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PRELIMINARY ASSESSMENT OF THE POTENTIAL OF A HOUSING GUARANTY PROGRAM AT THE MUNICIPAL LEVEL IN THE CZECH AND SLOVAK REPUBLICS

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BACKGROUND

Local governments in the Czech and Slovak Republics have begun to re-define their long-run functional priorities. To date, they have been pre-occupied with issues created by the transfer of the public housing stock from central government to the municipalities. However, the next round of sorting out of government responsibilities is likely to address capital-intensive public services. In particular, it must be decided which level of government will be responsible for capital investment in network services, such as water provision and wastewater collection, and how these investments will be financed.

Capital investment of this type in recent decades has been made directly by central government agencies. Local governments presented their budget "needs," including investment requirements, to central government, which then decided what investment would take place. This process has left a legacy of (i) very uneven capital facility endowments across communities, (ii) systematic underinvestment in areas that did not enjoy central-government priority--most conspicuously environmental protection and maintenance/replacement of old capital networks, (iii) lack of intergovernmental fiscal arrangements that would allow local governments to access capital borrowing or that would provide for sharing financing burdens between local and higher-level governments, and (iv) local public service authorities that fall under Republic ministries rather than local government.

The two Republics now face a triple challenge. They must increase substantially the level of local capital investment to catch up on deferred maintenance/replacement investment and neglected environmental investment. At the same time they must negotiate a new intergovernmental fiscal system that can support required levels of local spending, and must decide how much authority over local service delivery and local investment priorities to transfer to the local level.

CAPITAL NEEDS

The backlog of local capital needs is large. Because the Republics, as well as the international donor community, have assigned priority to environmental improvement, it is reasonable for USAID to focus on local investments in this sector.

1. Municipal Treatment Plants

By far the greatest capital expenditure must be targeted to municipal wastewater treatment plants. In the Czech Republic alone, 14 cities located on rivers with the highest classification of water pollution, have no wastewater treatment plants. Twelve of these cities are located in Moravia. Another 22 cities have treatment plants that are in some stage of construction, but are not completed. Work on many of these has been suspended. Twenty-five additional cities, including Prague, have treatment plants that are significantly deficient in treatment capacity.

No overall estimate of capital costs for these plants has been made. However, the total cost in the Czech Republic, excluding Prague, will surely exceed US $750 million, and on a per capita basis the cost in the Slovak Republic should be comparable.

Investment in treatment plants clearly is a national priority. However, it is less obviously suitable for a Housing Guaranty program. First, the very size of the investment needed implies that the HG program could not be the principal source of funding, and consequently could not exert principal policy leverage over the sector. Second, both the World Bank and the European Bank for Reconstruction and Development are in advanced stages of negotiating environmental financing packages that will focus on completion of municipal wastewater treatment facilities. Third, both Republics' current policy is to finance wastewater treatment plants with state funds--either through direct construction or through grant financing via the Environmental Fund--subject to investment priorities established at the Republic level. The investments thus do not open a route for enhancing the role of local government. Finally, though pricing policy in the sector remains to be clarified, there is no realistic possibility of establishing user fees or local taxes that will recover capital costs. The costs of treatment plants are too great to be paid by users; moreover, the large externalities associated with treatment plants make them a difficult place to start in establishing user cost principles.

2. Replacement of Water Distribution Systems

Given the slow growth of the population and the near-universal coverage rates of urban water systems, there is no substantial need for expansion of potable water networks. When network extension is needed to serve new housing developments, as much of the capital cost of network extension as possible should be built into the price of housing so that it can be recovered at once.

The cities in both Republics, however, face old water distribution networks, which are losing substantial amounts of water through leakage. There is an urgent need for pipe replacement programs. In Prague, 26.2% of the water entering the system is lost through pipe leaks, and another 9% is unaccounted for, due to faulty meters and faulty estimating methods for units where there are no meters. Approximately 20% of the pipe system is more than 75 years old. Studies of water loss have not been carried out in other cities. However, in many of these cities the distribution system is equally old and has received even less maintenance and replacement. It is reasonable to expect significantly higher rates of water loss in some of these cities.

The scale of the capital investment required for water pipe replacement is considerably more modest than that required for treatment plant construction. The Prague city engineer's office, for example, has developed a six-year plan for water pipe replacement in that city costing US $30 million, or $5 million per year.

A concentration on water distribution network replacement has several advantages as a Housing Guaranty program. First, it is an area in which no other international donors are presently active, allowing USAID to have more policy and financing leverage. Second, the scale of financing needs is more in line with potential HG resources. Third, there is much greater opportunity for establishing a successful cost recovery policy. The government already is committed to significantly increasing the price of water consumption. Water rates were raised in April 1991 by 150% for residential consumers and are targeted for further increases. Most importantly, however, customer rates do not have to be raised to full cost-recovery levels in order for water operators to have an economic incentive for replacement, or to earn an economic return from replacement investment. At present, water operators must be subsidized by government to cover their shortfalls in revenue. (The City of Prague, even under the new rate structure, has budgeted a transfer of 150 million kr. to the city water company to cover its operating deficit.) As long as the reduction in water loss, valued at supplier cost, provides a reasonable economic return, the supplier (or subsidizing government) will have an incentive for replacement. The capital cost of replacement under these conditions can be recovered through an annual reduction in operating deficits and thus in the general government subsidy that is needed.

