefiting from the programme have a strong sense of ownership, driving and developing the programme to meet their needs. Savings and loans programmes offer these advantages, thus meeting lower income groups' requirement for more holistic development interventions. Securing land and services requires a collective effort, and savings provide a good organizing basis for such efforts.

Many of these programmes were piloted by NGOs who were working with groups in acute need of housing, perhaps under threat of eviction (see Box 20). NGOs have been using revolving funds as one option to assist families with finance. One example is the work of the Carvajal Foundation in Colombia, which set up a number of programmes to assist with housing improvements. Their approaches included material banks in low-income settlements, which both assisted small businesses producing building materials to secure markets and helped to ensure that house builders had access to what they needed without high transportation costs.

The success of such initiatives built up confidence among NGOs and more ambitious plans were developed. NGOs (and other civil society groups) began to consider ways in which families could be assisted to save, and to develop mechanisms to draw in state subsidy funds. The scale and effectiveness of NGO innovation also began to be reflected in government programmes. NGOs argued that community

Box 19 Addressing urban poverty with community funds

Aspect of poverty	Poverty reduction strategy
Income	Enterprise development
Assets	Housing and land investment
Poor-quality housing	Housing and infrastructure investment
Inadequate public infrastructure	Negotiations with authorities; improved infrastructure from community investment; community-managed investments
Inadequate basic services	Negotiations with authorities; direct investment by the community; community-managed investments
Limited or no safety net	Emergency funds and savings
Inadequate protection of poor groups	Stronger community organizations; political negotiations
Voiceless/powerless	Stronger community organizations; federations and networks; political negotiations

Community funds also work well for infrastructure development at the neighbourhood level

funds deserved state support because they offered a real sense of capacity and confidence to low-income communities. The willingness of some governments to explore these processes has increased ambition among those interested in working with these funds.

Funding support has spread from being primarily Northern NGO, notably those with the larger budgets in Holland and Germany, to include national governments. In a limited number of cases, funds have also been sought from the commercial banking sector within countries. For example, SPARC accessed first HUDCO (a state housing bank) and then Citibank funds; however in both cases guarantees were needed from European NGOs.

The growing interest of state agencies in community funds has been in part due to the movement of staff between

Box 20 Fondo Nacional de Habitaciones (FONHAPO), Mexico

FONHAPO is a state institution which still has a role in Mexican government housing policy; but its most significant international influence stems from its work in the early and mid 1980s. FONHAPO sought a strategy that would enable it to reach the 60 to 70 per cent of the population whose incomes were below 2.5 times the minimum wage. During this period it provided loans to intermediate organizations, either public, private (such as financial institutions and development trusts) or social (co-operatives and other legally constituted social organizations). Five types of housing project were financed: sites and services; incremental housing; home improvements; finished dwellings; and production and distribution of building materials. FONHAPO, in contrast to the other housing institutions, progressively favoured financing partial housing solutions over finished dwellings.

FONHAPO offered a flexible range of credit packages, including small loans, on a large scale. The value of the loans was expressed in terms of multiples of the local daily minimum wage, the maximum value being 2000 minimum wages (about US$6000 in 1988). The amount of money loaned depended upon the income of the head of household. Those earning less than the minimum wage could be loaned up to 1200 daily minimum wages (about US$3700 in 1988), those earning between 1 and 1.5 minimum wages could be loaned up to 1600 daily minimum wages (US$4900) and those earning between 1.5 and 2.5 minimum wages could receive up to the maximum loan of 2000 minimum wages. The credit limits for sites and services, incremental housing, home improvements and finished housing were 600, 2000, 1150 and 2000, respectively (US$1847, US$6157, US$3540 and US$6147 in 1988).

A deposit of between 10 and 15 per cent had to be paid by the final beneficiaries. An initial subsidy of between 15 and 25 per cent was offered on the value of all loans. Additionally, a further 15 per cent would be offered for prompt repayment. This implied a direct subsidy of 30 per cent of the loan value for the larger loans for incremental or finished housing, and up to 40 per cent of the loan value for smaller loan packages. On the basis of a maximum payment of 25 per cent of the beneficiary's monthly income, the amount and number of repayments were calculated in terms of percentages of minimum wages at the time of contracting the loan. These payments would escalate according to the increase in minimum wage. In this way the real value of loans repayment was maintained approximately in line with inflation. In all, it was estimated that the total subsidy to the beneficiaries would average at 50 per cent – that is, the repayments from two loans would finance one more of similar amount.

Between 1982 and 1988, just over 10 per cent of new dwellings, including core houses, financed by the public sector can be attributed to FONHAPO, using just 4 per cent of the available funds. This was accomplished by giving high priority to smaller loan packages for core housing and sites-and-services, and to public and private housing organizations. Between 1982 and 1994, FONHAPO finished 203,657 core housing units, 115,870 sites-and-services projects, 179,661 home improvement loans and 1730 finished houses.

Source: Connolly, P. (2004) 'The Mexican National Popular Housing Fund' in D. Mitlin and D. Satterthwaite (eds) *Empowering Squatter Citizen*, Earthscan, London, pp82–111

the two sectors and in part to the recognized mutual benefits from close collaboration. In countries such as Chile, Mexico, the Philippines and South Africa, professionals with experience in housing NGOs have moved to posts in government poverty-reduction programmes. Part of the motivation for state involvement in such programmes has been an awareness of the need for poverty reduction in urban areas, coupled with an awareness that neighbourhood and housing improvement is essential.

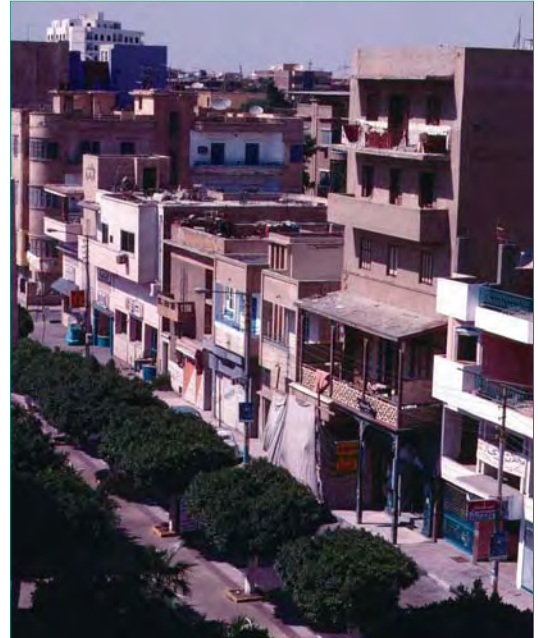
Generally, there has been increasing interest in community funds in the last decade. The growth is supported by a general acknowledgement that small-scale lending has been somewhat successful and that urban poverty is growing. Two further current trends related to the development of such funds are worth noting: first, the growing interest by local government in these approaches, in part related to the use of such funds to extend essential infrastructure; and second the expansion of Shack or Slum Dwellers International (SDI), a community/NGO network whose strategies incorporate savings and lending activities for shelter improvements.

Over the last 15 years, SDI has evolved into an international movement with affiliates in more than 12 countries. SDI groups have spawned a host of local community-owned and NGO-administered funds. In Cambodia, the Philippines, South Africa, Nepal, Sri Lanka, Zimbabwe and Kenya, federation groups have established their own funds which they lend to savings schemes. State contributions have been obtained in South Africa, Namibia and, more recently, Nepal.

FUNDING SOURCES

The importance of mixed funding sources is evident. In some cases, funds have been established by government and located within a state agency with access to subsidies. In other cases, the fund has been set up by civil society organizations and financed through a combination of state funds, NGO monies, community contributions and, generally, international development assistance agencies. In both cases, the communities may make direct contributions to the fund through deposits to secure loans.

An important and common characteristic of community funds is that some subsidy is provided – either through state funds or international development assistance. This is a further significant difference from conventional microfinance and its individualized housing loans. While conventional microfinance programmes may offer a subsidy, in general there is an understanding that this should be avoided. Within community funds, greater priority is placed on achieving poverty reduction goals and neighbourhood improvement. Subsidies may be needed for institutional survival if interest rates are below the level required to maintain the real value of the fund. Equally or alternatively, subsidies may be required to reach everyone in a community or to reach very low-income communities (see Box 21).



