

Operational Guidelines for Housing

Urban Development and Housing Policy
(OP-751)

Inter-American Development Bank

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Contents

Background Information on the Bank's Urban Development Policy

i

Rationale

1

Background: The Housing Problem

1

Objectives

2

Strategic Issues for Bank Activity in the Housing Sector

3

Instruments

7

General Issues

10

Background Information on the Bank's Urban Development Policy

In 1995 the Board of Executive Directors of the Inter-American Development Bank approved an amendment to the Operational Policy for Urban Development (OP-751) lifting the restrictions that it imposed on housing finance. In 1985, the date of the previous revision of the Operational Policy, the Board had restricted Bank intervention in housing to the financing of sites and services operations. However, sites and services projects alone proved incapable of improving the housing conditions of low-income households. This led several countries to consider profound reforms to housing production and finance systems in order to facilitate access to housing for low-income households. The 1985 Operational Policy restricted the Bank's capacity to support these reforms leading the Administration to request a modification of the Operational Policy on Urban Development.

The text of the Bank's modified Policy reads:

“Housing: The Bank will support borrowing countries' efforts to improve the living conditions of the low-income population, encouraging governments to pursue policies to efficiently mobilize private and public resources to help households in solving their housing problems. Consequently, Bank activities in housing will have the following objectives:

- a) Support policies and sustainable programs and projects directed to improve housing conditions for low-income households.*
- b) Improve public sector effectiveness both as a facilitator of private sector initiatives and in the management of public resources allocated to the sector.*
- c) Promote sector-wide allocative efficiency of housing markets and related markets such as land, financing and construction materials and services.*

The Bank will provide financing for programs and projects that directly improve the housing conditions of the low-income population. Fields of activity include financing for new cost-efficient housing solutions (for instance, basic core housing and sites and services) or the upgrading of existing low-income settlements and housing. The Bank will finance subsidy schemes for housing when these can be demonstrated to be an efficient and equitable means of promoting improved housing conditions for the low-income population. Subsidies should always be transparent, well targeted and explicitly itemized in gov-

ernment budgets. There should also be sufficient evidence that the subsidies can be sustained until sector objectives concerning the low-income population are attained.

The Bank will provide policy advice; technical cooperation and financing for the design and implementation of sector-wide reforms aimed at removing constraints to the efficient and equitable allocation of resources in housing. Fields of activity include, but are not limited to, the improvement of the regulatory framework for housing production, the promotion of efficient urban land markets, the establishment of efficient and sustainable housing finance mechanisms, promotion of private investment in rental housing, and the development of an efficient and competitive building industry. Deficiencies in housing finance mechanisms will be addressed within the framework of sound financial sector policies.

Preparation of Bank housing programs will be based on an analysis of the causes of the relevant sector problems. Project identification will be based on an analysis of the relative merits of different types of solutions to the problems and issues identified. To ensure maximization of the impact of Bank involvement in housing, project selection and design will pay attention to the expected impact in relation to the scale of the relevant problem and to the sustainability of the solutions proposed.”

The present Operational Guides for Housing, supplement the Policy and provide orientation on the preferred approaches and methods to reach the objectives of the Policy. In case of doubt about the interpretation of any point in the Guides, the text of the Policy and its technical interpretation will prevail. There are other documents that provide insight into several aspects of the housing problem and can be used in conjunction with these Guidelines. These documents can be accessed from the Bank’s Internet site (<http://www.iadb.org/sds/utility.cfm/78/ENGLISH/pub>).

Steve Mayo. July 1999. *Housing Subsidies: A Background Document*. SDS Technical Paper N° SOC-112. Contains a review of the role of subsidies under different approaches to housing policy and analyze its use in the context of policies oriented to enabling housing markets to function more efficiently.

Eduardo Rojas. July 1999. *The Long Road to Housing Sector Reform: Lessons from the Chilean Housing Experience*. SDS Technical Paper N° SOC-113. A good practice study. Reviews the evolution of the Chilean housing sector and discusses the lessons that can be learned from over 20 years of implementation of an enabling policy often used as a model in Latin America.