The total amount of the capital financing that is needed, or appropriate, for replacement of water distribution networks is not known. A first step in formulating a program of this type would involve working with local governments to identify specific needs outside of Prague. However, the principles of the program easily can (and eventually should) be expanded to cover all types of local capital replacement or reconstruction, including roads and other facilities. There therefore is flexibility in meeting whatever financing goals USAID or the Government may have in mind.

3. Other Local Capital Investment

Two other capital investment priorities deserve consideration for inclusion in a HG program.

Extension of municipal gas distribution lines will have high environmental payoff. Coal-burning residential furnaces are one of the most important contributors to air pollution. Conversion of residential heating to natural gas is being held back in most cities by the coverage of the gas distribution system. Investment in the gas distribution network is the responsibility of the national gas company. However, the slow pace of expansion has led at least one city to use its own reserves to contract for pipe installation that will extend the gas network to large clusters of newer residential housing.

A second priority use for municipal capital is in municipal development projects. Other reports by the Urban Institute have highlighted the opportunities local governments now face for generating revenue and economic activity through land development and re-development of municipally owned commercial buildings. As a rule, municipalities should look to private sector investors for the capital that is needed for these development projects. However, as in the United States, there will be occasions when a joint venture between the city and private-sector developers is appropriate, or projects where public investment in infrastructure is necessary to trigger private investment in income-generating development. Under current arrangements, municipalities' ability to launch such projects would be held back by their inability to access capital markets. If cities are to be prodded to act as development entrepreneurs, they must (like other entrepreneurs) have lines of capital open to them. Using the HG program to open such lines would be fully consistent with municipal priorities and HG principles.

POLICY ISSUES

A Housing Guaranty program should have a clear policy agenda, reasonably connected to the capital assistance that is being provided. Five important policy issues are identified below. The strength of the recommended program design is that it provides a logical entry point to these issues, each of which is critical to the future functioning of the local government sector. However, the recommended approach does tie capital financing through the HG to local government and thus to reforms that are necessary for local government to be able to make the investments or take on debt. It is possible that a program could be structured at the Republic level which would result in faster disbursement.

1. Pricing of Water Consumption

In the short run, cost recovery for water pipe replacement should be permitted from general government revenues. That is, part of the reduction in operating deficits achieved by reducing water loss should be used to repay the capital investment required for pipe replacement. Rates charged to the consumer do not have to be increased in order to pay for the replacement investment; on the contrary, both the economic and financial returns of projects depend solely on the costs of water supply. Projects should be designed so that the annual cost saving from reduced water leakage provides a satisfactory return on the initial investment.

Nonetheless, over the intermediate term USAID would want to tie its provision of capital financing to continued progress in increasing water tariffs to cost recovery rates. This is critical to establishing efficient pricing signals to consumers, but also is crucial to any plan for transferring water companies either to municipal governments or the private sector.

2. Transfer of Water Supply Function to Local Governments or to Locally Regulated Private Firms

At present, almost all water supply authorities are part of the Republics' public sector. In the Czech Republic only two water authorities are part of local government--those in Prague and Brno. All of the rest are dependencies of the Ministry of Agriculture. In the Slovak Republic water authorities are dependencies of the Ministry of Forestry.

It would seem logical, in the sorting out of government responsibilities that is taking place, to transfer local water companies to local government. However, at present none of these companies breaks even financially. Local governments therefore resist their transfer, which in effect would transfer to them the obligation to subsidize water companies' deficits. For the same reason, water companies cannot be sold to private investors.

Part of the policy agenda of a HG program should focus on the conditions that will allow transfer of water companies to local governments or, through them, to private investors. One way to achieve this would be to transfer water companies to local governments together with the current public subsidy that finances their deficit operations. The transfer from higher-level government could gradually be reduced as water consumption rates are raised (these are currently set by the federal Ministry of Finance), or as rate-setting authority is also transferred to local governments. Such a transfer program would be fiscally neutral at the outset, and contain built-in incentives for narrowing and eventually eliminating water companies' subsidies.

3. Establishment of Capital Borrowing Mechanisms for Local Government

Perhaps the most valuable institutional contribution that a HG program can make is to establish local governments' access to capital markets. Given the magnitude of investment that needs to occur at the local level, cities will lag badly in their investment levels if they depend solely upon current account surpluses for financing. They will remain damagingly dependent upon higher governments if they rely on the Federation or the Republic to carry out all capital investment for them. During this period of catch-up local investment, local governments need access to capital borrowing.

