

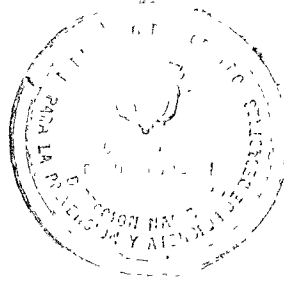


UNITED
NATIONS

HS



Commission on
Human Settlements



Distr.
GENERAL

HS/C/12/4
13 December 1988

ORIGINAL: ENGLISH

Twelfth session
Cartagena de Indias, Colombia
24 April - 3 May 1989
Item 5 of the provisional agenda
Global Strategy for Shelter to the Year 2000

FINANCING OF SHELTER AND INFRASTRUCTURE
Report of the Executive Director

SUMMARY

In its resolution 10/16 of 16 April 1987, the Commission on Human Settlements requested the Executive Director of the United Nations Centre for Human Settlements (Habitat) "to draw up a report on the financial constraints and needs of the developing countries and possible solutions for obtaining the funds required to attain the human settlements aims and goals set by the Commission." The resolution reflected the concern of the Commission that the lack of adequate financial resources would prove to be the main constraint to the goal of shelter for all by the year 2000. The Commission also decided to include consideration of the report in the agenda of its twelfth session.

The report is divided into four substantive parts (chapters two to five). Chapter two outlines the current trends in the world economy and their implications on national and international efforts of implementing the Global Strategy of Shelter for all by the year 2000. In chapter three, the basic principles of enabling shelter policies are reviewed in light of their implications for outlining the elements of effective financial systems. Chapter four outlines a number of characteristics of shelter finance which represent constraints to the development of the shelter sector and to integrating shelter finance into national finance systems. A number of options are then presented for increasing the availability of financial resources and for adopting effective mechanisms which channel those resources to a sustained shelter development. Chapter five presents financial options for infrastructure development which are consistent with the concept of enabling strategies. Introduced by general principles of financing in terms of investment needs, the chapter outlines techniques of infrastructure financing, the role of the private sector in financing infrastructure provisions, the need to enhance the role of local governments, and opportunities for public-private partnerships.

The conclusions in chapter six contain recommendations for national action, future directions for international assistance (including a discussion of debt-equity conversions and their potential implications for the shelter sector) and suggest a number of issues for discussion by the Commission when considering this report.

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I. BACKGROUND

1. At its forty-third session, the General Assembly adopted the Global Strategy for Shelter to the Year 2000, deciding, *inter alia*, that the objective of the Strategy should be to stimulate measures that will facilitate adequate shelter for all by the year 2000. The Strategy emphasizes that Governments have to take a number of fundamental decisions on required changes in existing approaches to the shelter problem. The basic policy change will be the adoption of an "enabling" approach, whereby the full potential and resources of all the actors in the shelter production and improvement process are mobilized.

2. In light of the crucial importance of establishing finance systems which are capable of supporting shelter and infrastructural development at the required scale, particularly for low-income groups, the Commission, at its tenth session, adopted resolution 10/16 entitled: "Raising the funds needed to ensure the effectiveness of national action to solve the housing problems of the homeless up to the year 2000". The resolution reflected the concern of the Commission, that lack of financial resources would prove to be the main constraint to the goal of facilitating shelter for all by the year 2000.

II. TRENDS IN THE WORLD ECONOMY AND IN INTERNATIONAL FINANCIAL ASSISTANCE TO SHELTER DEVELOPMENT: IMPLICATIONS FOR THE GLOBAL SHELTER STRATEGY

3. The past two decades have seen considerable turbulence in the world economy, as a result of which the growth rates since 1973 of both trade and world output have declined and become more erratic than in earlier periods. Successive oil price changes, high rates of inflation, the emergence of substantial current account imbalances and the increased integration of the world financial system have resulted in an unfavourable environment for the financial sector in developing countries. This implies that external capital flows to all but the poorest developing countries are likely to be on a smaller scale than in the past. Consequently, attention needs to be paid to efforts at domestic resource mobilization.

4. The shift in the external environment has serious effects on the financial systems which perform this mobilization. In many developing countries, the process of financial growth and development has been arrested, and financial systems have contracted and come under considerable stress. The World Bank Financial Intermediation Policy Paper of 1985 indicated that one third of the development finance institutions to which the World Bank lends are technically insolvent. In order to restore the ability of the financial systems of developing countries to generate and allocate resources, significant changes are necessary. For savers to participate in the financial system, rather than shift out of it into real assets (such as gold, land and real estate) or into assets held overseas, they must receive positive inflation-adjusted rates of return. For lenders to be able to pay these returns, they must have a reasonable portion of their loans in "safe assets" that have commensurate returns.

5. The effects of the debt situation of developing countries and the subsequent outflow of financial resources and/or reduced inflow of investment capital have restricted economic development. In recent years, developing countries facing high and rising debt burdens have had to adopt structural-adjustment policies, often formulated by the International Monetary Fund, which typically have included severe exchange-rate devaluations, credit restrictions, tight public sector budgets and "liberalization" of domestic and foreign trade markets. In many cases, cuts in consumption and investment have helped only to generate the foreign exchange to service existing debt and have done little to reduce the outstanding stock of debt. These measures have considerably slowed the process of development, and public and private investment has virtually ceased. Despite the severity of the measures taken by the debtor-countries in the past five years, the debt crisis is not near to being resolved.

6. Effects of the international debt crisis on the shelter sector in developing countries are clearly linked to the budgetary stringencies and deflationary policies urged on those countries. Shelter has suffered not only from direct cuts in public investment in the sector but also from the lack of private capital resulting from those policies. Cuts in shelter

investment are supported by the mistaken perception of housing as a purely consumptive expenditure or, at best, as an unproductive investment. The results are growing slums and squatter settlements and lack of water supply and sanitation for most of the poor.