Michael Jacobs and William Savedoff. January 1998. *There's more than One Way to Get a House: Housing Strategies in Panama*. OCE Working Paper N° 392. Using household data from two cities in Panama analyzes tenure decisions, from the perspective of the factors that determine whether households will buy, progressively built or rent their home.

Bruce Ferguson. April 1999. Micro-finance of housing: a key to housing the low or moderate-income majority? *Environment and Urbanization*, Vol. 11, No. 1, pp. 185-200.

Rationale

These guidelines provide orientation to Bank staff and Project Teams in the identification, orientation and analysis of housing projects. They complement the Urban Development and Housing Policy (OP751) that gave ample latitude to the Bank to support countries in their efforts to improve the housing conditions of low-income families, while demanding a more thorough justification, in terms of

sector-wide diagnoses and goals, of how the components of specific programs are selected and designed. The guidelines are designed to help in the preparation of housing operations and they should be followed as closely as possible by the staff. Deviations from the criteria listed should be discussed by Project Teams with Management as early as possible in the project cycle.

Background: The Housing Problem

The scale of housing problems in Latin America is vast, and the dimensions of the problem varied and broad. Currently most Latin American economies do not supply fully serviced dwellings for all the population. The formal mechanisms of housing production and financing do not reach all segments of the population, while informal mechanisms produce solutions that are either substandard or expensive. Lack of sanitation services, overcrowding and insufficient environmental protection are the most pervasive problems, while extended travel time to employment and urban services centers worsens the problem for most urban households. Poor housing affects mostly

low-income households in urban areas. Rural housing problems are also serious yet attract less attention.

Housing markets are typified by allocative and productive inefficiencies and often counterproductive public sector intervention. Minimally adequate housing is unaffordable for millions of families. Major market inefficiencies arise from high transaction costs, poor and asymmetric information, lumpiness of the investment and distortions in land markets. Government activities do not fully compensate for the market's failure.

One set of factors deserves emphasis. Poverty is both cause and effect of poor housing conditions. Lack of effective demand resulting from the low income of households is the underlying cause that prevents the private provision of houses through formal channels for most of the population and presents a challenge for governments attempting to reduce the scale of national housing problems through public expenditure. Conversely, improving housing conditions can have a major influence on poverty alleviation through improvements in the living standards of low-income families, and on poverty reduction via increased employment opportunities. Furthermore, the problems of poor housing and poor environmental conditions are closely interrelated in many cities.

Housing problems are not only complex and severe, but vary in character from place to place. Interventions in one housing submarket often have spillover effects in others. The physical housing unit superstructure is only one dimension of the problem. Indeed the critical issue of poor housing may have little to do with the condition of the physical superstructure. Infrastructure (water, sewerage, electricity, telephones, transport) and access to employment are often as or more important problems. Moreover, when it comes to providing solutions, families and communities have some capacity to build their own houses, but have difficulty solving these other non-divisible problems.

Objectives

The Bank's main goals in the housing sector are to improve housing conditions for low-income populations, to improve public sector efficacy and to promote sector-wide efficiency.

IMPROVED HOUSING CONDITIONS FOR LOW-INCOME HOUSEHOLDS

The principal Bank goal in housing is to improve housing conditions for low-

income populations. This will often involve a focus on upgrading existing housing stock, encouraging the construction of rental housing and regularizing semi-legal neighborhoods. Many times, solutions to these problems involve working closely with community organizations and NGOs. Priority attention should be paid to the lowest income quintile of the national population, to measures that generate employment, and

to the difficulties encountered by female heads of households.

PUBLIC SECTOR EFFICACY

Well-defined public sector goals and actions to achieve them efficiently are requisites of public sector reform in housing. The public sector should help markets to achieve greater productive and allocative efficiency, while the task of actually constructing houses and supplying "retail" credit should generally be handled by the private sector. The following is a nonexclusive list of actions which could be undertaken by the public sector: reduce transaction costs for land and houses; increase the supply of land with basic urban services, strengthen and rationalize regulatory functions in the public sector; ensure that financial ar-

rangements for public support to the housing sector are equitable and efficient in attaining their social goals.

