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Creating an Enabling Environment for Housing: Recent Reforms in Mexico

Thomas Lee Zearley
World Bank

Abstract

A recent World Bank policy statement on housing advocates the reform of government policies, institutions, and regulations to enable housing markets to work more efficiently. The policy statement identifies several instruments that governments can use to address housing market constraints, and to improve the performance of the housing sector as a whole, while paying particular attention to the needs of the poor.

In recent years, the government of Mexico has employed many of the enabling instruments described in the World Bank's housing policy statement. This article reviews the role of housing in the Mexican economy and the major reforms that the Mexican government has implemented to improve the operation of the housing market so that private lenders and home builders can play an expanded role in addressing the country's housing needs. The World Bank has supported the government's reform program, and since 1985 it has lent more than $1.2 billion to Mexico for low-income housing projects.

Introduction

Recently the World Bank issued a policy paper on housing that proposes new directions for the Bank and its borrowers (World Bank 1992). The Bank advocates reforming government policies, institutions, and regulations to make housing markets more efficient and to move away from the limited, project-based support of public agencies engaged in the production and financing of housing. Governments are advised to abandon their earlier role as producers of housing and to adopt an enabling role toward the housing sector. This fundamental shift reflects a growing understanding of the economic importance of the housing sector and the problems it faces. In most of the developing world, a new approach is necessary if housing problems are to be addressed on a large enough scale and if the efficiency of the housing sector is to be improved. The ultimate objective of such an approach would be to substantially improve the housing conditions of the poor.

The World Bank's new policy paper identifies seven enabling instruments that governments can use to enhance housing market operations: three that address demand-side constraints, three that address supply-side constraints, and one that improves the management of the housing sector as a whole. The three demand-side instruments are (1) development of mortgage finance by creating strong and competitive mortgage lending institutions and by fostering innovative arrangements for providing greater access to housing finance by the poor; (2) rationalization of subsidies by ensuring that subsidy programs are affordable, well targeted, measurable, and transparent and do not distort housing markets; and (3) development of property rights by establishing and enforcing laws that ensure rights to own and freely exchange housing and by administering programs of land tenure registration and legalization.

The three supply-side instruments are (1) regulation of housing and land development by balancing the costs and benefits of regulations that affect urban land and housing markets, especially land use and building, and by removing regulations that unnecessarily hinder housing supply: (2) provision of infrastructure for residential land development by coordinating the agencies responsible for providing residential infrastructure to focus on servicing existing and undeveloped urban land for efficient housing development; and (3) organization of the building industry to create greater competition and reduce trade barriers that apply to housing inputs. These instruments are supported and guided by the seventh instrument: development of an institutional framework for managing the housing sector—strengthening institutions that can oversee and manage the performance of the sector as a whole, bringing together all the major public agencies as well as private sector and nongovernmental representatives, and ensuring that policies and programs benefit the poor.

In recent years, Mexico has embraced many of the new directions and instruments presented in the World Bank's housing policy statement. This article describes the role of housing in the Mexican economy and the major reforms that the Mexican government has implemented to improve the functioning of the housing market so that private lenders and builders can play an expanded role in addressing the country's housing needs. This article will also review briefly the involvement of the World Bank in Mexico's housing sector.

The role of housing in the Mexican economy

Housing is an important sector of the Mexican economy. During the past decade, annual housing investment has represented an estimated 4 to 5 percent of gross domestic product.[1] The housing stock is the single largest form of wealth in Mexico; although no reliable figures are available, it could account for between 20 and 50 percent of total reproducible wealth—estimates commonly cited for other developing countries (World Bank 1992). Because of its high labor component, home building is one of the most prominent industries in the Mexican economy. About 7 percent of the formal sector jobs depend on the construction and home-building industry. An estimated 10,000 small firms and contractors build houses in Mexico; the majority of new housing projects are built by about 1,000 large and medium-size developers nationwide.

Mexico's housing needs

Mexico's housing stock is estimated at 17 million units. About 3 million additional units would be required to adequately house all the country's 83 million inhabitants. Because current production is about 600,000 units per year, much less than the annual incremental and replacement needs of more than 800,000 units, the housing deficit continues to grow.[1] Mexico's housing problem is intensified by a moderate rate of population growth; a rapid pace of urbanization, particularly in the three largest cities (Mexico City, Guadalajara, and Monterrey) and along the U.S. border where the "in-bond" or *maquiladora* industry is concentrated; and the uneven capacity of the population to finance its own housing needs. A large proportion of the population at present has no access to formal housing sector finance except through public sector programs.