7. The Global Shelter Strategy can play a significant role not only in improving shelter conditions in developing countries but in contributing to the changes in financial policy that are necessary to restore the resiliency of financial systems and to improve domestic resource mobilization. It can do this by following an enabling strategy that seeks integration of the financing for shelter - an asset that is often the largest single form of wealth-holding of the household sector - with the formal financial system. Such an integration can provide lenders with financial assets that can reasonably be expected to yield a positive and safe rate of return.

8. The shelter sector plays an important role in social and economic development in developing countries, both in terms of investment in housing stock and in terms of output of services. First, on the national level, investment in housing represents a large share of total capital formation. Secondly, expenditure on consumption of housing services accounts for a substantial part of the disposable income of private households. Thirdly, for the individual household, housing (and particularly house-ownership) means much more than just shelter: it is the most important incentive to save, the principal asset a household might own and, in the case of self-built housing, a means of converting the occupant's labour into a capital asset. It is, often, a source of rental income and the basis of economic activities - the shop or the workshop for small-scale enterprises.

9. Arguments of low productivity of shelter investment, of high capital-to-output ratio and of diversion of scarce resources from more productive uses than housing do not hold in low-income settlements, where micro-economic considerations of employment and income effects are more important than external debt problems. There is no doubt that shelter is a capital-intensive investment, but the measurement of the output (housing services) is usually distorted by such factors as undervalued imputed rent of owner-occupied housing or rents set below market value in public rental housing. Thus, the price tag put on housing services, in the form of rent, does not reflect the full value of the services provided, which may, in the case of improved squatter settlements and low-income family housing, include such factors as improved health, increased labour productivity or expanded income opportunities in informal economic activities in the dwelling. This means that the total value of shelter services is not reflected sufficiently in national accounts.

10. Increased shelter investment can help provide a stimulus for domestic economic growth. A new view of shelter

investment and its role in economic development has emerged over the past decade. Today, the potential of housing investment as a motor for economic growth is gaining recognition. The case for "enabling" approaches by governments to stimulate and support shelter investment is strengthened by the ability of housing construction to stimulate domestic economic activity. First, it is labour-intensive, creating employment, especially of unskilled and semi-skilled labour; secondly, it relies, for most of its inputs, on locally produced materials, especially for low-income housing; thirdly, it creates demand for goods and services; and, finally, it develops the infrastructure required for economic expansion and improves the living environment of the people. Multiplier effects of low-income housing investments have been estimated at between two and three, which means that every dollar invested creates additional income of two to three dollars through backward links in the building-materials industry and an increased demand for goods and services. Because of these characteristics, the stimulation of the construction sector has long been a tool to fight domestic recessions in industrialized countries. Now, some developing countries have started to look at shelter investment from the point of view not only of its diverse social benefits but also of its role in generating domestic economic growth and as a central component of national development plans.

11. A low proportion of international aid is channelled to fund the construction or improvement of shelter and the provision of basic infrastructure and services. During the period 1980-1987, less than 2 per cent of all aid to developing countries went to shelter projects (including slum and squatter-settlement upgrading, serviced-site projects and support for housing finance), and 6 per cent for

projects to provide water and sanitation to housing. Overall, a low priority has been given by aid agencies to the shelter sector. Several explanations are put forth for the low priority given to the sector, including the perception of aid agencies of shelter as an expensive and ineffective "social welfare" item and the high administrative cost for the aid agency in planning and implementing a shelter project.

12. However, recent years have seen a change in the approach to the shelter-sector problem taken by aid agencies. Since 1972, the World Bank has concentrated shelter lending on traditional sites-and-services and slum and squatter-settlement upgrading schemes. However, in the short time since it began lending for housing-finance projects in 1983, the volume of such lending has already exceeded the total for shelter "project" loans. In light of such recent changes in attitude, it might well be that past trends are no longer applicable and that a general shift towards assistance in support of institutional development is taking place.

13. Aid agencies are channelling an increasing proportion of aid to the shelter sector through non-governmental organizations (NGOs). Official aid agencies channel funds directly to NGOs in developing countries or through private voluntary organizations (PVOs) based in their own countries. Such aid flows have gained considerable importance for shelter for two reasons: first, the projects implemented by PVOs and NGOs usually reach much poorer people than conventional official projects and they usually give much greater scope for community participation, and, secondly, there is an increasing need to serve people not reached by provider-based housing programmes, and official housing agencies are slow to re-orient policies towards the approach outlined in the Global Shelter Strategy.

III. BASIC PRINCIPLES OF SHELTER POLICIES

14. Projecting shelter needs in quantitative terms to specific years in the future, costing shelter production on the basis of average house construction costs and mobilizing the required amount of financial resources on the national and international level for such construction activities are not a feasible strategy. In fact, such efforts distort the perception of the housing problem. Internationally, such a level of funds can never be raised, given present world economic trends and conditions. In addition, such efforts would not be consistent with the basic orientation of the Global Shelter Strategy.

15. With the goal of facilitating Shelter for All by the Year 2000, it must be the overall objective of shelter policies to support the creation of self-sustaining shelter development systems which can deal with the main issues of delivering land, housing and services at the required scale and at affordable costs. Shelter policies need to evolve continuously in response to changing demands and must take into consideration current economic and social conditions in each country. The rates of growth and redistribution of a country's population, as well as economic and social needs, are the essential factors which determine the evolutionary character of shelter policies.

16. Effective shelter policies address the need to put shelter-delivery systems in place which allow everyone access to shelter, whether through purchase, renting, self-help construction or subsidized access to basic units. Consequently, enabling shelter strategies provides for specific support services to developers and households rather than formulation of house-construction target figures for so-called beneficiaries. The success of such strategies will be measured by the number of families who have benefited from support services such as the provision of access to land, building materials, services, credit or technical assistance, whether directly or through participation in a targeted housing market. Policies which are based on providing support to an effective demand have inherently greater chances of success than those based on normative definitions of housing needs in quantitative terms.

17. Shelter policies have to deal with the issues of shelter and infrastructural provision at the national scale. The concept of planning and implementing shelter projects in single locations with defined dimensions and over specific periods of time ("project cycles") must give way to one of establishing long-term support services which can operate at the national scale. Despite efforts to make projects replicable, the concept of carrying out single projects up to levels of completion ties up large amounts of national and international resources, trained personnel and institutional capacities in limited project locations.