SECTOR-WIDE EFFICIENCY

Tinkering with housing problems through partial reforms or by addressing only one or two inputs may bring little improvement and may exacerbate existing problems. To facilitate change across the whole housing sector, the Bank will therefore carry out studies and establish a dialogue with the borrowing country to identify and evaluate key problems, and to develop a sector-wide strategy for addressing them systematically. Aspects that deserve special attention in any such diagnosis are housing finance, land markets and the construction industry.

Strategic Issues for Bank Activity in the Housing Sector

LOW-INCOME FOCUS

Bank experience with housing projects shows the difficulties of establishing efficient and sustainable mechanisms to reach the poor. Many attempts have proven unsustainable and others lacked the capacity to reach the target population. Success often came with a high

financial and institutional price tag for governments. However, IDB-8 mandates commit the Bank to emphasize lending for poverty alleviation projects, and lending for housing can be very effective in solving poverty-related problems of households. Shelter and sanitation services provided by housing projects rank high in the priorities of house-

holds and governments. Cautious adaptation of successful cases will enable the Bank to effectively collaborate with governments in establishing low-income housing support mechanisms that respond to household needs and priorities, and are institutionally and financially sustainable. Management of the Bank will ensure that, as part of the process of project identification, the relative merits of different types of programs will be duly considered. This consideration should include an estimate of how the benefits of different programs might be distributed over different income groups.

SECTOR APPROACH IN PROJECT DESIGN

Isolated housing projects have proven incapable of solving the housing problems of low-income households. A major lesson from this experience is that to ensure targeting, Bank projects should be concerned with the operations of housing markets serving households with incomes above and below the target group. This requires a sector approach to project design and implementation. Projects should be based on a diagnosis of the housing markets in which they operate, particularly of the constraints affecting the demand and supply of low-income housing. Bank projects should fit into housing markets efficiently to ensure that solutions to the problems faced by the target population are a part of a coherent system that ensures solutions to other demand groups. The key

to an effective strategy will not be a plethora of detailed studies, but a broad sector framework within which the priority issues, including investment needs, can be identified. In general, it will be neither possible nor desirable to resolve all sector problems in one phase; rather, an iterative process of diagnostic studies, dialogue with the borrowing country to review options, and definition of operational priorities will allow the timely implementation of programs without sacrifice of longer-term objectives.

ROLE OF THE PRIVATE SECTOR

Bank resources will only represent a minor proportion of the resources required to solve the sizable housing problem faced by Latin American countries. The solution will require the mobilization of a significant amount of local private resources. Long-term saving instruments and mortgage lending are central in this process. There may be cases in which insufficiently developed financial markets will limit the scope of housing projects (for instance reducing them to well targeted government financed low-income settlement upgrading programs). In circumstances of macroeconomic stability, housing projects can go further in promoting sector reforms and even be instrumental in developing depth and breadth in financial markets promoting financial instruments to mobilize resources for the sector. The Bank is in a privileged position to promote projects

that take full advantage of these synergies.

The construction of housing is largely in the hands of the private sector. Efficient developers backed by an efficient construction industry are essential for competitive housing markets. Bank housing projects need to be aware of the constraints faced by the private sector and should strive to correct inefficient regulatory regimes and other sources of distortions.

URBAN IMPACT OF HOUSING POLICIES

Bank housing projects need to explicitly address the urban development determinants of housing markets and the impact that housing policy has on urban development. Residential activities are the largest consumers of urban land and major users of urban infrastructure and services. Housing policies have significant impact over the pace and direction of urban development. Their impact on the behavior of developers and households determines, for instance, whether cities undergo horizontal expansion or whether significant urban renewal activities take place in large cities. The regulatory environment of housing markets, including land use, utilities and building regulations, often represent barriers to entry to the market or impose restrictions that prevent supply from efficiently meeting demand. The Bank can promote an integrated approach to

the issues and help coordinate housing and urban development policies to increase the efficiency of housing markets.

USE OF BANK RESOURCES

The scale of the housing problem of most borrowing countries is such that no single Bank operation will solve them. In fact, many traditional housing programs have been cosmetic or partial. As it is desirable that policies to solve the housing problems of the poor be designed with due regard to the scale of the problem, Bank operations in the sector should support significant policy innovation or be demonstration/pilot schemes that are designed to be replicable on a larger scale in the future. Bank operations should have an enabling character, being geared to the removal of constraints that prevent countries from undertaking the required reforms or implementing desirable programs.