Community funds use savings and loans to trigger a development process and to strengthen social bonds

There are several routes through which subsidies are delivered. The primary sources are direct subsidies, interest rate subsidies, additional support (for example, community development and technical assistance) and unintended subsidies when delayed payment and/or default occurs.

While the need for a subsidy might imply a lack of scale, some programmes have been successful in reaching large numbers of those in shelter need. Source of funding are both national governments (in some cases) and development assistance. While many of the original supporters of this work were Northern NGOs (notably Cordaid, Homeless International, Misereor, SELAVIP), international development assistance agencies have become increasingly interested in supporting such initiatives. Funding for some recent initiatives has been provided by DFID (the UK Deparetment for International Development), European Union, Inter-American Development Bank, and Swedish International Development Agency.

Box 21 Adding value: The *uTshani* Fund, South Africa

The uTshani Fund of the South African Homeless People's Federation was set up in 1994 to provide an opportunity for federation members to experiment with a self-build approach to housing. It was hoped that success in this regard would lead to greater government willingness to release housing subsidies directly to organized poor communities rather than through commercial developers. From 1995 to 1999, the uTshani Fund received substantial grant funding, including 10 million rand (US$1.5 million) from the South Africa Department of Housing and many millions more from European donors who supported the federation's strategy. It on-lent this money to federation members who used it to start building houses while waiting for subsidy approval. During this period the uTshani Fund facilitated the construction of almost 15,000 houses, all of them larger and of better quality than comparable developer-built products.

The uTshani Fund provides several positive examples of a way forward for South African low-income housing finance. First, accessing finance directly and controlling its use allowed federation members to produce much better houses than the Reconstruction and Development Programme (RDP) driven model that has dominated the post-1994 housing drive. Second, uTshani showed that ordinary households could manage external housing finance successfully and at low cost if supported by an appropriate institutional framework with clear rules. Third, uTshani was able to act as a financial management tool for community-based residential land acquisition and development, allowing the federation to produce some of South Africa's best examples of community-driven housing.

Taking a somewhat conservative view of the benefits secured, making modest assumptions about the value that has been generated and only considering those benefits that can be quantified financially, the development investment in the People's Dialogue on Land and Shelter and the South African Homeless People's Federation has created a net present value of 540 million rand (in 2000 prices) or US$47 million. In just eight years, the uTshani process has created assets worth seven times the value of the original investment. With average monthly incomes for federation members of 700 rand, these assets have directly contributed to adding to the well-being of some of South Africa's poorest urban citizens. The overwhelming bulk of the value added is attributable to the housing that has been developed. In contrast to much privately developed state housing in South Africa, a federation house is worth considerably more than the resources put into it. Values of three to eight times the cost of the building materials and skilled labour have been suggested and sometimes offered by potential non-federation purchasers, although few federation members have been interested in selling. The value of federation houses stands in sharp contrast to the experience of many RDP housing developments, where beneficiaries have resold their new houses at far less than the amount spent on them by the state.

Source: Baumann, T. and Mitlin, D. (2003) 'The South African Homeless People's Federation: Investing in the poor', *Small Enterprise Development* **14**(1), pp32–41

A further source of finance is that of commercial financial institutions. A number of groups managing community funds have sought to draw in commercial banks. At a minimal level, loan funds are released through banks thereby encouraging the poor to see such institutions as something that they might use. In CLIFF, a donor-financed programme working with SPARC, the National Slum Dwellers Federation and Mahila Milan in India, there is an expectation that the urban poor groups will become strong enough to be able to borrow from the banks.

TERMS AND CONDITIONS

The emphasis on local funds has resulted in a complexity of arrangements within community funds themselves. In the simplest form, the fund passes a loan to a community for a specifically defined shelter-related activity. The community then collects repayments and passes them back to the fund. In some cases, communities also manage local revolving funds (capitalized by their own savings) which are used to give small loans to members for multiple purposes and which are then augmented by the larger-scale community fund. Hence a wide variety of terms and conditions may be found.

Savings play a central role in community funds. However the programmes may differ in the speed and the intensity of savings. This difference reflects both the orientation of the programme itself and the possibilities within different countries. For example, in a large number of countries (including those with experience of informal savings and loan mechanisms) communities have been sceptical about the value of savings for shelter investment and loan finance has been provided rapidly once the savings commitment was fulfilled. This is particularly true of countries that have experienced rapid inflation and/or where the state has confiscated or temporarily frozen savings.

Box 22 Determining housing interest at the Urban Community Development Office (UCDO), Thailand

When the Urban Community Development Fund (UCDF) was established, the UCDO board calculated that it could be self-sustainable with an annual average interest rate of 7 per cent. These monies would cover all administration expenses, including the community development process (an estimated 4 per cent), with a small allowance for inflation (which was relatively low). The setting of the terms and conditions of the loan processes was immediately a political rather than a technical issue. The idea of a 'shared' interest rate with a proportion remaining with the community organization developed during the initial study phase from the experience with earlier loan funds. These groups (and, later, the networks) were allowed to add a margin to cover their own costs and to provide funds for development costs or their community welfare fund. The decision on this margin or on an additional rate depends upon agreement made within the community and ranges between 2 and 10 per cent.

Achieving the aggregate figure of 7 per cent return across all loans was an objective used to design the interest rate structure for the various loans, considering the amount of capital, repayment period and use made of the loans. The more conservative board members were anxious that UCDO loans did not undercut existing financial markets. When they understood that the reason why they did not undercut existing financial institutions was because the community itself added to the interest rate of the office, there was a discussion about why the office itself should not benefit from high interest rates. Eventually the board agreed that the interest charges would be shared with the savings schemes.

In reality, the actual average interest gained across all lending was only 5 per cent. This shortfall was caused by the high percentage of housing loans requested during the initial years. The interest rate on housing loans is only 3 per cent. However, only one third of the total fund was being loaned to communities and the rest remained on deposit. The interest earned on deposit was generally sufficient to compensate for the shortfall. Therefore, annual average interest gained from all the monies in the fund has averaged 7 per cent. Total expenses for all development activities and management costs have averaged 3 per cent a year.

Source: Boonyabancha, S. (2004) 'A decade of change: From the Urban Community Development Office to the Community Organization Development Institute in Thailand' in D. Mitlin and D. Satterthwaite (eds) *Empowering Squatter Citizen*, Earthscan, London, pp25–53

These programmes are primarily orientated towards urban poor neighbourhoods, often with insecure tenure and inadequate services, as well as towards families using self-build strategies to provide themselves with housing. As noted above, while finance is integral to these approaches, the role of finance is set within a comprehensive development approach. Finance becomes the means to build strong communities as well as the resource needed to improve material conditions.

With an emphasis on solutions that work for the poorest, land purchase and infrastructure development become important, perhaps more important that housing improvement. Land purchase and infrastructure developments can only be undertaken with groups – they are unaffordable for the poor (even for the not-so-poor) as individualized developments. Infrastructure is similar to land in that it is likely to benefit from a greater collective capacity. There is also the recognition that collective action can save money. A further reason for the emphasis on savings is that managing collective finance builds within communities an understanding of how to manage money.

Interest rates are generally subsidized, especially for land purchase and infrastructure, but often also for housing investment (see Box 22). Three major reasons emerge for this policy: practical, political and social. On the practical side, many of these early programmes evolved with an interest rate subsidy because the relatively large size of the loan made affordability difficult if market rates were used. Politically, the policies may have been influenced by communities that were familiar with state support for housing through a reduced interest rate. This appears to be particularly strong in Asia where, for example, the Bangladeshi, Indian, Thai and Philippine governments all have programmes with interest rate subsidies for low-income (and low–medium-income) households.

From a social development perspective, inclusion of the poorest and affordability are critical. The preference for interest rate subsidies is because there is no direct grant involved. The concern is that if something is offered for free there will be a struggle within the community to secure such a free resource.

There are two distinctive characteristics of the collateral strategies used by community funds. First, there is reliance on community systems and community collateral rather than claims over the individual borrowers. Second, in

cases of land purchase, legal title deeds may be used. However, the difficulties of loan security are considerable because of the different attitude towards non-repayment.