In 1992, the volume of new private and public sector mortgage credit provided by Mexico's housing finance system was U.S. $7.9 billion equivalent, or about 3 percent of gross domestic product (box 1). Although this level of financing is comparable to that in other countries at a similar stage of development, it has not been nearly enough to address Mexico's growing housing

[1] Estimates made by the author on the basis of information provided by Mexican government authorities.

problems and reinforces the need for the policy changes now being implemented.

1. Mexico's housing finance system

The Mexican housing finance system comprises several institutional groups. The largest, most important source of housing finance is the commercial banks that provided about U.S. $5.0 billion equivalent of new mortgage credit in 1992. Commercial banks mainly lend funds for new residential housing to families earning more than five times the minimum wage (about U.S. $600 equivalent per month as of December 1992). In 1992, the commercial banks financed the construction of nearly 140,000 housing units. Only with the long-term resources of the housing fund for commercial banks (FOVI), a special fund of the Central Bank, are commercial banks willing to lend to households that earn less than five times minimum wage. FOVI, whose financing is assigned to developers for the sale of low- and moderate-cost housing through public auctions (box 21, provided U.S. $335 million equivalent of new mortgage credit in 1992 to support the sale of nearly 25,000 low-cost housing units. Housing programs run by two workers' pension funds—INFONAVIT for private sector workers and FOVISSSTE for public employees—lent about U.S. $2 billion equivalent in 1992, mainly for new homes and home improvement credit. INFONAVIT and FOVISSSTE finance their operations through a mandatory contribution from employers equal to 5 percent of payroll and lend these funds to unionized workers earning less than five times minimum wage. Another important source of housing finance consists of several public housing agencies that serve the needs of the poor, mainly nonsalaried households earning less than three times minimum wage. The public housing agencies carry out their operations with government transfers and loan repayments. In 1992, the public housing agencies provided financing of U.S. $544 million equivalent. The largest of these agencies is FONHAPO, the government's low-income housing fund, which provides a mix of credits and subsidies to poor families for the purchase of urbanized lots, starter homes, and home improvements.

Reforms addressing demand-side constraints

Successive Mexican governments, starting with President de la Madrid (1982 to 1988) and continuing with President Salinas de Gortari, have implemented reforms to remove demand-side constraints that hinder the functioning of the housing market. Many of the reforms have promoted the development of mortgage finance. In the mid-1980s—when inflation soared in Mexico, reaching a peak of nearly 160 percent in 1987—the government authorized housing finance lenders to use an innovative mortgage instrument that allows market rates of interest to be charged on loans but ties borrowers' monthly payments to adjustments in the minimum wage, making monthly mortgage payments affordable to borrowers and attractive to lenders under inflationary conditions (Ball 1992; Roldán and Campos Spoor

1992).[2] Although inflation in Mexico today is less than 1 percent per month, this type of mortgage instrument is still commonly used.

In 1989, the government abolished quantitative lending requirements that gave housing a claim on 6 percent of all bank loans and gave other "priority" sectors separate claims on bank lending. At the same time, the government eliminated controls on interest rates for bank loans and deposits and permitted such rates to be determined by the market. Deregulation of the interest rates was followed by the reprivatization of the commercial banking system, which had been nationalized in 1982. To further strengthen bank management and performance and to stimulate competition in the financial sector, the government also passed legislation allowing the formation of diversified bank holding companies. Regulations on creating specialized financial institutions and opening bank branches were also liberalized to encourage the development of consumer banking services. To further integrate the housing finance system with the overall financial sector, various government agencies, including the Central Bank and the stock exchange commission, together with commercial banks and other financial intermediaries, are currently developing a secondary mortgage market in Mexico.

In February 1992, the Mexican congress approved a constitutional amendment that overhauls the largest workers' housing fund, INFONAVIT, whose operations are supported by mandatory 5 percent contributions paid by private employers on their wage bills. The reforms—which were implemented in late 1992—converted INFONAVIT from a construction agency into a housing bank, with new rules to ensure fairness in the assignment of mortgages, to cut subsidies, and to make INFONAVIT financially self-sufficient. As a result, borrowers have more choice in the kind of housing they can purchase, and housing construction contracts are being awarded through public auctions or competitive public bidding. Similar reforms have also been made in the public employees' housing fund, FOVISSSTE. In 1992, INFONAVIT and FOVISSSTE provided U.S. $2 billion equivalent of financing for housing.

[2] This instrument is known as the "dual rate" mortgage. If, because of an adjustment in the minimum wage, the borrower's payments do not cover the interest due, then the difference is capitalized and the loan term is extended (Ball 1991).