Any decision to commit Bank resources has to consider the following concerns:

- (a) Additionality in savings: it is important to ensure that Bank resources do not substitute for domestic savings that would otherwise have occurred.
- (b) Leverage: through a mix of dialogue and conditionality the Bank should, where appropriate, encourage policy change and institutional reform, utilizing the most appropriate modality.
- (c) Sustainability: it is essential that investment and reform measures can reasonably be expected to endure

without dependence on Bank resources.

- (d) Impact in relation to problem scale: policies supported by loan proposals must be judged according to the expected impact in relation to the total size of the problem: in particular, projects to improve the housing conditions of the poor should include an estimate of their measurable impact compared with the scale of the problem in a specified time period. The objective is not to justify large loans, but to ensure that the cost, type and delivery mechanisms, of the proposed solution constitute a sustainable scenario for coming to grips with the full dimension of the problem.
- (e) Appropriate financial mechanisms: Bank supported reforms in the housing sector must anticipate its effects on financial markets and support sound financial intermediation mechanisms including demand driven allocation of resources, appropriate pricing and funding (for instances avoid interest rate subsidies and housing funds based on special taxes) and the development of financial intermediaries capable of managing this type of credit risk.

DEFINITION OF STRATEGIC PRIORITIES

Given the size and complexity of housing problems, progress toward a solution must occur in phases. The definition of priorities for each phase of Bank activities in any particular country must consider macroeconomic issues affecting the development process. Highly indebted middle-income countries place particular emphasis on macroeconomic stabilization and give priority to fiscal and financial policy. In these cases, housing sector reform may emphasize improving the financial soundness of institutions providing housing finance. In cases of severe macroeconomic instability, housing sector priorities may have to be restricted to improving the efficiency and equity of transfers made to households that help solve their housing problems, even if this means postponing other housing sector objectives such as more efficient housing finance mechanisms.

Instruments

To design an effective housing program, many or all of the following aspects need to be evaluated: (a) housing finance systems, both formal and informal; (b) a wide variety of government regulations and policies at both national and local levels; (c) land markets; (d) the organization of the building materials and real estate development industries; (e) the supply of infrastructure services, including water supply, sewerage, electricity and telephones; (f) transport issues; (g) the legal aspects of urban land, particularly title registration, mortgage collateral, sale and purchase procedures; (h) public subsidy schemes; and (i) location of employment opportunities. A variety of instruments may be appropriate to achieve Bank goals in the sector. An indicative nonexclusive list of some possible operational components follows.

REGULATORY FRAMEWORK REFORM

Establishing an efficient regulatory framework that enables the market to supply houses and housing finance to all income groups. Such a regulatory framework includes the regulation of financial institutions providing housing finance within the policies set up by the institutions in charge of macroeconomic man-

agement (Central Banks, Ministries of Finance); regulation of land uses and environmental codes that affect the operations of urban land markets; building and sanitary codes that affect housing construction; the regulations affecting the construction industry and those regulating the titling and transfers of property rights of real estate. Often the withdrawal of public sector driven distortions can go a long way in accomplishing sector goals; consequently, they need to be assessed early in the project preparation process. Regressive taxation, complicated planning regulations, interest rate subsidies, excessively high service standards, and other legal and institutional impediments to efficiency and equity goals are commonplace.

STRENGTHENING HOUSING FINANCE SYSTEMS

Intermediation of housing financing requires a well functioning financial sector. While resources may flow with relative efficiency to other sectors, they face specific problems in housing. Beyond the mechanics of collecting funds, keeping track of the transactions, servicing loans, etc., the management of the risks associated with long-term lending pose particular problems. Credit, liquidity, cash flow, agency, system and po-

litical risks emerge as areas to be addressed. Bank operations can help governments to adopt appropriate policies and provide the institutional environment required for private entities to meet the demand for financial intermediation, including the management of risks. Instruments available include: (a) the development of mortgage lending within the development of the financial sector; (b) the promotion of financial policies that enable institutions to develop long-term financial instruments for savings and mortgage backed lending for housing in a competitive environment; (c) promotion of secondary markets for mortgage based securities and (d) the establishment of efficient property titling systems and easily enforced foreclosure procedures that provide secure collateral.