NGOs may find themselves taking on the role of guarantor to give the communities space to develop systems and get confidence, and because links with more conventional financial institutions require it. For example, SPARC (an Indian NGO supporting funds at the community groups that it works with) set up a fund financed by grants, and this fund operated like a guarantee for the savings.

As is the case with shelter microfinance, community funds seek to ensure that households do not over-burden themselves with debt and most do not let households borrow such that repayments are more than 25 per cent of their income.

Loan periods appear to be longer than those used for shelter microfinance with, for example, periods of 25 years in the Philippines and 10 years in Thailand. In part this is because of the large size of the loan relative to family incomes. It is also acknowledged that land purchase, for example, may be only a part of the investments that the family needs to make. NGO loan periods are lower and generally less than 5 years. While some appear longer, such as those of the uTshani Fund in South Africa, the design reflects the fact that funds are primarily released as bridge finance for the state subsidy.

Community funds generally place some emphasis on technical assistance, in part because access to land and infrastructure may be more difficult than simple house construction. Support is often given around linking to the local authority both in respect of the professional staff responsible for municipal rules and regulations and also the politicians.

In general, technical advice around land and infrastructure development is provided by professional staff attached to the government department and/or local NGOs. In many cases such as Namibia, Zimbabwe and Philippines, support may be given by local authority staff even if they do not make a financial contribution.

Community funds differ significantly in their attitude to income-generation lending. Some funds have a specific focus on a particular activity and no interest in lending beyond that activity. More conventional microfinance lending may take place alongside the work supported by the community funds with a different set of staff, procedures and often clients. In other cases, the funds have developed a number of windows offering an integrated lending package for their members, almost universally with more conventional microfinance strategies being used for the enterprise component. Interest rates are generally higher, loan periods shorter and the size of loans is smaller.

CHALLENGES

Community funds face very similar challenges to those faced by agencies supporting shelter microfinance initiatives. How can they secure the funding they need for long-term viability and how can they be effective in reaching out to those in need of shelter investment?

A particularly different challenge faces community funds as they develop – what should their strategy be with respect to the state? Fundamentally this is about strategies that maximize possibilities for scaling up funds while retaining a process that can be controlled by local communities. Links to the state are almost certainly essential if funding on the required scale is to be available. However, there is a concern that funds will be bureaucratized.

Community fund programmes are designed for relatively stable communities that are in need of finance to secure land tenure and upgrading their neighbourhood. In respect of the challenge of inclusion, community funds may struggle to include all residents living within the settlement. They may also find it difficult to assist those who do not live permanently in areas of the city.

Throughout Asia, Latin America and Africa, conventional development processes have failed to deal with many groups of poor people. In some cases, these are the poorest, but this is not always the case. There are particular groups that are vulnerable and often excluded, such as illegal migrants, for example, Nicaraguans living in Costa Rica, Peruvians in Ecuador or West Africans in South Africa. The practice of daily saving in India helps to ensure that even the poorest can participate. The livelihoods of the poor are generally managed daily (or in three to five day cycles), not monthly. Groups that save monthly exclude the poor. At the same time, richer households may not be interested in a process that requires them to save daily. A group that may also face exclusion is tenants. It may be difficult to ensure that tenants are granted equal rights as tenure is secured and development takes place.

A further aspect of inclusion is that of gender. There is a widespread understanding that the centrality of women is important. In part this is because women are concerned about their neighbours, about who is sick and who needs what; it is also related to the level of poverty and vulnerability experienced by women. Women's community role means that if women are central to managing the savings process, then it is likely that there will be fewer problems with exclusion within the community. However, this requires that the process is orientated towards women taking up a leadership role. While this seems prevalent in the case of savings and loans, in some contexts, the shift to construction encourages higher levels of involvement by men.

PART III

TOWARDS SUSTAINABLE SHELTER FINANCE SYSTEMS

CHAPTER 8

ASSESSING SHELTER FINANCE SYSTEMS

The analysis in the previous chapters highlights a number of specific issues that have policy implications in respect of the value of shelter finance in addressing urban shelter needs. This chapter discusses these issues across the different approaches to shelter finance addressed in the report. The issues considered are:

- affordability and the difficulties of reaching the poor;
- access to capital and the lack of loan finance;
- the move to markets and what the market cannot manage – including the issues of maintaining financial viability; and
- connections and diversity within globalization, as well as risk management within the market.

AFFORDABILITY AND THE DIFFICULTIES OF REACHING THE POOR

The discussion in Chapter 4 highlights the difficulties that the poor have in affording mortgage finance to purchase a complete dwelling through a single purchase which is funded primarily (but rarely exclusively) by a loan. Significant numbers of people in the North remain in rental accommodation and cannot afford the costs of home-ownership, even in a context in which subsidies have been provided. The indications are that rising house prices have made affordability more difficult in the North. There have been very considerable attempts supported by government to extend home-ownership to lower-income groups, for example through the more extensive use of mortgage insurance. There are some indications of success (higher home-ownership rates) and some areas of concern as households may find it difficult to manage the associated risks.

In the South the percentage of those who cannot afford mortgage loans is significantly higher in many countries, reflecting high levels of poverty. The estimates in Chapter 4 suggest that these numbers may be over 70 per cent in sub-Saharan Africa and the lower-income countries of Asia and at or above 40 per cent in the higher-income countries of Asia and Latin America.

There is no doubt that the poor wish to save and accumulate assets and the scale of informal saving appears to be very significant. As the discussion of community funds notes, programmes have been able to build on such experiences to increase take-up of financial services.

Opportunities to acquire small loans for land acquisition, infrastructure and housing do appear to have grown significantly in the last two decades, particularly in the last ten years. However, provision still appears very small, given potential demand (and in the context of estimated housing deficits).

The growth of microfinance agencies for enterprise development pre-dates the specific rise of shelter microfinance. These agencies have been encouraged to move into this sector in part due to the scale of enterprise loans that were 'misdirected' at housing investment. In other cases, they have extended their loan services to respond to explicit needs and requests, and because of their own commercial needs to expand their markets. The major problem faced by these agencies appears to be a lack of capital for expansion.

Microfinance provides essential assistance in enabling urban improvements to take place in many areas in which tenure is secure and in some urban informal settlements in the South. It may also be of significance in illegal subdivision where the tenure is not in dispute but where additional

investment is required for infrastructure and services, as well as upgrading of dwellings. However, its value is predominantly for those who already have tenure (although this may not be formal legal tenure).

The tradition of community funds has grown in response to the needs of urban poor groups to invest in land purchase and develop infrastructure on such land. While many loans are for secure tenure and infrastructure, the financial systems are also used for more individualized lending both for housing and for income generation.

However, once more, there are indications that the poorest find it difficult to participate. Such problems are evident in assessments of the Community Mortgage Programme, a group-lending scheme in the Philippines that has provided almost 150,000 households with secure tenure, but which finds it difficult to include the poorest households. However, it has to be recognized that the use of loans carries inherent risks for those who are too poor to manage repayment risk, and greater emphasis may need to be placed on savings and grant combinations. While there have been some attempts to develop microinsurance schemes with microfinance initiatives, relatively little attention has been given to such strategies in the context of shelter microfinance.

Both shelter microfinance and community funds have been integrated with neighbourhood improvement or slum upgrading programmes for a more comprehensive approach to address the needs of the urban poor.

Within the community fund programmes described in Chapter 7, savings strengthen relations between community members, enabling them to be more effective (skilled and cohesive) groups, while the joint development of land and infrastructure for the poor are the basis for new relationships between urban poor communities and local authorities.

THE ROLE OF MORTGAGE FINANCE: ACCESS TO CAPITAL AND THE LACK OF LOAN FINANCE

As noted earlier, mortgage finance is unaffordable for many of those living in the South and a significant minority in the North. Despite this, great emphasis has been placed by both governments and development agencies on mortgage finance, and state subsidies for mortgage finance still appear to be at a considerable scale in more than a few countries. The fairly extensive use of interest-based subsidies for mortgage finance is likely to be reducing competition significantly in some countries and hence may be delaying the development of more extensive private provision of mortgage finance.