18. Measures to incorporate improved access to affordable rental housing must be included in shelter policies. The

growing understanding of the importance of rental housing has become evident in expanding low-income settlements. The promotion of rental housing has to receive high-priority attention in the range of shelter-support services which governments can extend to low-income households. In order to become effective, rental housing options require detailed research in the context of local housing markets and the impact of rent controls, particularly in conditions of high rates of inflation.

19. Government support for the shelter sector should seek to reduce the real costs of shelter provision. This policy will require governments to re-examine the building and plot size standards they impose, with a view to eliminating or relaxing all standards that are not necessary to the protection of health or safety. It will require governments to carry out investment in roads, water lines and other infrastructure, in order to open up new lands for development and, thus, restrain land-price increases. It will also require governments to support or create institutions that can act as financing intermediaries, focused on the special credit requirements for low-income shelter.

20. The incorporation of targeted systems of subsidies in a national shelter policy is required in order to reach the lowest income groups. Shelter strategies have to pay special attention to those who lack sufficient income to present an effective demand in the housing market. To deal with this problem, countries have instituted a variety of subsidy programmes which are explicitly or implicitly reflected in governmental budgets. Most of these programmes have been unaffordable and have missed their target. Therefore, the volume and structure of subsidy systems have to be carefully appraised against the scale of target needs and the availability of financial resources. Well-designed subsidy systems have to be compassionate, equitable and efficient. They require a balancing of shelter objectives for the poor and disadvantaged against such objectives as education, health and general income support.

21. To make workable shelter policies operational, governments should take a number of fundamental steps in changing existing approaches to shelter problems. Most governments have realized that there are serious financial, technological and organizational limitations to the quantity, affordability and appropriateness of shelter that they can produce directly through their agencies. Shifts are needed which emphasize, on the one hand, the integration of the shelter sector with economic development decisions and, on the other, decentralized and, often, community-focused efforts by all actors in the shelter-delivery process. If shelter policies are to be effective in meeting their goals, they require co-ordinated action at the highest levels on a considerably broader range of issues than public housing production.

IV. FINANCIAL OPTIONS FOR SHELTER DEVELOPMENT

A. Constraints to mobilizing resources for shelter finance

22. Increasing financial resources for shelter development, particularly for the development of low-income settlements, can only be achieved by integrating the shelter-finance system with the national finance system. Because this sector is rarely able to bid effectively for resources, this integration should increase the availability of financial resources for shelter development. While approaches to financing shelter development may differ, three basic issues need to be addressed; mobilization of financial resources on a sustainable basis; institutional arrangements to channel resources into shelter development; and specific loan mechanisms and conditions to finance housing and infrastructure to serve low-income groups.

23. There is a wide variation in the level of development of financial markets in developing countries and the policy approach to the provision of shelter finance will similarly vary. Where individual land ownership or use-rights are not clearly defined and where only a basic financial infrastructure exists, the costs of mobilizing resources and administering a large number of relatively small mortgage loans are very high. Mutual-aid organizations, NGOs and self-help associations at community levels are the basic channels through which shelter finance has to flow in such situations: formal housing finance systems have little relevance. However, in many developing countries, significant improvements in formal financial mechanisms are not only possible but also highly desirable from both a sectoral and economic perspective. In such situations, reducing the costs of administering contracts can be expected to lead to increased resource flows to the sector.

24. A number of characteristics set financing of shelter development apart from financing of other investments. First, housing-finance institutions need to lend relatively large sums for long terms of 15 to 25 years. As these sums represent up to five times the annual income of most borrowers, homeowners require long periods to repay loans. The consequence is that problems can arise out of so-called term-intermediation, i.e., raising money on a short-term basis to lend for long terms. A second issue is the cost of funds - the interest rate. In the case of long-term loans, the interest rate is the most important parameter for the calculation of amortization payments, and, in countries with high rates of inflation, interest rates will be very high and long-term finance practically unavailable. However, such high interest rates have to be paid, to protect savers from the effects of inflation (i.e., devaluation of the purchasing power of savings) so as to be able to attract deposits. A third specific problem of housing finance is related to the form of security - usually, mortgaged property. Housing loans are normally secured by using the dwelling unit as collateral. While residential property has desirable qualities as collateral (stable value

and in-built protection against misappropriation), legal protection of house-owners and time-consuming foreclosure procedures can transform it from a very safe to a doubtful security. Another side of lending secured by mortgage is that it requires a clear title to the land and registration of the mortgage in a land register - a highly formalized procedure handled by lawyers. Low-income households who build their own shelter in informal settlements have, therefore, no access to formal shelter finance.

25. An important constraint to financing shelter development is the need to mobilize unproductive savings such as property, gold and other goods to overcome the shortage of long-term funds, i.e., savings held as financial assets. The ability of the finance system to mobilize savings as long-term funds for investment in housing depends on the economic environment, i.e., the level of economic development, the rate of inflation and the constraints of financial policies and regulations. Three basic conditions are required for the functioning of a financial system - economic or monetary stability, a real return on investment and confidence in the security and stability of financial institutions. These constraints, rather than the lack of savings potential, have left capital markets underdeveloped, even in countries which have enjoyed rapid economic progress during the past decades.

26. Inflation at high and volatile levels devalues financial assets, such as savings, deposits and bonds, in real terms. To counter this effect, financial markets offer high and/or variable interest rates which adversely affect long-term financing. Unless the interest rate on savings instruments is above the level of inflation, people tend to invest in real estate, gold etc. The issue is of central importance to shelter finance, because, as inflation increases and interest rates follow, it becomes impossible to maintain an adequate volume of long-term loans at affordable interest rates, thus driving up the costs of shelter development for low-income groups.