IMPROVE THE FUNCTIONING OF URBAN LAND MARKETS

Governments can influence the efficiency of urban land markets through a variety of measures. They can establish efficient and low cost mechanisms for handling land and property titles, thus reducing legal entry barriers to the market. Governments may increase the transparency of urban land markets providing unbiased and freely accessible information about land and housing transactions. In some cases taxation mechanisms may limit the speculative withdrawal of lands from the markets. Flexible land use and building regulations can improve the private provision

of serviced land and houses making them accessible to households in all income brackets. Land market audits help identify the distortions affecting the operation of land markets and the measures required to improve functioning.

PROVISION OF INFRASTRUCTURE FOR RESIDENTIAL LAND DEVELOPMENT AND THE PROVISION OF SERVICED LAND FOR LOW-INCOME HOUSEHOLDS

Trunk infrastructure is the most important determinant of urban growth, affecting the price at which land is incorporated into urban uses. Ensuring the efficient provision of trunk sanitation and transportation infrastructure helps the private sector subdivide land for housing use. By reducing the premium on serviced land, such measures help make housing more affordable. Since this could become a major impediment for the effective operation of the housing sector, housing operations need to review the capacity of existing mechanisms to ensure the adequate supply of infrastructure on a sustainable basis. Governments can set up special programs for the provision of low-cost serviced lots to facilitate access to serviced land by low-income households when it is demonstrated that the private sector cannot be persuaded to supply this market

PROMOTING SLUM UPGRADING

The provision of basic sanitation (potable water, elimination of wastewater, and solid wastes and drainage) and access to infrastructure on substandard settlements has a significant impact on the quality of living. Further, providing secure tenure encourages investment in home improvement and the consolidation of neighborhoods. Neighborhood upgrading programs with these kinds of components can play a significant role in government policies aimed at reaching the poor with good housing services.

PROMOTING THE RENTAL HOUSING MARKET

Rent controls have had a negative effect on rental markets in many countries. Rental housing serves several purposes in efficient housing markets. It provides housing for households not interested in buying homes or for those undergoing a transition in the family cycle. In some circumstances rental housing is the most affordable solution for low-income households. Finally, rental housing provides a venue for investors interested in long-term investments that provide a steady cash flow (typically institutional investors). Rental market deregulation can be accompanied by other measures to boost supply. Rental market audits should be conducted to identify constraints on supply and the most efficient mechanisms to overcome them.

PROMOTING HOME-BASED MICROENTERPRISES

Home-based microenterprises are an important source of income for low-income households. Land use and sanitary regulations often impede development of these activities. Selective elimination of these regulations and well targeted technical cooperation programs can go a long way in fostering these activities that make a significant contribution to the provision of goods and services in the urban economy and to job creation.

BUILDING INDUSTRY REFORMS

Governments should promote competition in the building and real estate development industries, eliminating regulatory barriers to entry; facilitating equal access to markets and inputs for small and medium size firms; reducing trade barriers that apply to housing construction; and fostering technological innovations and adaptation.

General Issues

REFORMING OR ESTABLISHING EFFICIENT SUBSIDIES

Subsidies are a controversial issue. The impact of many past national schemes has run counter to the public interest, to poverty reduction and to principles of equal opportunity and allocative efficiency. As a result, the use of subsidies requires a thorough evaluation beginning with a diagnosis of the problems faced by housing markets to supply housing solutions to all segments of the population. Project Teams should work on the premise that subsidies are a policy tool of last resort whose use must be considered only after other means of attaining the objectives have been explored. To this end, the studies should demonstrate that subsidies are a cost-effective tool to attain the objectives. Subsidies are best used as a policy tool to facilitate the transition from the existing situation to one in which housing markets function effectively to fulfill social goals. In this regard, they should not be conceived as permanent. Among the considerations that should be analyzed when conducting country sector studies and country programming are the following:

- (a) Are the proposed subsidies for housing justified in the context of the country's overall policies for social

services and poverty alleviation? Specifically, are housing subsidies an appropriate use of public resources relative to alternative programs?