In some countries (and particularly in Latin America) there has been a shift to direct demand subsidies. They are associated with large-scale programmes, notably in Chile and South Africa, that address housing need through the provision of finance. However, as noted in Chapter 5, issues of quality remain.

Different housing markets are not necessarily distinct and if possibilities are not created for higher income groups to secure the housing improvements that they seek through the market, they are likely to seek to take up those that are being offered to the poor.

In both Latin America and Asia, there have been initiatives at the government and multilateral agency level to support the development of secondary markets to increase wholesale finance to mortgage lenders. Generally, these efforts appear to be overdone. As discussed in Chapter 4, in many cases these have not been successful because market conditions have not been right.

While it is possible that it is a shortage of capital that is preventing the expansion of mortgage finance, many other reasons have been identified in this report. What appears to be of most significance is the scale of informality in property and labour markets. It appears that much emphasis has been placed on formalizing land titles but, as seen in Peru, this has not necessarily increased the take-up of either mortgages or enterprise loans. This suggests that access to loans may be limited in ways that cannot be addressed by reforms to property titles, increasing the ease of foreclosure or the scale of finance and competition in the sector.

Despite these problems, mortgage lending does appear to have expanded in a number of countries. This appears to be associated with economic growth and with growing affluence. Competition has increased and the market for

Cities are built the way they are financed

mortgage finance is moving beyond a small number of lenders in several countries.

There are risks for individual households in taking on these loans and some of these risks have been evident when housing prices have fallen, notably in the UK and Japan. While mortgage insurance has been extended, it appears that much emphasis has been placed on protecting the lender rather than the borrower.

At a national level, mortgage finance has survived difficult circumstances in Asia and Latin America during the last decade. As seen by the examples of Colombia, Mexico and Thailand, there is evidence of systemic strain and of recovery.

THE BIGGER PICTURE AND WHAT THE MARKET CANNOT MANAGE

Despite a general emphasis on the expansion of market-orientated mortgage finance and housing support more generally, the analysis in the report does point to a number of areas in which markets alone appear to be struggling. Three have emerged as being particularly important: systemic financial risk, institutional failings related to necessarily collective rather than individual investments in shelter, and issues related to urban planning and land use management

As suggested in the discussion of house prices above, there is evidence that the expansion of housing finance has helped to fuel house price increases. If houses prices fell rapidly in a number of countries, resulting in the risks of negative equity and a sharp reduction in housing investment, then the effects might be felt on a larger scale within the global economy.

The housing finance market is strongly orientated to providing loans to individual households. In two of the situations discussed in this report there is a need for collective investment: to maintain multi-family dwellings in transition countries and to invest in land and infrastructure for those without tenure in the South. In both cases, it appears that the market is unable to make an adequate response, in part due to reasons of affordability, but also because local institutions that can manage the finance are missing. While the suggestion proposed by government agencies is often the establishment of formal management committees, care needs to be taken that these do not discriminate against the poor. To address the housing needs of the poor, housing finance systems need to provide for loans for such collective purposes and appropriate local structures need to be in place for this to happen.

Studies have pointed out a number of areas in which markets alone appear to be struggling, one of which is the maintenance of multi-family dwellings

Finally, the market seems to struggle with ensuring the quality of the urban environmental (in a physical and social sense). The greater emphasis on targeting and reduced social provision in the North appears to have resulted in a greater concentration of low-income households in specific areas. This applies both in the case of the transition countries and for richer countries of Western Europe.

A second issue is the nature of the developments that are being supported by the direct demand subsidies, for example in South Africa and Chile. A consequence in both countries is that low-income housing has been located on low-cost sites, often a considerable distance from jobs, services and other facilities, with little consideration of the social cost that results from such physical exclusion. This suggests that the market is unable to respond to the needs

Globalization has many reflections in diversified townscapes

of the poor without greater interventions from the state, either the funding agency and/or the local authority. This also suggests that a key task for government is to ensure adequate supplies of well-located and well-serviced land.

CONNECTIONS AND DIVERSITY WITHIN GLOBALIZATION

The broad context within which this discussion is situated is one in which financial markets are deregulating and the state is withdrawing from direct involvement in the economy. Despite this financial deregulation, there is relatively little evidence that financial globalization is taking place in the housing sector. Markets for housing finance have internationalized rather than globalized. Hence, at present, while money can flow across borders and assets are sold offshore as well as domestically, there is no globalized market in which there is a continuous flow of funds into assets whose risks and returns are independent of national regulatory and banking structures and where prices are identical across national borders (for areas with similar risks).

Internationalization has occurred in place of globalization because, although the state has withdrawn to some extent, it remains involved and housing finance markets are still particular, depending on their specific historical and structural contexts, hence rather than there being a single market there remain many national markets.

Despite these conclusions about specific investment flows that are directly concerned with housing, there is evidence that economies are becoming more interdependent and this is affecting housing finance markets. A recent study emphasizes that there is evidence of the synchronization of housing price increases in developed country markets.

CONCLUSION

It is evident that many of the poor cannot afford access to mortgage loan finance to improve their shelter because of the conditions attached to loans and the scale of poverty. This is not to say that mortgage finance is unimportant. Mortgage finance systems have to address the needs of those that can afford financial markets and have to do so efficiently. But the groups that are targeted by the Millennium Development Goals (MDGs) are not those that can afford mortgage finance.

Additional measures are needed for those who cannot afford mortgage finance and/or who live and work in informal markets and who cannot obtain mortgages. Small loans will help these households address their desire and need for shelter improvements. However, the experience of shelter microfinance suggests that it is limited in what it can contribute directly to the MDGs. Most small loans through shelter microfinance agencies go to households with land tenure. Moreover, such loans are rarely used for infrastructure, in part because few communities have a suitable social organization through which to borrow for infrastructure improvements. Hence these loans improve dwellings but do not address other development priorities.

The experiences with community funds are particularly interesting because their target group is people with low incomes and few assets. As noted above, with respect to the needs of the poor in developing countries, the greatest potential appears to lie in integrating neighbourhood development strategies with small loan packages (including income generation, housing improvement and community fund methodologies for additional needs).

It should be noted that neighbourhood development packages tend to concentrate on those who already have some claim to land within the designated areas (even if it is not a legal title) and tenants may be neglected even if they are also interested in securing tenure.

Housing finance markets have developed significantly during the last two decades. The extension of the market for housing finance has offered assistance to more affluent citizens, particularly urban dwellers. If the Millennium Development Goals are to be achieved, much greater consideration has to be given to how the lowest-income group can be reached with effective financial systems and strategies that build assets and that do not increase vulnerability.

CHAPTER 9

POLICY DIRECTIONS TOWARDS SUSTAINABLE URBAN SHELTER FINANCE SYSTEMS

Chapter 9 discusses the ways in which shelter finance systems could be strengthened, in terms of both performance and sustainability, on the basis of the experiences reviewed in the preceding chapters. Its main purpose is to point the way forward, highlighting best policies and practices. The chapter starts by identifying policy directions in improving urban development finance, which is necessary for city-wide infrastructure development. It then proceeds to identify policy directions in shelter finance.

TOWARDS INCLUSIVE URBAN INFRASTRUCTURE AND SERVICES

In the ideal world, there is a compact between householders and the public realm represented by city authorities and the providers of services. Householders expect that their dwelling will exist within an efficient public environment which supplies them with convenience and location. They will receive the benefits of road access, water supply, sanitation, waste disposal, energy and telecommunications; commercial, educational and social services, and the other benefits of city life. In exchange, they will pay for what they receive at a level that is both affordable and recompenses the providers for the public services they provide. This will not only happen at the beginning of the development of their dwelling but will also persist through their lives and those of their children in perpetuity. This is the ideal, but is not usually the reality, especially for low-income households.

The essential basis of the municipal side of the compact is a system of financing public goods so that they can be provided across the city, in appropriate quality and quantity, and at affordable cost, and that the city can be managed effectively. Unless urban areas can produce more income at the same rate that they absorb more people, the resources to develop infrastructure and build shelter will not be available.

It is vital that powers, duties and revenues are congruent. If the municipal authority is responsible for social housing, it should have the power to take policy decisions on how it will act and receive the required revenue or be able to raise the finance.