B. Mobilization of savings

27. The principal pool of financial resources for shelter development is household savings which have to be mobilized on a broad scale. The importance of household savings is clearly reflected in the fact that the private and public sectors have to draw on capital markets, which are, in principle, markets for household savings. Households save for various purposes and require different forms of saving instruments. In order to broaden the savings base, financial institutions need to attract savings from all sections of the population and in forms that best meet the requirements of savers.

28. Saving-for-housing schemes combine contractual saving plans with the guarantee to provide housing loans when the saving plan has been fulfilled. Adapting saving-for-housing systems to the needs of developing countries could present an avenue by which to deepen the financial system, to reach

out to low-income groups and to mobilize untapped household savings, if obstacles to their introduction can be surmounted. Promoting saving-for-housing schemes in developing countries requires, therefore, supportive measures regarding integration with the housing-delivery system and, in inflationary environments, protection of savings through adequate monetary policy.

29. A number of countries have introduced compulsory savings schemes in the form of social security systems or provident funds. Generally, these funds are raised through payroll deductions and are managed by a governmental or parastatal organization, with the objective of paying unemployment or pension benefits to contributors: to fulfil this objective, these funds need to be invested in long-term assets earning a fair return. Housing-finance institutions can offer debt instruments which meet this requirement.

30. The formation and promotion of community-based finance institutions, such as co-operative savings-and-loan associations or building societies, appears to be a suitable way to provide access to financial services to low-income groups. Support might be needed for mobilizing savings and developing savings habits of low-income groups, since transaction costs of maintaining small accounts and servicing frequent small transactions are high in relation to savings volume. Support might include securing the funds through publicly backed deposit insurance, providing seed capital at concessional terms (as an interim measure to promote savings habits) and granting tax benefits to savers (actually a governmental subsidy in the form of reduced tax revenues). Direct subsidies might be justified to cover operating costs, in view of the desirable social and economic impacts on low-income groups of the development of savings habits.

C. Channelling funds to the shelter-finance sector

31. The financial system also has to channel into the shelter finance sector resources which are accumulated by institutional investors, such as pension funds, insurance companies and finance institutions which do not at present lend for housing. Using their regulatory powers, governments and monetary authorities can direct financial resources from such institutions to the shelter sector, e.g., commercial banks might be asked to hold housing bonds to fulfil their statutory liquidity requirements. It should, however, be recognized that, where such investments carry below-market interest rates, they have an effect of indirect taxation of the financial institutions. Extensive use of such measures can adversely affect the development of the capital market.

32. The development of secondary mortgage markets has been widely discussed and proposed as an instrument to channel resources to shelter finance. This mechanism for attracting additional funds to the shelter sector addresses the problem that housing-finance institutions face on account of the slow recycling of their funds lent for long periods. In primary mortgage markets, lending institutions make loans for building or buying houses, using the property as security:

the principle of secondary market operation is that a finance institution makes a loan and then sells that loan to an institutional investor, such as a pension fund, which lacks expertise in real-estate lending and is, therefore, reluctant to take the risks of originating long-term loans. Various instruments have been designed which obviate this need and yet provide security for investors. A number of similar loans originated by housing-finance institutions are packaged and sold either as a whole or in shares. An important feature of secondary market operations is default insurance of the individual primary loans, provided by specialized institutions.

33. Special funds can be set up and financed out of surtaxes on imports and the consumption of certain goods and services. It requires a high-level political decision on national priorities, in favour of housing and urban development to introduce special levies to create a housing fund. Levies can be imposed as a surcharge on any existing tax, e.g., tobacco and alcohol, and on luxury consumption. Such special taxes can create a considerable volume of resources, but a danger exists that such funds, once established, can be diverted to make up for general budget deficits.

D. Lending for shelter development

34. The conventional fixed-rate fully amortizing mortgage, which is still prevalent in most countries, is characterized by restrictive terms and conditions. Such mortgages are long-term, fixed-interest-rate loans, with monthly repayment instalments, which, in general, require the borrower to provide a down payment, have all general approvals for construction, possess a legal title to the property and to register the debt. Such long and cumbersome procedures tend to keep low-income people away from the formal shelter-finance sector. Also lending institutions are affected by the inflexibility of interest rates which, in an era of rising interest rates could lead to negative real rates of return, if the loans have been funded out of short-term borrowings. If current income is used as the basis for determining loan amounts, low-income and young borrowers are typically most affected.

35. Lending instruments can be designed to correct the shortcoming of conventional mortgages. Low-income borrowers can opt for loans which offer reduced repayment instalments in the early years and which rise with anticipated increases in income. Mismatches in funding and lending terms can be corrected through the use of variable-rate mortgages. These protect the lender but tend to have a negative effect on the borrower's repaying capacity which, to some extent, can be protected by extending the loan period. The needs of low-income people for house-improvement loans can be met effectively through short-term loans (which also eliminate term-intermediation risks). Where conventional mortgage security is not available, shelter-finance institutions have to search for innovative security arrangements. Advantage could be taken of the close social bonds that often exist in low-income communities to secure

personal or collective guarantees from neighbours, relatives or colleagues.

36. The common practice of low-income groups of investing incrementally in housing could be supported by multiple, small, short-term loans. Through the granting of repeated loans, the progressive investment process could be substantially accelerated, and maintenance could be improved. The incremental-loan approach enables the house-owner to improve or expand shelter in increments as income permits. Such loans would be small in size to conform to the income of the borrower at the time. They would also fit in with the idea of credit union type savings and loan associations which would rely chiefly on the small saver for their lending ability. Removal of non-financial constraints can also encourage lending to low-income groups. Lending to low-income categories could be encouraged through co-ordinated initiatives that would remove non-financial constraints: (a) specification of appropriate building standards that are affordable; (b) use of low-cost building technologies, including local materials and shared labour; and (c) operation of a building-materials loan programme.

E. Subsidies

37. Virtually every country subsidizes housing in one form or another, with the main objective of enabling the poor to afford a minimum standard of shelter. Other objectives are the promotion of home ownership, of capital formation and of saving habits. The need of governmental assistance, including subsidies, in housing the ultra-poor is obvious, since market mechanisms have failed to provide adequate shelter. The issue is, therefore, how to ensure that assistance reaches the target groups and how to distribute subsidies so that the largest possible number of low-income households benefit.

