Strategizing for the Future in the Four ECA Cities: Budapest, St. Petersburg, Sofia and Split

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I. Background

A. Introduction and Purpose of the Paper

The present paper is a component of an overview study prepared for the 2000 World Bank/IMF Annual Meetings, entitled "Urban Policy in Transition Economies: Its Role in Poverty Alleviation and Sustainable Growth". The thesis of this overview study is that socialism has left three significant urban legacies in these countries which are highly relevant to policies for their future social and economic development. First, socialism provoked an unusually high level of urban growth (relative to income levels), as part of the emphasis on forced industrialization. Second, the dominance of central planning created urban infrastructure and services in ways that were not at all demand-or cost-responsive, and dependant on large and unsustainable subsidies. Third, and as a result, most of the fixed capital stock in socialist cities (including productive, infrastructural and residential) was located without reference to market signals of cost and demand, so that the transition period will require considerable redevelopment and redeployment of urban investment as population and productive activities shift in response to the emerging market activity. These adjustments will invariably exacerbate urban poverty, which has already reached unprecedented levels in these countries as a result of the difficult macroeconomic situation of recent years coupled with the structural rigidities caused by socialist urban policies.

These policy legacies create particular challenges for the future urban strategy in the transition economies of this Region. These issues are explored in depth in the overview paper with particular attention to urban implications of policies and trends in private sector development, public sector decentralization, and integration of municipal finance into liberalized private financial markets. Within this analytical context, the following essay reviews the transition issues present in four cities—Budapest, Hungary; St. Petersburg, Russia; Sofia, Bulgaria; and Split, Croatia—as illustrative of the challenges they and other cities in the East and Central Asia (ECA) Region face in articulating socially and economically sustainable development strategies for their medium-term future.

B. The Context for this Review

Why the focus on cities?

Cities face new opportunities… The economic fate of citizens in all countries is increasingly dependent not only on national government policies but also on global developments and on how cities respond. The integration of global markets for capital, labor and information is well recognized (WDR 99/00). The transition economies have the additional challenge of learning the new rules of footloose foreign investment and

volatile international markets while instilling the basic rules of market behavior in their population and domestic institutions. The global economic actors are not blind to location but rather very place-sensitive, and a wide array of characteristics of specific cities and subregions enter into decision-making about location of international capital, expertise and labor movements. Box 1 gives one recent illustration.

Box 1: How one multinational company rates cities

One influential "livability index" produced by a major multinational corporation to guide its own and other firms' location decisions rates 218 cities worldwide on composite criteria including local political, economic, and environmental conditions, public safety, and quality of public services. In the latest (January 2000) rankings, against a benchmark of 100 (for New York City), Budapest has risen this year to the highest level (91) for Eastern Europe. Sofia is measured at 74, while St. Petersburg has achieved a score of only 58 due to issues of political stability, personal safety and health.[1] These rankings are only one source of judgments about the relative attractiveness of urban locations to prospective investors, but they underscore that multiple features of individual cities affect how these cities are perceived by potential investors.

Adding to the demands of global competition and of the transition from socialism, countries in the East and Central European region are also confronting regulatory and investment requirements for their prospective accession to the European Union. Many of these conditions will have to be met in cities, where the bulk of the existing infrastructure and most environmental problems of concern to the EU (such as industrial pollution) are located.

…and new responsibilities…Along with this more demanding economic context, the cities of the ECA Region enjoy new opportunities to take greater responsibility for their future than ever before. Political and fiscal authority has been devolving to the local government level, albeit to varying degrees in different countries. The decentralization process has often been implemented inconsistently, and has typically involved vesting very inexperienced municipal governments with expenditure obligations for public infrastructure and services that are run-down, high-cost, outmoded, and unresponsive to an increasingly demanding customer base. Intergovernmental frameworks for fiscal and financial policy still need to be refined in every country to ensure that the local governments develop true accountability to their constituents, meet their new obligations with hard budget constraints, and have realistic opportunities for mobilizing necessary resources to meet the city's needs and to realize its economic potential.

…to achieve widely-shared growth. Ultimately, how the cities of the ECA Region respond to these changing external and internal conditions will determine the prospects for their most vulnerable citizens, the poor. The magnitude and severity of poverty will, of course, be affected greatly by macroeconomic trends and by national

[1] William M. Mercer Companies LLC, company press release ("Four Cities Share Top Ranking in Worldwide Quality of Living Survey"), New York, January 12, 2000.

policies regarding safety nets. But the location of the poor and their welfare in terms of living standards, housing conditions and employment will be very much subject to urban policies and regulations that will be set by both national and local governments, and often implemented by the latter. Some countries in this Region have been suffering additional stresses of war and ethnic conflict which worsen poverty, add refugees to the cities, and create further economic hardship in cities by destroying housing, factories and infrastructure facilities.

Why these particular cities?