- (b) Are subsidies justified and sustainable in the light of the government's fiscal position?

Deciding the size of subsidies is a complex problem for which no standard solution exists. Approaches that set subsidies on the basis of making minimum housing “affordable” do not yield the best results because they usually lead to large subsidies that are unaffordable for most governments. Furthermore, they frequently displace household savings. In the context of housing sector reform subsidies should generally be set equal to the minimum required by each household group to be able to enter the market segment that satisfies its housing needs while mobilizing their full saving and repayment capacity.

In the context of identifying and developing specific projects, the following questions will help ensure that the resources allocated for subsidies are used in the most effective way:

- (a) Will the subsidies be targeted on the most appropriate social groups, not just in terms of project intentions, but

in terms of the likely outcome of the proposed mechanisms for managing the subsidy schemes? Are schemes sufficiently transparent to promote equal access by all members of the target population?

- (b) Are the total resources committed to the housing subsidy, and the levels of unit (per family) subsidy, such that a significant proportion of the targeted housing problem will be resolved within a specified time period?
- (c) Has the correct form of subsidy been selected? In the past, subsidies have been provided in different ways: via effective interest rates (using tax rebates, for example), via increases in income (voucher schemes and cash grants for example), or via the below cost provision of specific goods or services. The impact of the proposed scheme on the integrity of the financial system and on the feasibility of the targeting goals must be carefully evaluated. In any case, subsidies must be transparent, well targeted and explicitly itemized in government budgets.

ESTABLISHING AN EFFICIENT INSTITUTIONAL FRAMEWORK

The use of most of the instruments listed requires, among other activities, the establishment of efficient institutional mechanisms able to: (i) collect, analyze, interpret, and publish data on the performance of the housing sector; (ii) provide institutional linkages between

housing and macroeconomic policies; (iii) manage subsidies; (iv) bring together infrastructure agencies so as to coordinate infrastructure provision and create an adequate supply of serviced land; (v) generate long-term plans for the development of the sector and coordinate the involvement of private and public actors in its execution; (vi) provide a forum for the involvement of the private sector, NGOs and the public in the formulation of housing policy; (vii) initiate regulatory reforms and evaluate their impact; (viii) promote housing research and technological development. Institutional reform or, at least, reorganizing roles and institutional relationships may help in making efficient use of the other instruments.

THE ECONOMIC ANALYSIS OF HOUSING PROJECTS

As established in Bank practice concerning the economic analysis of social programs, this analysis is expected to demonstrate that the proposed program is the least cost solution and that it has an adequate economic rate of return. The search for least cost solutions should focus attention on quantitative evaluations of the alternative policies for increasing the number of households with adequate housing conditions. At a minimum, this would include comparing the average cost of such policies as land clearing, land titling, slum upgrading, home improvement loans, and others detailed in this paper to determine which

are better applications of limited economic, financial, and institutional public resources.

The demonstration of an adequate rate of return is affected by the sectoral focus emphasized in these guidelines. The sectoral approach requires economic analysis to shift its attention away from the traditional calculation based on individuals' willingness-to-pay an evaluation of the benefits expected from improving the efficiency of the sector as a whole. In some cases, this may not be quantifiable, but some evidence must be provided to explain why particular courses of action and expenditures are reasonably expected to leverage substantial and positive gains in housing conditions.

Economic analysis has also been used in Bank housing programs to estimate the required magnitude of subsidies for low-income groups. The record of applying

various methods of ex-ante estimation of willingness-to-pay has not been very good. More promising estimates can be derived from the actual behavior of families in the housing market, calculating current expenditures on housing services and using these figures to estimate the dimension of any subsidies that might be considered. The most promising use of economic analysis is to gain a better understanding of how the existing markets operate, the structure of the construction industry, factors affecting the supply and demand for land, household budget expenditures on housing and utilities, savings behavior, and access to credit. The most highly effective programs will take advantage of existing markets, resource flows and spending patterns to support and further the creation and improvement of housing.