38. Subsidies through lowered interest rates have led to distortions in the financial system and, thus, to inefficient allocation of scarce resources. More often than not, the beneficiaries of low-interest loans have been the middle-income and high-income groups who have access to formal housing finance. Another common form of indirect subsidy is the deductibility from taxable income of certain expenditures related to acquisition and financing of housing - mostly interest paid on mortgages. This instrument usually favours owner-occupied housing and, by its nature as a tax break, it favours only households with taxable incomes. In developing countries, only high-income and middle-income groups benefit from such tax exemptions.

39. The use of direct subsidies, although transparent, faces other problems. Where absolutely essential, direct housing subsidies to carefully identified beneficiaries might be provided. Such subsidies could be in the form of rental vouchers for low-income tenants or of plots at below-market prices for intending house-owners. Despite its difficulties, the rental voucher system is clearly the most economical, efficient and easily targeted form of subsidy. Negative

indicators for subsidized allocation of land are: (a) the difficulty and high cost for public agencies to supply suitably located land in most urban centres, leading to low-income settlements being pushed away from places of employment, especially in the informal sector; and (b) frequent misdirection of subsidy when plots change hands, enabling individual allottees to realize substantial windfall gains at the expense of the community at large.

40. Subsidy can be provided in the form of so-called equity participation, where the beneficiary does not acquire full ownership of the property. Only a 50 per cent share in the property is sold to the beneficiary who has to make repayments on his share, while the development agency maintains the other half in joint ownership. The owner has the option of buying out the second half at any time at the then prevailing market value, but, if the property is sold, 50 per cent of the proceeds go to the agency which holds pre-emptive purchase right over the property. This avoids windfall profits to the subsidized household in times of rising property values.

F. Institutional arrangements

41. In situations where the costs of administering a shelter-finance programme are high, it might be desirable to address basic regulatory issues which hamper efforts to increase the provision of shelter finance. Issues relating to security of collateral, foreclosure laws, building standards, land registration, land management etc. need to be addressed before addressing institutional issues of shelter finance. Although the principles involved in determining an appropriate institutional set-up are important, the mechanism used depends mainly on the economic system of a country and the development of its financial markets.

42. A variety of financial institutions must be supported to meet the financing requirements of the shelter sector. With integration of shelter finance in the national finance system, use can be made of conventional financial institutions in meeting shelter-sector financing needs. However, for the foreseeable future, specialized segments of the shelter sector will need financing institutions that understand their specialized type of collateral and repayment practices. Different types of institutions will be required to (a) meet the financing needs of the formal sector; (b) address the savings and credit needs of the informal sector, including for progressive building of shelter; (c) provide funding to promote rental housing for those unable to aspire to being house-owners; (d) provide access to capital for improving the building-materials industry; and (e) channel financial resources to efforts of maintenance and repair.

43. Institutions will have to be able to promote enabling and progressive shelter-sector policies. Such institutions could be local-level mutual societies, building societies, decentralized mortgage banks and community-based finance institutions encouraging thrift amongst members and reciprocating with credit for house improvements. Existing networks of bank and post office branches can be effectively utilized to increase reach at minimal cost.

V. FINANCIAL OPTIONS FOR INFRASTRUCTURAL DEVELOPMENT

A. What an enabling strategy means for infrastructure

Infrastructure is a critical element of shelter and, therefore, of a shelter strategy. Adequate shelter requires access to safe and sufficient drinking water, a sanitary means of disposing of wastes and wastewater, and a means of transport for getting to and from work, schools and other locations. The capital facilities that provide these and other basic services often are grouped together under the common heading of "infrastructure", as necessary complements to land and housing in shelter provision. They also form a significant part of the financing challenge for the shelter sector. In newly settled low-income areas, infrastructural costs typically represent 50 per cent or more of the total costs of development.

There is a larger direct role for the public sector to play in the provision and financing of infrastructure than in the provision and financing of housing. As the Global Shelter Strategy points out, many utility services cannot be bought and sold on the private market as housing can, which makes a new type of collective provision and financing necessary. The "public" nature of infrastructure, however, is not synonymous with a need for governmental ownership and support. Most infrastructural provision involves a number of fundamentally different tasks which, traditionally, have been grouped together in a single, publicly provided service, but different types of intervention called for might be quite varied, depending upon the task to be performed. Moreover, many utility services are inherently local in character and are best addressed by local governments, community associations or non-governmental collectives than by central government.

In addition to providing direct service benefits, infrastructural investment is the key to restraining urban land prices and, thus, total shelter costs. Land prices are the most rapidly escalating element of urban shelter costs. Land price increases have an impact throughout all segments of the urban housing market, especially in cities that are growing in population and economic activity. Opening new land areas for shelter development, through the provision of transport facilities and the installation of utility lines, can augment land supply and restrain overall land prices. Where infrastructural investment is restricted, shortages of developable land result, with overall land prices.

Infrastructural investment supports the economic life of cities and towns, and at the same time meets household needs. The same road systems that support household movement support goods movement; and power and water supplies are as vital to production and commerce as they are to shelter. Most infrastructural investments can, at least to some degree, simultaneously serve the needs of the shelter sector and the production and distribution of goods and services.

48. There is strong evidence that high rates of infrastructural investment are economically justified in most developing countries. The World Bank, among other funding organizations, has found *ex post* rates of return to urban infrastructural investment to be among the highest of the projects it finances. Even in countries where users must pay for the full costs of infrastructural investment, there often is excess, unsatisfied household demand for water systems or local roads. These are firm indications that increased infrastructural investment can meet a strict market test of economic viability.