As part of the INFONAVIT reforms, the government also set up a new retirement saving system that will substantially increase the volume of long-term finance available to banks for mortgage and other lending and will bring low-income savers in contact with the financial system. Under this system, private employers are required to deposit 2 percent of a worker's wages into pension funds administered by commercial banks (a plan similar to individual retirement accounts in the United States, but compulsory). At the start up in September 1992, employers deposited more than U.S. $1 billion equivalent in 10 million new individual workers' accounts opened in commercial banks.

The government has also addressed demand-side constraints by reducing housing subsidies and improving their targeting. The government released banks from subsidizing mortgage borrowers in 1989 by removing the interest rate controls and the 6 percent mandatory lending requirement for housing placed on commercial banks. Mexican authorities have estimated that during the mid-1980s when inflation reached record levels, commercial banks were providing home borrowers with subsidies of U.S. $300 to $500 million equivalent per year in the form of mandated below-market-rate loans.[3]

Subsidies were also reduced when the government announced in 1989 that funds for low- and moderate-cost housing provided through FOVI, a special fund in the Central Bank, would be assigned to developers and eventually to home buyers by public auctions rather than direct placement (see box 2). Such auctions have several advantages. They allow the government to capture, in the bid prices received by FOVI, the premium that home builders and borrowers are willing to pay for long-term mortgage finance. The auctions also reward the most efficient home builders, who can bid more for FOVI funds. In the past three years FOVI has begun to phase out financing for houses costing more than U.S. $18,000 equivalent to encourage commercial banks to penetrate lower cost segments of the market with their

[3] Measured as the difference between the banking system's average cost of funds and the actual yield on the commercial bank's mortgage portfolio. Before 1988, Central Bank regulations set ceilings both on the interest rate commercial banks could charge on their mandatory mortgage loans and on the amount of interest they could capitalize on such loans. In 1988, the Central Bank amended its regulations on mandatory mortgage loans to allow banks to charge an interest rate equal to the average cost of funds and to abolish the limit on interest capitalization.

own funds. In 1992, FOVI auctioned about U.S. $325 million equivalent of mortgages administered by commercial banks, for households earning less than U.S. $600 equivalent per month.

2. FOVI's funds auction system

FOVI provides home builders with long-term financing, administered by commercial banks, to sell low- and moderate-cost houses to new home buyers. Until 1989, the high demand for FOVI funds created difficulties in deciding how to allocate funds fairly. The public auctions, begun in July 1989, solved this problem by allocating financing to the highest bidder. The FOVI auction system works as follows: Several times each year, FOVI publicly announces one month before the auction dates the amount of mortgage money it will auction. Home builders with planned housing units that meet general technical criteria and are priced for sale to low-income home buyers (at present, the final sale price of the house must be less than about U.S. $18,000 equivalent) arrange for commercial banks to provide construction financing, if needed, and to administer the FOVI loans. Commercial banks then submit bids for FOVI funds on behalf of the home builders. A bid is presented as a percent of the amount of mortgage financing requested. For example, if a home builder wants to construct 100 houses that require U.S. $10,000 equivalent each of mortgage financing and wants to bid, for example, 5 cents for each dollar of mortgage credit obtained (or 5 percent), the home builder would, if successful in winning an auction, pay FOVI U.S. $500 equivalent per house at the time the houses are sold and the home buyers take possession. Bidding is not based on the interest rate charged on the FOVI loan, because that interest is paid by the final borrower, not by the home builder.

In recent years, the govenunent has directed other housing finance programs to cut subsidies and better target their financing to low-income households. This was one of the main goals of the reorganization of INFONAVIT and FOVISSSTE. In addition, the government is developing plans to restructure its low-income housing agency, FONHAPO, which together with numerous small state and local housing institutions provided about U.S. $544 million equivalent of financing for low-cost housing units in 1992. The aims of this restructuring are to further improve FONHAPO's efficiency, to encourage low-income groups to solve their housing needs through more self-help construction efforts, and to better target FONHAPO's funding and subsidies to the truly needy.

Steps have also been taken to relieve constraints on property rights development. During the past four years, federal and state authorities have implemented massive programs of land tenure regularization that have resulted in the legalization of 1.2 million properties occupied mainly by low-income urban families. With clear title to their properties, these homeowners can offer them as collateral to secure credit for home improvements and other purposes.

Because of these and other measures, commercial banks now have market incentives and additional resources to increase lending for housing. In 1992, new bank lending for housing totaled U.S. $5 billion equivalent, up more than 30 percent in real terms from the previous year. Measured as a proportion of total bank credits, outstanding mortgage loans have risen from about 10 percent at the end of 1989 to 18 percent at the end of 1992. Moreover, the credit quality of these loans appears to be good. As of December 1992, mortgage loans past due by more than one month represented less than 2 percent of total mortgages held by banks.