Municipalities should be able to raise at least part of their revenue from local taxation, at levels which reflect local conditions. As a consequence, municipalities and governments need to build the institutional capacity to levy and collect these taxes, and to spend them responsibly. Indeed, legislation may be needed to guide the responsible use of municipal revenues.

The policy road towards inclusive cities has many impediments

Affordability and difficulties of reaching the poor are key challenges in many cities today

It is vital that there is some source of loans for capital projects to which municipalities can apply to allow them to develop major projects which cannot be financed out of annual budgets. There are many models. Funds may be made available through loans from central government or an agency thereof, a mortgage bank, a finance company, a provincial level institution, or a group of municipalities working co-operatively.

Just as protecting endangered environments can be funded through debt swaps, so such exercises can be used to fund housing and urban services, as shown in the case of Bolivia (described in Chapter 3). As in many other financing arrangements, having a Poverty Reduction Strategy Paper (PRSP) in place influencing urban policy enables debt swapping in that it gives the parties confidence that the money will be spent within a strategy for poverty reduction rather than *ad hoc*.

The rising value of urban land is a significant potential source of finance for cities. Extracting public value out of the development process has been practised in many countries, some with great success. The US linkage process, in which city authorities leverage funds from the profits derived by developers of real estate to fund social projects, might be effective in cities in the South.

As a means of increasing revenue for a municipality, it is important actually to collect the taxes and revenues to which it is entitled from those who are liable to pay. For this to happen, the following conditions have to be met: up-to-date information on who should pay; transparent charging structures adhered to during collection and recording; efficient collection methods with respect to reaching all who should pay; career progression prospects and other reward systems for tax and charge collectors so that they have incentives to collect efficiently; effective penalties for those who do not pay; and appropriate means to keep tax levels in line with inflation and changes in costs.

The level of accuracy required in land records for collection of property taxes is lower than that for avoidance or resolution of land disputes. Thus, such systems as half cadastres and the use of regular low-resolution aerial photography can provide a level of accuracy well able to support property taxation systems at relatively low cost compared with an expensive, high-resolution land survey.

Debt management is a field in which there is an urgent need for capacity-building within local authorities in rapidly developing countries. It is also important that municipalities are paid economic charges for their services. Thus, functions such as land registry, building regulation and planning control should be subject to a charge which covers the cost. Similarly, user fees for municipal services (markets, abattoirs, car parks, transport interchanges, bus services, assembly halls, etc.) should cover life-cycle costs and, where appropriate, generate revenue.

In many cities, there is a culture of replacing regular maintenance with irregular capital projects. It is better practice to cost infrastructure over its whole life (life-cycle costing) and put aside money for periodic maintenance over a long life. The savings are considerable compared with rebuilding at the end of a short life.

The ability of the small-scale private sector to run local supplies of water, waste collection, and other services in partnership with the public authorities is well-documented and should be explored by municipalities not already using such partnerships.

Just as life-cycle costing is important to maintain the momentum of maintenance, planning budgets ahead of the

next financial year also allows for programmatic investment. Multiyear capital investment planning has proved very successful in Szczecin, Poland, as the city carried out a programme of transformation during the 1990s.

Where municipalities (as in Brazil) have implemented popular participation in budgeting, four key features have been introduced in the process: representation of residents; accountability by officials; transparency, with open voting; and objectivity in prioritization, for example, through a quality of life index. Participatory budgeting has changed the dynamics of citizen–municipality relationships, from confrontation and corrupt political bargaining to trust and constructive engagement.

It has become almost established practice by many governments and their agencies to delay payments to municipal councils. Such exploitation of its position by central government is highly detrimental and not in the interest of effective local government and service provision. Similarly, municipalities should pay service providers on time and at the levels agreed.

Wherever it occurs, corruption saps the ability of central and municipal governments to meet the needs of their constituents through diverting money away from the development and maintenance of services. Only when real progress is made on making corruption simply unacceptable in business and government, and involving people in eradicating it wherever it is found, will cities function efficiently and with trust from all partners.

It is likely that government funding can have the greatest effect if it is directed towards infrastructure and services for low-income neighbourhoods and welfare services for the poorest. In the provision of land, basic infrastructure and social services to the poor and poorest, subsidy is likely to be required unless the cost of services is low indeed.

Unless urban areas can produce more income at the same rate that they absorb more people, per capita incomes will fall and urban poverty will deepen. Thus, employment and income are central to the financing of urban development. The potential of shelter provision to generate employment for low-income workers should be utilized to generate income to improve people's ability to pay for housing. Income multipliers are very high for construction and even higher for low-technology, labour-intensive construction. In parallel, the provision of efficient infrastructure and appropriate shelter is critical in ensuring the economic productivity of the workforce in urban areas and countries as a whole.

Local governments should reduce the costs of economic activity by streamlining land allocation, development control, and other regulatory activities while retaining appropriate ability to act in the public good. One-stop shops allowing planning and building control to be streamlined are capable of radically reducing the transaction costs of development and encourage more people to take the formal development route.

STRENGTHENING THE PERFORMANCE AND SUSTAINABILITY OF SHELTER FINANCE SYSTEMS

Turning to housing finance, there is both a need and a demand for layers of finance for different sectors of the housing supply process. Mortgage finance, for relatively large sums over a long period of repayment, is essential for those well-off enough to buy a complete formal dwelling. However, small loans, taken out over short terms of between one and eight years, lent at market rates, are growing in importance in the housing sector.

The problem in many developing and even in some developed countries is not that housing is too expensive, but that incomes are too low. The locus of attention should not be on the minimum quality and cost of housing, but also on the level of payment received by workers. This demand-side focus is in line with current trends in subsidies and concentrates attention on the systemic problem of poverty, which is the cause of poor housing conditions.

In many countries in the South, the cost of urban housing is increased significantly by the high standards to which it must comply. The introduction of lower standards that are more appropriate to the local context could

There is much to be gained from encouraging multi-family housing development

Box 23 Low-income rental housing: encouraging self-help landlords

Few developing countries have in the past put in place incentives to encourage private landlords to develop or improve the quality of rental housing. A recent review proposes the following ways of encouraging self-help landlords to create more and better rental accommodation for low-income households:

- **Providing subsidies to poor owners, or poor private landlords, who create living space for others.** If landlords are as poor as their tenants, equity objections to this approach do not present a problem. Subsidies could also be in the form of tax relief, the difficulty being, of course, that very few small landlords pay formal taxes.
- **Building rental incentives into upgrading programmes.** Planners and managers of slum upgrading programmes should take the needs of tenants into consideration and encourage homeowners to increase the supply of rental housing by, for example, offering credit or subsidies. Good examples of this approach are the Plan Terrazas Programme in Colombia, implemented in the 1970s in the cities of Medellin, Cali and Bogotá, as well as the more recent Mawani Squatter Resettlement Programme in Voi, Kenya.
- **Providing microcredit for self-help landlords.** The idea of extending credit to informal sector landlords is now widely recommended, particularly since the emergence and rapid growth of shelter microfinance during the last decade. Governments should also encourage banks to move into the low-income housing sector and to lend to landlords wishing to enlarge or improve their rental properties.
- **Modifying planning regulations.** House extensions are often discouraged by planning regulations on maximum use of plots. In addition, the projected impact of densification on the supply of urban services is often used as a reason for prohibiting owners from adding rental rooms to their existing houses. Incorporating rental housing into upgrading programmes or encouraging its development in upgraded settlements may therefore require some modifications to existing building regulations.
- **Reassuring self-help landlords.** Existing and potential landlords often feel threatened by government policies that either give tenants the right to claim a house that has been rented to them illegally or that do not sufficiently protect them when tenants fail to pay rent. The adoption of rental regulations that protect the rights of both landlords and tenants, subject to the housing meeting specified minimum standards, will go a long way in encouraging landlords to invest more in rental housing. Governments and local authorities could also facilitate use of standard written lease agreements and establish mediation and reconciliation tribunals to address tenant–landlord disputes.
- **Application of more carefully designed rent control measures.** Many governments have in the past used rent control measures to achieve housing affordability. Unfortunately, such measures have often turned out to be inequitable and inefficient, as they tend to distort market values. They have also tended to discourage good maintenance, as they often rendered rental housing unprofitable, and have sometimes been applied in a haphazard way. Where it is necessary to apply rent control measures, care should be taken to avoid these negative results.