The Czech and Slovak Republics enjoy several conditions that make it easier to set up a market-oriented borrowing mechanism than it has been in other countries. Local governments already have the legal authority to borrow. Moreover, they have a reputation for taking their indebtedness seriously, which should facilitate arrangements with private-sector lenders. There has been discussion of the possibility that when the state banks are privatized, some of the shares will be transferred to municipal governments. This structure would follow the German model, where municipalities own shares in certain parts of the banking system and use their ownership to gain access to capital lending. (In the German system, this influence is reinforced by federal regulations that require the banks to channel a certain percentage of their lending to municipal governments.) Nonetheless, at present the volume of municipal borrowing is very low in the Czech and Slovak Republics--primarily because local governments have so little free revenue to use for debt repayment.

The HG program of municipal lending should be designed expressly to be taken over by private (or to-be-privatized) banks, using commercial sources of funds. This implies resisting the temptation to set up a special municipal development bank, whose capital is provided to it by Government and international donors.

4. Reform of the Local Government Revenue Structure

The tax and revenue legislation planned for January 1993 is supposed to establish the fiscal basis of local government, by specifying the intergovernmental grant and tax-sharing system that the country will use, as well as the own-source revenues that municipalities will be able to impose. The legislation may also transfer some rate-setting authority for public services to the local level.

This legislation obviously is critical to the future of local government in the country, and specifically to the feasibility of any plans for capital lending to municipalities. Without adequate revenues, local governments will not be able to repay their loans, and cannot prudently take on increased capital investment responsibility. Without significant discretionary resources, local governments will not be able to respond efficiently to citizens' demands for services or capital projects.

If adequate local revenue sources are provided for in the legislation, it should be possible to structure a HG program in which banks lend directly to municipal governments and bear most of the repayment risk. This would distinguish the Czech and Slovak Republics from the majority of countries, where municipal development banks have ended up replacing or retarding lending made through the private banking system.

IMPLEMENTATION AND NEXT STEPS

Preparation for a HG program of the kind described will require several steps, as outlined below. It is important to emphasize that the work program involved closely parallels the priorities for strengthening local government, even without a HG. Therefore, a decision as to the feasibility and desirability of a HG can be deferred until some of the preparatory work has been completed.

[This memorandum does not address at all the issue of the Federal government's willingness to borrow under HG terms, or the priority within USAID of a HG program for the Czech and Slovak Republics, two questions on which I have no independent information.]

1. Identify Cities' Investment Needs, Interest in Capital Borrowing, and Ability to Plan and Administer Capital Investment Efficiently

This process will involve visits to individual cities. It should be carried out in collaboration with the Association of Cities and Towns of the respective Republics, which have already solicited information on capital priorities from their memberships. Examination of the responses to these requests should both help identify the magnitude and character of investment needs and help pinpoint the cities that have capital investment planning practices that can efficiently support the HG program. It would be most effective to visit local governments jointly with a representative of the Association of Cities and Towns, and perhaps with a representative of the appropriate Republic ministry, as well.

Although priority would be given to quantifying the needs for water system replacement, the team should investigate the feasibility of capital financing for other types of projects identified as priorities by local officials. These might include economic development projects, infrastructure support for housing development, low-cost wastewater treatment plants, and expansion of gas distribution networks, among others.

2. Technical Assistance to Selected Municipalities to Strengthen Capital Planning and Local Financing

Under the Municipal Government technical assistance program for Eastern Europe, the Office of Housing will have resources to help strengthen local financial management and local capital planning. If the HG program design goes forward, this technical assistance should be coordinated with HG development, so that technical support is given to cities likely to participate in HG borrowing and focused on functional areas that are necessary to make the program succeed. Fortunately, these requirements coincide with the priorities for local technical assistance, independent of HG program development.

3. Technical Assistance in Preparation of the 1993 Revenue Law

The 1993 revenue law, specifying local governments' taxing and pricing authority, as well as the structure of the intergovernmental fiscal system, will be critical to defining municipalities' future path. The Office of Housing and USAID should look for opportunities to contribute to the preparation of this legislation. The most promising avenue would appear to be through technical assistance to the Associations of Cities and Towns, which have been invited to participate in the legislative process. USAID should provide these associations with strong technical counsel which they can use in negotiating with federal legislators. It is striking that, 10 months before this critical legislation is scheduled for adoption, no technical papers have been prepared on the implications of different forms of local-republic-federal tax sharing or alternative types of intergovernmental grant programs.

4. Preparatory Work with the Banks to Define a Program Structure that Encourages Lending to Municipal Governments

The final preparatory step involves working with various elements of the banking system to define a program structure that will effectively support banks' lending to local governments. If the HG program is to be private-sector oriented, this step is critical. It should include clarification of what the banks perceive to be the risks in municipal lending, and identification of procedures that can safeguard against these risks. Much of the preparatory work can be conducted directly with bank management, or by convening meetings between bank officials and local government officials. ome of the preparation, however, may again involve contributions to draft legislation or draft proposals for privatization. In particular, the final form of privatization of the state banks is likely to be critical in determining their interest, and legal ability, to lend to local governments.