49. Infrastructural investment need falls into three broad categories. First, there is the investment needed to accommodate population growth, new household formation and new economic activity: this refers to the extension and expansion of utility services needed to support new users. Secondly, there is the catch-up investment needed to expand infrastructural coverage rates among the existing population: this involves bringing water, roads, waste-removal and other services to those now living without them. Finally, there is the investment needed to replace, repair and maintain infrastructural facilities that are already built and in service. Each country and each urban area or rural district should assess its own priorities among these categories of investment, based upon its growth rate, the adequacy of existing service coverage and the physical condition of its inherited capital stock. An "enabling strategy" for infrastructure financing must find ways to support each of these valid claims on resources. It must be able to mobilize, at market rates of interest, the capital needed to carry out investments that are economically justified; it must be able to target below-market resources, when the most basic health and safety needs of the very poor are at stake or when there are external benefits that the individual user cannot be expected to pay for; it must be able to assess and raise funds for the appropriate level of investment to open up urban-wide supplies of developable land in support of the other elements of a shelter strategy.

50. Much of the "enabling strategy" will involve finding new ways to support local governments, community associations, non-governmental organizations and the business sector in infrastructural provision. The same fiscal constraints that limit the capacity of central governments to finance housing limit their ability to finance infrastructure. It appears that, in times of governmental investment-cutting or revenue uncertainty, it is capital investment that is cut most sharply. Governments often hope that the budgetary pressure will be temporary, in which case spending on capital projects can be halted and resumed more easily than spending on social programmes or defence. In the current economic environment, however, the retrenchment in central-government infrastructural investment is unlikely to be temporary.

B. Principles and techniques of infrastructure financing

51. Methods to finance infrastructure should simultaneously raise revenue to pay for infrastructural investment and guide public authorities toward the efficient level of investment to undertake. In the housing segment of the shelter sector, an enabling policy can leave to individual households the decision about how much and what type of housing they want to obtain for themselves. In the infrastructure segment, investment decisions must be made collectively, taking into account the costs and benefits of infrastructural facilities. The costs as well as the benefits of public investment should be made clear, so that knowledgeable investment decisions can be made.

52. For many utility services, beneficiaries can be charged the full, incremental cost of capital installation, then voluntarily and collectively decide on the level of the service they want to pay for. As long as the benefits of a service are captured by the users or other identifiable beneficiaries, these people can be required to pay for the capital costs and be allowed to decide how much capital investment should take place. In this way, infrastructural investment becomes self-financing. Collective decision-making of this kind often will, however, require new institutional arrangements.

53. At the neighborhood level, communities can vote on whether they want to pay for the costs of installing such improved infrastructural items as water connections or paved roads. Economic efficiency requires that these items be provided to and paid for by all households in the community, or not be provided at all. A community decision, therefore, must be binding on all members. The capital cost itself can be recovered from households through various forms of special assessments the payment of which can be spread over several years, when this is necessary.

54. For area-wide services, the costs of capital expansion often can be incorporated in consumption fees that are charged to users. Tariffs for water and electricity consumption, for example, should be set so that they cover the costs of system expansion as well as the costs of current service provision. A special tax on motor fuels can serve as an approximate substitute for charges on road use. With charges of this type in place, governments can allow their investment decisions to be guided by the market. As long as there is user demand for capital facilities at a fee structure that can recover costs, public authorities should respond to this demand through further investment. Critical to the successful application of user-charges fees for infrastructural finance is the assurance that the revenues generated will, in fact, be set aside for capital expenditures.

55. Landowners are a special class of beneficiaries from infrastructural investment. Investment in local roads and other capital networks greatly increases the economic value of land having access to the new facilities. Therefore, landowners can be required to pay the full costs of localized investments of this type, while voluntarily and collectively

deciding whether they want investment to take place. There are various financing techniques for recovering costs from landowners. One is the betterment tax which allocates the costs of capital improvements among landowners in proportion to the capital gains they enjoy from the public improvement. Another technique is land readjustment which requires landowners benefiting from public improvements to give part of their land holdings to a public authority. Upon the completion of improvements, the public authority can sell or otherwise use the land to recover the costs of investment. Both betterment taxes and land readjustment can be made voluntary, because the additional economic value created by infrastructural investment exceeds the cost of the investment.

56. Most of the external or public benefits of infrastructural investment are captured at the scale of the city, town or rural district. Local governments appear to be the most appropriate level of government for deciding how much of this investment should take place. As long as local governments and local citizens enjoy the benefits of infrastructural investment but central governments pay for it, excessive demand for investment is likely, leading to arbitrary allocation of central government resources. By contrast, when local governments use locally raised revenues to pay for investment, they are likely to undertake only those investments for which local firms and households are willing to pay. Augmenting the capacity of local governments to plan and finance infrastructural investment will require fundamental reforms in many countries. It will require technical skills in investment analysis; it will require new national authorization for local governments to levy taxes and user-charges fees to recover investment costs; and it will require delegating investment choices to the local level.

57. An alternative strategy for raising financing for infrastructural investment is to dedicate a certain proportion of national revenues to local investment. The "earmarking" of specialized taxes or a share of all national tax receipts for local capital investment can raise investment amounts dramatically. Earmarking as an infrastructure-financing strategy takes note of the governmental tendency to underinvest in infrastructure and responds by prescribing that certain revenues be used only for such investment, regardless of future competing needs. However, it runs the risk of transferring more revenues to local governments than they can wisely invest in a given period and employs an arbitrary mechanism for establishing future investment levels.

58. Whatever strategy is used to pay for the costs of infrastructural investment, there will remain the challenge of assembling the financial capital to pay for it. Almost all cost recovery mechanisms raise funds over a prolonged period of time: therefore, borrowing or other strategies must be used to raise capital in the first instance. Over the long run governmental financing should be integrated in national financial markets, as borrowing on competitive terms from private sources of capital. However, in the short and intermediate terms, most local governments will require special

termediary institutions, with national government support, to assemble funds from the private sector and relend them to municipal governments. Municipal development banks now perform this function in several countries.