Reforms addressing supply-side constraints

The government has taken equally strong measures to remove supply-side constraints in the housing market. Since 1990, to gauge the regulatory burden on housing, the government has compiled information from private builders showing that regulatory costs are unnecessarily high. In some states, the costs associated with obtaining building permits, paying construction fees and taxes, securing utility service rights, and titling a new home added more than 25 percent to the price of a house. In other states, the regulatory costs were only 7 percent of the price.

To reduce and make more transparent the regulatory burden on housing, SEDESOL, the government's urban development and housing ministry, together with the Finance Ministry and FOVI, has recently begun signing deregulation agreements with the states (which, along with municipalities, control most housing regulations). At a presidential ceremony in November 1992, governors of all 31 states and the Federal District signed an agreement that set specific targets for reasonable building standards, time limits for approving permits and licenses, and a schedule for reducing lower overall bureaucratic costs. Moreover, in these agreements states have confirmed their intentions to simplify the process of obtaining construction permits and licenses by having municipalities throughout the country establish a single office for reviewing and approving developers' housing projects. So far, more than 75 municipalities have complied with this commitment.

States have also expressed in these agreements their willingness to review and consider the gradual liberalization of rent controls, where such controls exist, to stimulate private investment in rental housing. Recently, public officials both in Mexico City and in the state of Nuevo Leon (whose capital, Monterrey, is the country's second largest city) approved legislation that will gradually abolish all rent controls.

To add impetus to the deregulation efforts, the government has begun to track certain indicators of housing sector performance on a state-by-state basis. These "regulatory surveys" identify and describe the direct and indirect bureaucratic costs levied on the construction of housing projects and measure progress in meeting overall reform goals. The surveys will be used to evaluate state performance and encourage further regulatory improvements.

The government has also signed an agreement with the National Association of Notaries committing public notaries nationwide to standardize and reduce the fees charged for searching and conveying property titles. Implementation of this agreement could substantially lower regulatory costs, because notary fees can push up the purchase price of a home by more than 10 percent.

To relieve bottlenecks in the urban land market, the Salinas administration is taking advantage of a 1992 constitutional amendment, passed primarily to modernize Mexico's agricultural sector, to permit communal landholders (known as *ejidos*) to associate themselves with private investors or to sell their parcels of land to builders for housing development. Because many rapidly growing cities in Mexico are currently surrounded by *ejido* properties that no longer function as farms, the 1992 amendment is expected to make more urban land available for housing.

The government has also introduced fiscal reform aimed at encouraging owners of undeveloped urban land to put their properties on the market. Under a law passed in 1990, municipalities are required to gradually reduce their property transfer taxes (from 10 percent in 1990 to 2 percent in 1994), while central authorities would provide federal funds to make up for revenues lost to the municipalities that comply. In the past, high property transfer taxes discouraged landholders from selling underused or vacant lots, thereby constraining the availability of land for housing development.

To address infrastructure shortages related to low-cost housing, the government is channeling significant funding to public works investments under its poverty alleviation program, Solidarity. In addition, the government is developing self-financing programs to support the installation of primary infrastructure (i.e., water and sewerage networks) for housing in urban centers through its public works development bank, BANOBRAS.

To strengthen the Mexican home-building and materials industries, the government is currently supporting private sector initiatives to establish wholesale markets. Having wholesale markets will increase access to construction materials of competitive quality and prices and expand the availability of local information about these materials characteristics, quality, prices, and construction procedures relative to housing. The Salinas administration also hopes to finalize soon the North American Free Trade Agreement (NAFTA) with the United States and Canada, which would create a more open and competitive environment for Mexican businesses. NAFTA could produce benefits for Mexican home buyers as competition from abroad pressures domestic builders and suppliers to be more productive and to accelerate the use of new low-cost construction technologies and materials.

World Bank involvement in Mexico's housing sector

Since 1985, the World Bank has lent Mexico U.S. $1.25 billion equivalent through four separate housing loans. In general, the thrust of the Bank's support has been to help the government create a more supportive environment in which the private sector can expand its role in solving the country's housing problems and in strengthening the operations and funding of public sector housing programs for the poor. Many of the housing reforms mentioned above formed part of the Mexican government's dialogue with the World Bank and, because of their importance, were supported by projects financed by the World Bank. The World Bank's experience in Mexico's housing sector has been positive and rewarding primarily because the government has demonstrated a sustained commitment to reform its housing policies, regulatory frameworks, and institutional arrangements and to establish a sustainable system that can better meet the housing needs of the country.

Author

Thomas Lee Zearley is Senior Financial Analyst, Latin America and Caribbean Region, World Bank.

The views presented in this paper are solely those of the author and should not be attributed to the World Bank or any of its affiliated organizations.

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