Source: UN-Habitat (2003) *Rental Housing: An Essential Option for the Urban Poor in Developing Countries*, UN-Habitat, Nairobi

potentially make housing more affordable to a far greater proportion of the urban population. Lower standards would still, however, have to safeguard the health and safety of the occupants and protect the public interest.

Most national shelter policies, including those supported by official development assistance, are based on the provision of independently serviced, single household dwellings, owned by their occupants. However, this is by no means the main form of occupation by households living in poverty. Instead, large numbers of households live in buildings occupied by many households. There is much to be gained from encouraging multi-occupied housing development where it fits in with local norms.

Small-scale landlords in informal settlements are a major source of affordable housing for a growing majority of households living in poverty in the urban South, but there are few initiatives to assist them. It is imperative, therefore, to understand how best to assist the informal rental sector,

and at the same time preserve affordability so as to preclude gentrification (see Box 23).

In the spirit of the Habitat Agenda, and if the housing backlog is to be cleared at all, it is vital that all actors in the housing process are involved in the role in which they are most efficient. The most important suppliers of the dwellings, and their ancillary services, are the millions of small-scale building contractors, the single artisans or small groups of skilled people and the labourers who service their needs. However much demand there is for housing, it can only be supplied as quickly as the construction industry can build it. Finance to provide healthy liquidity among small-scale contractors and single artisans is an essential prerequisite to effective housing supply to scale.

In countries where the housing supply system is efficient and speculative of what the market demands, developers are often an important part of the process. Some mechanism for recognizing their contribution with financial assistance, especially for bridging loans, may be very beneficial for the housing supply process in developing country cities and could institute the efficient speculative building of housing which is common in developed economies.

Recent research into regulatory frameworks for urban upgrading and new housing development has recommended the removal of constraints that prevent the poor from borrowing from financial institutions or accessing credit through other formal channels. In particular, administrative procedures that delay investments and/or increase risks should be reviewed, as they add to the cost and deter the poor from conforming.

The countries in which most of the urban growth will take place in the next 25 years have very low domestic savings, measured as both per capita and as a percentage of GDP. As savings are the foundations for investment, this does not auger well for urban development. It is important that developing countries maintain as much of the investment and savings arising from local economic activity within their borders, or benefit from net inflows from investments overseas. It is difficult to overstress the importance of reliable banks and low inflation in discouraging capital flight.

It is in the interest of governments to extend mortgage markets down the income scale, as home-ownership is beneficial economically, socially and politically. Measures that could be adopted include: reducing the cost of lending, especially through reducing interest rates; supporting the system of mortgage financing, especially through extending secondary markets and reducing risks; and providing direct capital grants to reduce the size of the households' mortgage in comparison with the dwelling cost.

Developers and banks are important agents of urban revitalization

The importance of legal property titles for developing sound economies cannot be overemphasized. However, not all experience has supported the idea that legalizing land holdings leads to a greater availability of some of the benefits of capitalism, including bank finance.

Well-run mortgage facilities are undoubtedly important to the health of the housing supply system in developed countries and may be a major contributor to housing improvement in transitional countries. They are also important in providing upper and middle-income groups in developing country cities with housing finance, without which they would claim the shelter opportunities provided for those lower down the income scale. However, as mortgage finance is unlikely to assist the majority of the people, it must not be allowed to divert attention from financing helpful to lower-income groups or to drain resources away from low-income households towards those in the middle- or upper-income groups.

Loan periods and loan to value ratios (LTVs) are vital components of mortgage loans which are determined by the lender rather than the global macroeconomic environment. Decisions about them can be the difference between success and failure of the mortgage company and determine who can afford to borrow, at least at the margins. Low LTVs (and, therefore, high initial deposits) reduce risk but increase the need for upfront capital. The level of repayments can be varied to help households meet their obligations. Variable interest loans allow low payments at the beginning, increasing as income improves to repay the loan on time.

Social housing is, almost by definition, subsidized housing. The subsidy element is a financial credit to the

occupier and, thus, often constitutes an important element in a nation's housing finance system. Although social housing is becoming residual in Europe and transitional countries, the need to provide more housing that is affordable to low-income households is still present. Those who cannot afford home-ownership or market rents in the private market need shelter through public rental housing. In the South, however, few countries have been successful in large-scale public rental housing.

Subsidies come in many guises including: direct interest rate reductions; allowing mortgage interest payments to be deducted from income tax; supporting housing-related savings; supporting insurance of mortgages; supporting the secondary mortgage markets; and direct grants for shelter. If appropriate housing finance is in place, the proportion of households requiring subsidy should be minimized, i.e. to only those too poor to afford the real cost of the shelter available. The need for subsidy can, thus, be reduced by adopting effective financing systems. The work of some NGOs to provide funding for the individual's contribution to attract a subsidy is very helpful to many households. In Ecuador, a revolving fund provides the down-payment necessary to obtain a national housing subsidy grant.

The majority of housing in developing countries is developed incrementally in stages separated by many months or years. In new building, this is usually implemented a room or a few rooms at a time but it may, less commonly, occur in construction stages, i.e. all the foundations, followed by all the walls, etc. It is imperative that national and international institutions recognize that low-income people build incrementally and provide microfinance suitable for that process. This may also call for reform of building regulations that often do not allow incremental building of formally recognized dwellings.

Short-term, small-scale loans, of one to eight years and in amounts of US$500 to 5000, are more useful for incremental development than the long-term, large value loans favoured by the mortgage markets. Improvements and efficiency gains possible through incremental building with small loans, rather than with savings, include: greater likelihood of building well (though small) immediately and avoiding high annual maintenance costs arising from poor construction; avoiding the wasteful process of improvising a dwelling in temporary materials and then discarding them as they are replaced with permanent materials; and reducing the age at which a householder can afford to be an owner as stages do not have to await money being saved but can be paid for in arrears.

There is a well-documented link between finance for income generation and progressive improvements in housing. Many home-owners operate one or more home-based enterprises from the structure on which they raise housing finance. The same goes for rental income. One of the most important sources of low-cost rental property, which is becoming more important as the years pass, is the extra room built on to a home and rented out to a stranger for rent, or to a co-villager or relative for no rent but some other benefit (if only to satisfy family obligations).

It is obvious that progressive improvements in housing can benefit home-based income generation, including room rentals. Thus, lenders should take account of the likelihood of income improvements in the application procedure, through a process which factors in future income generated by the housing goods to be provided under the loan. It is also important that financiers recognize that the poor are more concerned about access to credit than its cost. Experience shows that there is great demand for microfinance even if interest rates are high.

Small housing loans, disbursed through housing microfinance institutions (HMFIs), are some of the most promising developments in housing finance during the last decade. They are suitable for extending existing dwellings, building on already serviced land, adding rooms (often for renting out), adding services such as toilets, and housing improvements within in-situ neighbourhood upgrading. They tend to reach much further down the income scale than mortgage financing, but not to the households close to or below poverty lines.

In the context of large numbers of new low-income households in cities over the next two decades, it is important to increase the number of lenders in the housing microfinance sector rather than concentrate only on mortgage finance which, inevitably, serves the middle and upper income groups.

There is a serious issue of funding for on-lending by HMFIs. Many have received concessionary funds and their lending reflects the low price of the capital. If they are to expand their operations, they will need to cope with borrowing at international market rates and reflect this in their loans.

In comparison to enterprise microfinance, however, microfinance loans for shelter development are long term and large, thus generating a need for group security, or some security of tenure backed by documentation. In the context of group lending, mandatory savings periods before loans not only build up an understanding of finance, but also strengthen community ties among savers through regular group

meetings. Then the group becomes the collateral, as the members will support each other in times of difficulty and take the complication of following up defaulters away from the lender.

With respect to risk, it may seem self-evident that lower-income borrowers are more likely to default on their loans than those with higher incomes, but the evidence does not support this. Repayment rates can be further improved by flexibility in where and when payments can be made. Travelling banking vans visiting low-income neighbourhoods, banks which are open outside office hours, repayments through local supermarkets: all these and others can assist lenders to minimize defaults and encourage borrowers to keep up with their payments.