C. The private-sector role in infrastructure provision

1. The private sector already plays a large, if often unacknowledged, role in the provision of shelter-related infrastructure. Most attention has been devoted either to public-sector contracting with private infrastructure suppliers or to formal "privatization", i.e., the sale or transfer of public sector enterprises to private owners. At the upper end of the income scale, developers for the formal residential sector often are required by national development standards to install, at their own expense, internal roads, water-distribution lines, and local sewage-removal facilities. The cost of this on-site infrastructure is capitalized in the price of land and housing and paid for by the purchaser. In this way, it relieves public-sector budgets of the need to finance a small part of infrastructural investment. At the lower end of the income distribution, public authorities often do not provide infrastructure at all to the poorest of urban neighbourhoods, where people are forced to rely on private suppliers of substitute services. More often than not, such suppliers operate "informally", that is, without public licensing and without complying with publicly promulgated standards. In fact, in many countries, public authorities have tried to exclude private operators of this type, even when service coverage by public entities is inadequate or non-existent. prudent public policy should instead look for ways to extend private-sector activity, while enforcing those minimum standards of health and safety that are truly necessary.

2. There are special opportunities for public-private cooperation in bringing basic services to poor neighbourhoods where "standard" infrastructure cannot be provided in the near term. Some public water-supply companies now contract with private kiosk operators, to retail public water to households in areas where "standard" household connections are not available. Public solid-waste-collection agencies might contract with small entrepreneurs to collect wastes in certain neighbourhoods. Non-governmental community organizations, also, could be critical partners in establishing neighbourhood distribution systems that public authorities have neither the budget nor manpower to establish on their own. In areas where infrastructure-coverage rates are low, initiatives such as these are the fastest way to reach large numbers of new users.

3. Where capital availability is the constraint, the public sector can contract with private sector firms to build capital facilities or acquire equipment, and then lease to the public agency for use. For the private firm, this becomes a straightforward business arrangement. Besides transferring to the private sector the task of initial capital accumulation, however, the approach precludes implicit competition between public and private builders of capital facilities. Such competition has the potential for lowering costs, as each

party imitates the successful innovations of its competitor. In some countries, capital costs might be further lowered by tax provisions that allow private owners of capital facilities (but not public owners) to take advantage of depreciation allowances.

62. There is a difficult balance to strike in establishing public control over standards of private infrastructure. On the one hand, public authorities have the responsibility to protect public health and safety, while on the other, much of the informal-sector activity in utility services has sprung up precisely because the public sector has established unrealistic service norms which consumers do not want to meet, given the extra costs they impose. Informal operators serve not just neighbourhoods neglected by public agencies but also, at low standards and low costs, households who cannot afford to buy the services provided by public authorities or by licensed, formal private-sector suppliers. As with regulations concerning house and plot sizes, public agencies can best support the shelter sector by imposing the fewest and least burdensome regulations consistent with fundamental health and safety requirements.

D. Social implications of infrastructural financing

63. An infrastructure financing strategy that shifts costs to users and to local governments should be carefully designed to avoid regressivity. Attempts to raise revenues, by placing flat-rate charges on consumption or increasing rates of current local taxes, will, in many countries, place special burdens on the poor. However, the most regressive policy that a government can pursue is not to provide infrastructure at all in very poor areas and not to support private-sector or community-service provision there. By setting user-charges below cost for minimum levels of consumption ("lifeline rates") and by moving towards local tax structures that place part of the tax burden on wealthy households (through taxes on property, land and motor vehicles), governments can achieve aggregate cost-recovery from a mix of fees and taxes that are not regressive.

64. Infrastructure is a possible vehicle for targeting shelter-sector subsidies, through financing from general tax revenues of the costs of extending infrastructure trunk lines to areas of new, low-income shelter development. These "off-site" infrastructure costs typically are large and raise costs beyond what poor households can afford. A subsidy in the form of infrastructural support is to be preferred to interest-rate subsidies which are difficult to target and run the risk of spreading market distortions throughout the economy. Nevertheless, any form of location-targeted subsidy is inherently inferior to a household-targeted subsidy, such as a rebate on user-charges.

65. Subsidies, in the form of financing from general government revenues, might be appropriate and necessary in other specific cases, such as:

VI. CONCLUSION

A. National action

6. Methods of financing shelter and infrastructure will have to be integrated with the national finance system. A continuous flow of funds into the shelter sector requires that shelter-financing institutions mobilize funds on the same terms and conditions as other intermediaries in the financial market. Integrating shelter finance in the national finance system is critical for enhancing the capability of the shelter sector to raise domestic resources and, thus, meet needs effectively.

7. Financial policies will have to support a well-functioning financial market, capable of directing resource allocation to the required types of shelter and infrastructural investment. Liberalizing monetary policies and leaving the regulation of financial markets to market forces can contribute substantially to the development of the financial sector, enabling it to play its due role in financing shelter and infrastructure for all. This does not mean that governments have to abrogate interest-rate policy as an instrument of regulating economic development, but rather that they have to use it to set the framework in which market forces can then direct the allocation of financial resources.

8. A policy of stable development of the national financial system is a prerequisite for developing shelter and infrastructure. In an economic environment where interest rates are volatile and the economy is experiencing inflationary pressures, use has to be made of adjustment mechanisms to protect the ability of finance institutions to raise resources as well as to lend. The important point to note is that both assets and liabilities of housing-finance institutions are adjusted periodically to the rate of inflation, so that large variations in the flow of funds to the shelter sector are avoided. A direct benefit to borrowers is that, in such a situation, institutions are willing to operate on narrow margins, as the speculative element is eliminated.

9. In the field of lending, alternatives to the traditional fixed-rate mortgage which requires a clear registered land title and registration of the debt in official land records, are needed. Land titles can be replaced by simple documents, e.g., occupation certificates or allocation cards, which are then retained by lending institutions and can be revoked in cases of default under the allocation rules. Where local conditions and social norms allow, it might be possible to reduce the risk of individual defaults by forming groups of households, possibly as co-operative societies. This has the advantage of removing the need to issue and secure loans to individuals but makes it possible to write a single mortgage covering a jointly-owned property. The group can repay the loan and organize collections from its members.

10. Institutions could seek ways of mobilizing funds from the formal sector. Innovative instruments and mechanisms

(including mobile vans and door-to-door collection agents) would need to be devised by housing-finance institutions to draw the savings of the poor into financial markets. Such efforts should be made to help them develop the habit of thrift.

71. Subsequently, housing-finance institutions have to review their lending criteria and procedures to promote rental housing, including rooms for rent. Although rent control is meant to protect the poor, it has effectively brought to a halt any flow of funds into this market in those countries where the law is strictly enforced.

72. The shelter sector should be able to raise finance for infrastructural investment at market rates. With proper pricing of services, infrastructural investment could become self-supporting. User-charges and other levies that could be used should cover not only servicing and maintenance costs but also costs of new investment. Financing strategy should avoid placing a relatively larger burden on the poorer than on the well-off sections of society.

73. Infrastructural investment could be, to a large extent, a matter for local-government decision. It is desirable to move to a framework of local-government independence in decision making. It is, therefore, essential that, through technical assistance programmes, management capacity of local governments and community groups is enhanced. Local governments, where they do not already have it, could be given legal authority to raise finances and use them for infrastructural investment.

74. There are ample opportunities for private/public partnerships in financing infrastructural development. Although the public sector plays a significant role in the provision of infrastructure, largely on account of its capital-intensive nature, there is a need to recognize the role of the private sector, both formal and informal, in meeting gaps in supply. Wherever such services can be provided efficiently and at a low cost to the end-user by the private sector, involvement should not only be welcomed but also be encouraged.

75. The financial system is not an appropriate vehicle for targeting subsidies. On account of the interlinked nature of financial markets, any subsidy directed through the financial system is bound to lead to distortions in the allocation of resources to this sector. While recognizing that subsidies are needed to support the goals of the shelter strategy, it is preferable to have them accurately targeted and clearly transparent. Subsidies which are linked directly to the poorest households are inherently better than indirect fiscal or location-tied subsidies.

76. The small-scale building-materials industry needs to be supported as an essential ingredient of the shelter strategy. Specialized financial institutions catering to small businesses or industries should be involved in the implementation of the shelter strategy. The need for assisting small-scale

building- materials industries in selecting appropriate technologies and raising resources cannot be overemphasized. Besides helping lower costs, through use of appropriate local materials and cheap labour, this industry can increase employment opportunities and, at the same time, reduce dependence on imported goods.

B. International assistance

77. Aid agencies need to reassess their current orientation to aid for shelter, with a view to increasing support (including technical assistance to improve managerial capacity) to national and local governments as "enablers" of shelter and infrastructural development. International assistance could focus on improving the ability to mobilize domestic resources and on financing a broad range of support measures rather than on financing the production of shelter. Such support measures could include providing seed capital for mobilizing the construction sector, setting up or supporting appropriate finance systems (including community-based systems), establishing systems of land registration, supporting the development of local building- materials production, strengthening local-government capacity and encouraging the expansion of national training capacities.

78. Aid agencies could encourage national shelter-strategy formulation. Each country will have to prepare a national shelter strategy which will lay out an action plan to address the housing needs of the country in terms of physical, financial and institutional inputs. Governments will have to create an enabling environment under which housing-finance institutions can be established and can operate to meet the demands of the housing market. With the increasing importance of local governments in meeting infrastructural requirements, it is essential that aid agencies embark on an institution building exercise to enhance the capabilities of local government and municipal staff.

79. Aid agencies can provide technical and financial assistance for the rehabilitation, repair and upgrading of existing infrastructural networks. International investments in rehabilitation and repair are often much cheaper and more cost effective than new capital investments. Aid for such purposes could include a component to strengthen local-governmental capacity to rehabilitate and repair infrastructure.

80. Given favourable conditions, debt-equity conversions could be considered as a tool for reducing the level of external debt and channelling investment into shelter and infrastructure. It has become evident that conventional measures, such as new loans replacing old debt, debt roll-overs and debt re-scheduling, are insufficient to relieve the burden on the economies of developing countries. One innovative approach in recent years has been either to exchange governmental debts or to convert "blocked deposits" into equity participation in local enterprises. This can be an instrument for the financing of construction activities and the development of building materials in countries which wish to replace large import components going into the construction industry.

81. The mechanism of debt exchanges and conversions is that foreign entities purchase the debt of a debtor-country from commercial banks at a discount. The investor then presents the debt paper to the debtor country and obtains the equivalent amount in local currency which is used to make equity purchases in the debtor country. If, for instance, a debtor-country has a housing development fund, there would be an opportunity for an overseas investor in the creditor-country to consider equity participation in the fund.

82. In principle, debt conversion schemes benefit both the investor and the debtor country. One of the benefits to the investor is that debt is being purchased at a discount, obtaining substantially more in local currency for investment than could otherwise be purchased. The debtor country benefits by cancelling part of the original debt, thereby reducing its overall foreign debt. However, no experience exists with debt exchange and debt- equity conversion in support of shelter development. Experience, for instance in the field of environmental management, suggests that it could be a useful instrument for donor agencies but also that the scope of such transactions is very limited and can never be a substitute for continued efforts to mobilize domestic resource. Debt conversion should still be further explored as a possible source of credit on a case-by-case basis.

C. Points for discussion

83. The Commission may wish to consider the following points for discussion:

(a) Investments in the development of adequate shelter and infrastructure have far-reaching implications for national economic recovery programmes. Such investments can become a focus for domestic resource mobilization through their impact on the formation of capital assets, on the output of goods and services, and on the generation of employment.

(b) Enabling strategies in the field of financing shelter development require thorough reviews of national financial systems, of legislation and regulations governing the existing financial systems with a view of reducing or removing public interventions regarding interest rates and of lending policies.

(c) The effective financing of shelter development requires the adoption of supportive measures in such areas as land legislation and management, strengthening of local government roles, or increasing the capacity of the building materials industry.

(d) Infrastructure provision, including land, appears to be a more effective vehicle for targeting required subsidies to the lowest income groups than the housing sector itself, which is more vulnerable to the effects of market distortions.