Guarantees are important in broadening the appeal of housing microfinance to lenders as they will look for ways of reducing their risks, even though the lowest income groups tend to be assiduous at repayment. The establishment of formal guarantee organizations is an important prerequisite to lending in many circumstances. Governments have much to gain from setting up guarantee funds to allow HMFIs to lend to low-income households at reduced risk. Official development assistance should also be directed towards them so that the full value of guarantees as catalysts for shelter development can be captured for the low-income groups.

Throughout the days of sites-and-services projects and other aided self-help, efforts were made to reduce the financial burden of low-income home-owners by allowing materials to be drawn from dedicated warehouses, or to be supplied on credit through local commercial suppliers. Recent experience in Mexico and elsewhere has shown how there may be great potential for this to expand alongside housing microfinance and the downscaling of mortgages to lower-income households using the longstanding credit culture operated by furniture and household goods retailers.

Community-based financing of housing and services is increasing in popularity and has been used for both settlement upgrading and for building on green-field sites. In a context where small loans are evidently successful and where there is an increase in poverty, it has many advantages for low-income and otherwise disempowered households. It provides the benefits of scale – strength in lobbying, ability to affect neighbourhoods comprehensively rather than just single dwellings, ability to raise capital funding – and it builds the cohesion of the community because its members act together. It takes strength from the willingness of people to work together as communities through traditions such as *gotong royong* in Indonesia. The experience of the affiliates

Sustainability of urban development is central to all forms of financing

of Shack/Slum Dwellers' International (SDI) has demonstrated that there is great potential for community-based organizations to manage development finance to the benefit of large numbers of relatively poor households.

The evident success of community funds has attracted some governments to take part in their financing. However, there are issues about how far non-members of such community groups are excluded by the activities of groups who so successfully lay claim to limited resources.

Savings are now seen as not only one of the most important prerequisites for obtaining finance, but also one of the most effective ways of building social cohesion in neighbourhoods. They are central to housing microfinance and community funds.

Remittances from overseas residents of local nationality are an important part of housing finance in many countries. Many people can remit enough to build a house in a few years overseas in quite lowly employment that would be impossible if they stayed at home in higher-level employment. But there is a danger that tastes, standards and ability to pay from a different context may take over the local markets and drive other residents into poorer housing than they would otherwise have.

Finally, many charities give large amounts of money towards housing improvement and shelter for the poorest (see Box 24). There is a place in funding shelter for the poor for that which arises from altruistic humanitarian support. However, there is a need to target such support towards those who need it most and to avoid reinforcing dependency.

Box 24 Hogar de Cristo, Chile

Hogar de Cristo is a non-governmental, non-profit, Church institution, whose mission is to provide appropriate and loving shelter to the poorest among the poor and, particularly, to the helpless aged, to the homeless, to the terminally ill and irrecoverable who lack any form of support, and to children and youths who are abandoned, excluded and lacking in opportunities. It also seeks to generate an awareness of the real extent of the problems of the poor in order to encourage drives to relieve them, and to denounce what can be solved.[i]

Founded in Chile over 50 years ago, and featuring many programmes to help the poor, Viviendas Hogar de Cristo (VHC) has grown into a major provider of wooden sectional housing to the poor. Its Ecuadorian branch produces 100 dwellings daily from bamboo, which it grows in its own plantations. Seventy-seven per cent of its beneficiaries have incomes of less than US$20 per month. About half are widows or female single parents.[ii]

The overall costs of the house are US$450; but there is a government subsidy of US$144 (US$4 per month for three years). The client has to pay US$186 through payments of US$4–$5 per month. If they pay at the VHC office, the client can simultaneously receive medical attention and lunch for themselves and their youngest children, subsidized by the government. They can pay with their social welfare of US$11 per month or with other income. Some are supported by VHC's charitable funds.

Currently, VHC has 16,000 clients, of whom 80 per cent pay every month; some even pay several months in advance. Only 1 to 2 per cent of clients are regarded as permanent defaulters.

Notes: i Hogar de Cristo (undated) *Our Mission*, available at www.hogardecristo.com/navegacion/home.asp
ii Costa, R. (2002) 'Hogar de Cristo – Ecuador: 30 Years!' *SELAVIP Newsletter*, April, pp39–40

Source: International Network for Bamboo and Rattan website at www.inbar.int/

TOWARDS SUSTAINABLE URBAN SHELTER

Among the issues addressed in the *Global Report on Human Settlements 2005* is the financing of shelter for the urban poor. This focus is but the latest manifestation of a broader concern that has been at the centre of the preoccupation of social activists, reformers and public authorities since the dawn of the Industrial Revolution, when the issue arose of providing humane living conditions to workers and poor families crowded in the rapidly growing cities of Europe.

This Epilogue starts from the premise that 'special approaches' and *ad hoc* solutions to shelter supply for the urban poor, however ingenious, will never work at the scale required. Three points are made. First, the percentage of the urban poor in the cities of the developing world is far too high to be considered a residual issue. Second, the demand for affordable shelter is increasing at an extremely fast pace, notably in the rapidly growing cities of the developing world. Third, the standards and costs that city life requires are high and complex. Shelter is only one, albeit the central, requirement of all citizens.

Sharing experiences of urban poverty reduction can contribute towards the realization of the Millennium Development Goals

The definition of 'adequate shelter' in the Habitat Agenda alludes to the multiple and complex characteristics of minimum standards in an urban setting:

> *Adequate shelter means more than a roof over one's head. It also means adequate privacy; adequate space; physical accessibility; adequate security; security of tenure; structural stability and durability; adequate lighting, heating and ventilation; adequate basic infrastructure, such as water supply, sanitation and waste management facilities; suitable environmental quality and health-related factors; and adequate and accessible location with regard to work and basic facilities: all of which should be available at affordable cost.*

This definition highlights the idea that all citizens should be able to afford adequate shelter, as described. Given these considerations, the issue is not simply financing shelter for the poor. The issue is making adequate shelter affordable to the poor. This approach may be called 'sustainable shelter': shelter that is environmentally, socially and economically sustainable because it satisfies the Habitat Agenda requirements of adequacy.

The two main kinds of existing mechanisms – informal and 'legal'– for providing sustainable shelter are both unsuitable. The first one is unsuitable because it is 'affordable', but not adequate. The second – conventional housing built by the private sector – is adequate but not affordable. Slum upgrading is the solution offered to make 'affordable shelter' adequate. This solution has been championed by all international agencies and is strongly supported by the United Nations Millennium Project Task

Force on Improving the Lives of Slum Dwellers. It is seen as a necessary and humane remedy to consolidated situations where the urban poor have created communities.

Ultimately, the affordability question hinges on costs and real demand. Therefore, a good starting point is to act on all the elements that make adequate housing unaffordable to the poor. Making adequate shelter affordable to the poor has two requirements: reducing housing production and delivery costs and increasing income levels. These are examined in succession.

FIRST ELEMENT: ABATING HOUSING COSTS

Housing is becoming an increasingly expensive commodity in all countries. Affordability, therefore, rests to a large extent on policies capable of bringing down housing production costs. Housing production cost components are known: capital, land, infrastructure, building materials, standards, design, location and modes of production. To be affordable, all of these elements will require a substantive element of subsidy; but in some cases they will only need intelligent policy changes.

Activities that create wealth for the richer segments of the city population must be tapped in order to subsidize sustainable shelter. The obvious one is an important source of wealth in rapidly growing cities: the rapid increase in land values. Efficient collection of property taxes, as well as taxation of land and property transactions, is the basic capital resource that cities can tap in order to cross-subsidize social investment, including sustainable shelter.

Cities in developing countries still hold large tracts of unused land, both publicly and privately held. Although some efforts to avoid land hoarding for speculation purposes have proven unsuccessful, as in the case of the Land Ceiling Act of India, other countries have enacted legislation to encourage the utilization of idle urban land. Cities must engage, as a first priority, in identifying public land to be developed for sustainable shelter and related income-generating activities.

With sound planning, trunk infrastructure developed for upper- and middle-income housing and commercial development can be extended at marginal additional costs to nearby areas reserved for sustainable shelter for lower income groups. There could be nothing more intelligent and environmentally, socially and economically sound than locating sustainable low-cost shelter in the proximity of industrial and commercial areas.

Assisted self-help housing is the most affordable and intelligent way of providing sustainable shelter. But all construction, and particularly incremental upgrading, requires a suitable supply of building materials, components and fittings. These markets already exist and thrive in virtually every city of the developing world because they respond to a huge solvent demand. They have to be supported by the public and large-scale private sector because they abate housing costs and provide precious jobs and incomes.

For decades, UN-Habitat and other international agencies have recommended reforming building codes and standards in order to allow for housing construction that is affordable for the poor. Now is the time for developing-country central and local governments to engage in sweeping reforms to establish realistic and reasonable minimal standards for sustainable shelter. This reform alone would cut housing production costs considerably and, equally importantly, legalize a huge chunk of the existing and future housing stock.

Design is a cost factor that has also been neglected for too long. Often, large-scale, high-rise housing projects result in very high costs per unit because they entail high overheads and are a typical target for corrupt contracting practices. At the other end of the spectrum, non-assisted self-help housing can be cheaper in the long run, but can result in flimsy and hazardous construction. The happy medium is design practices that combine the skills and briefs of clients/users with the abilities of dedicated trained professionals (architects, engineers, planners, surveyors) and reconcile the need for an efficient use of land with human-scale design.

Although, as a rule, land and housing costs tend to decrease with distance from the city, it is important for sustainable low-cost shelter to be located as close as possible to the widest range and concentration of income-earning opportunities, which is found in or near the cities' central areas. This is why it is important for slum dwellers located in central and peri-central parts of the city to be able to hold on to their most important asset – consolidated settlement in a favourable location.

'Assisted self-help housing', which incorporates a large component of donor and domestic government technical and financial inputs, is the mode of production recommended by the United Nations Millennium Project's Task Force on Improving the Lives of Slum Dwellers as the best and cheapest alternative to new slum formation in the developing countries. Another successful approach is cooperative housing. This approach does not necessarily reach the poorest of the poor, but it does produce housing that is more affordable, by virtue of the elimination of the profit component and the advantage of government subsidies granted by law by virtue of its social nature.

SECOND ELEMENT: INCREASING PURCHASING POWER

As highlighted in the 2003 issue of the *Global Report on Human Settlements*, 'the goal of cities without slums is only going to be achieved in a predominantly market economy once a good majority of the urban workforce has middle-class incomes.'

The issue, of course, is not simply that of higher wages. A regular income is also a standard prerequisite for accessing mortgage or shelter microfinance markets. Continuity in income earning is also important once one enters a mortgage agreement in order to avoid the risk of losing all of one's investment through the painful process of repossession.

It is often argued that low wages in developing countries, particularly in sub-Saharan Africa, are justified by a variety of factors, including the low skills of the workforce, low productivity, the volatility of the economy, capital restrictions and various forms of risks for the capital invested. However, some of these negative factors may not play such a large role today as they did previously. An informed guess is that there is no reason why wages in the sectors where the urban poor are usually employed – domestic work, retail shops, warehouses, security services, factories, construction, repairs and maintenance, public institutions, schools, hospitals, and so on – should be so abysmally low all across the board. It may well be that this relates more to a non-signed understanding among all kinds of formal and informal employers than to a real reflection of the costs and benefits of decently paid work. The suggestion here is that salaries should not follow a 'race to the bottom', but the inverse route.

Economists and policy-makers also tend to disregard important factors that dramatically lower productivity in developing countries, all linked to the inadequate residential circumstances of the working poor. However, it is now recognized that investment in improving the living conditions of the urban poor through sustainable shelter is a precondition for sustainable economic and social development.

Many specialists also point at ways of easing the burden and increasing the earning capacity of the huge numbers of people who draw their livelihood from the 'informal sector'. The following recommendations have been made by such specialists:

- providing the physical infrastructure for business development and job creation, including home-based enterprises;
- adopting pro-poor and labour-based methods when creating and maintaining infrastructure and providing basic services;
- easing the regulatory and fiscal burden for starting and growing enterprises;
- facilitating financial and business support for local enterprises;
- adopting community contracting on a much larger scale; and
- facilitating the regularization and operations of informal-sector activities.

SYNERGIZING THE TWO: LOWER HOUSING PRICES AND HIGHER INCOMES

An important aspect is the synergies between lower housing prices and higher incomes.

Increasing both wages and income opportunities for the working poor augments the saving potential of the same earning group. This triggers virtuous circles: the more capital is saved, the more is available for improving shelter conditions, productivity, skills formation and income-earning activities.

Investments in infrastructure and land-use planning can provide important income-earning opportunities for the working poor. One of them is 'community contracts', whereby contracts for physical improvements are offered to the communities themselves, thus internalizing at least part of public investments in upgrading and rehabilitation.

The revision of standards in favour of locally produced building materials, in addition to enabling 'home-grown' construction practices, can give a strong impetus to the local building materials industry, which typically employs low-income workers and a large part of the so-called informal sector.

The development of appropriate design solutions for urban living, from fixtures and furniture, to new building material production techniques, shelter design and residential and other development schemes – including environmentally sound solutions for waste management and energy sources and use – can open up wide avenues for employment and skills training.

The more participatory assisted upgrading and new housing development programmes and projects are, the

Innovative financing policies can turn the dream of affordable shelter into reality

greater the chance they have to improve the access of the working poor to the foundations of a modern urban economy: from credit to design, planning, management, trade and so on.

FORMULATING AND IMPLEMENTING URBAN SHELTER POLICIES: SHELTERING THE POOR FROM 'MARKET POACHING'

The identification of sustainable ways of guaranteeing adequate and affordable shelter for the urban poor requires close attention to a third aspect, in addition to reducing costs and improving incomes. This third aspect has to do with the fact that all shelter submarkets are permeable, and that different levels of demand (from very low income, to low income, up to middle income) can come into conflict and/or competition with one another. In these cases, it is always the poorest who lose. This undesirable outcome can be defined as 'market poaching': an outcome whereby more affluent social groups, taking advantage of their more favourable positions in the land and housing markets, can end up, voluntarily or not, absorbing resources (financial, spatial and otherwise) that are of vital importance in satisfying the shelter needs of the more vulnerable members of society. Addressing this challenge requires the formulation and implementation of holistic urban shelter policies that meet the needs of all income groups. Such policies should be linked to broader poverty reduction efforts.

The Millennium Project, in developing a practical plan for the achievement of the Millennium Development Goals (MDGs), pointed out that developing countries, and particularly the poorest among them, can achieve the MDGs only if they manage to devote much greater resources to sustainable policies for the reduction of poverty and the improvement of the living conditions of people. The report of the Millennium Project Task Force on Improving the Lives of Slum Dwellers identifies official development assistance as an indispensable component of this effort, and suggests that all countries should develop, as a matter of urgency, MDG-based poverty reduction strategies indicating the domestic and international resources required to achieve the goals.

Therefore, governments should consider, as a priority matter, adopting the innovative policy changes required to improve the shelter conditions of the urban poor and to achieve sustainable shelter development. Among them are:

- reallocating a reasonable level of domestic resources to the shelter sector, particularly to programmes specifically geared to slum regularization and upgrading and the provision of low-cost housing;
- mobilizing public resources for urban and shelter development through a transparent and rigorous use of existing public revenue-generation mechanisms, including property taxes;
- actively seeking donor support for funding pro-poor programmes linked to increased public-sector and administrative efficiency, taking advantage of the MDG-based poverty reduction strategy approach;
- identifying blockages and introducing incentives for the expansion of housing mortgage financing;
- creating or strengthening funding mechanisms for the provision of adequate shelter to the urban poor through, for example, national housing funds and direct subsidies; and
- involving the working poor and their organizations in every step of policy review, reform and implementation, from the national to the local level.

Financing shelter is only a component of the broader goal of securing solutions that can make shelter truly sustainable and fill the gap between the two extreme outcomes that are being witnessed today: affordable shelter that is inadequate and adequate shelter that is unaffordable. One starting point is to look at the inhabitants of informal settlements not simply as 'slum dwellers', but as 'working poor'. Important opportunities exist for addressing the affordability gap by acting on both ends of the sustainable shelter equation – reducing housing production costs and increasing the incomes of the working poor.