Dialogue with the Bank. The cities of Budapest, St. Petersburg, Sofia and Split have been chosen as the focus of discussion in this essay for a number of reasons. First, the local governments of these cities are engaged with the Bank in their efforts to reform policy, develop institutions, and undertake investment. Budapest is the recipient of one Bank loan for the Budapest urban transport project and partial beneficiary of another for a municipal wastewater project. The city has engaged in extensive policy dialogue with the Bank over several years on housing reform, decentralization and local fiscal reform, municipal capital market development, and land market reforms. The Bank has also provided feedback, particularly on spatial planning implications, on a city strategy exercise initiated by the city in 1998. St. Petersburg is the target of the Bank-financed Center City Rehabilitation Project (approved 1997), which also helped to fund the city's strategic plan, and discussions continue on implementation of the strategy and further Bank assistance. The Bank has also been actively involved in lending and policy dialogue on housing reform in Russia, which is a pivotal area of urban policy for every city. In 1999, the Bank and City of Sofia began discussions of the city's development issues, including in particular the need for reforms in management of municipal infrastructure, city finances, and land use. The city of Split and Splitiska/Dalmatia region have received one loan for a Municipal Environment Project and another project is under preparation for a Split/Kastela Bay Cultural Heritage project. Broader issues of intergovernmental fiscal relations and local government management are entering the dialogue as well.

Transition and urban issues. Second, these four cities are, in various ways, representative of many of the key characteristics and development challenges of other cities in the ECA Region. Each plays an important role in its national system of cities. Budapest and Sofia are both capitals and have a large share of the countries' urban population (21 and 31 percent) by international standards. The urban sector of Croatia is even more dominated by its capital, Zagreb, but Split is of particular interest here as an example of the more numerous modestly-sized cities throughout the Region—with a population of about 200,000, Split is second to Zagreb but less than a fourth of its size. St. Petersburg is second only to Moscow in population and economic dominance in Russia, but holds equivalent status as a region (oblast).

The cities present at different points along the continuum of transition and of urban issues:

- Inarguably, Hungary has advanced farthest in establishing privatization and market forces in its economy, has been a greater recipient of foreign direct investment, and has achieved more consistently positive economic growth since the end of the socialist era, than most other transition economies. It is also a front-runner in the path to EU accession.[2]

- Russia has suffered a largely declining trend in GDP in the 1990s and an erratic record of implementing the structural and institutional reforms needed to put a market economy on a sound footing and establish investor confidence. Even so, St. Petersburg has demonstrated some of the stronger reform efforts compared to other cities in the country (especially in the privatization of housing and land). As a major port, the city benefits from international trade even during economic recession and has unrivaled historical and cultural assets.[3] Yet the city ranks far below Moscow as a destination for foreign direct investment, and the local business leaders cite the city's taxation system as the greatest obstacle facing them in the current business climate.

- Sofia is the governmental, financial and cultural center of Bulgaria, with a favorable location at the intersection of three main road transport corridors. Although Bulgaria has not advanced in privatization of the economy as far as Hungary, 50 percent of Sofia's employment was in the private sector in 1998. The country's foreign trade has shifted rapidly from dominant dependence on CMEA and Soviet markets before the transition to over 60 percent of exports going to OECD markets by 1997. Sofia, which already receives over half of the foreign investment into Bulgaria, faces challenges to increase further the competitiveness of its economy especially by developing higher value added industries and a more sophisticated service sector.

- Since winning independence in 1991, Croatia has been undergoing both transition from armed conflict (internal and regional) as well as from socialism, and still features a highly centralized economy—a status partly exacerbated by the war. Yet, it has a relatively strong tradition of local government management and stronger capacity of local government than many other countries in Eastern Europe, although it remains to implement reforms giving municipalities such as Split greater autonomy and responsibility for managing its own economy to serve sustainable growth.

How well each of these cities address issues of quality of life for their citizens, and in particular the emerging problems of poverty and inequality in their midst, will determine the ultimate success of their political and economic transition efforts.

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[2] The EU Commission's October 1999 report on accession progress by ten applicant countries gave Hungary a generally positive evaluation, noting that it is a leader among the ten in terms of existence of a functioning market economy, ability to maintain macroeconomic stability and growth, ability to withstand competitive pressures from within the EU, legal reforms, and administrative and judicial reforms. (Economist Intelligence Unit, EIU Country Report 4th quarter, 1999).

[3] According to a UN rating, St. Petersburg ranks eighth among the most popular and attractive cities in the world. *Strategic Plan for St. Petersburg*, 1998, p. 17.

Budapest has not escaped growing poverty despite Hungary's positive economic growth record, and income inequalities have widened as many individuals are not able to take advantage of new market opportunities. In St. Petersburg, almost one-fifth of the residents were living in poverty by the mid-1990s due to economic retrenchment and the reduction in state subsidies. Average real disposable income for the city's residents stood at 70 percent of its 1991 levels in 1996 and suffered a further setback due to the macroeconomic upset in 1998.[4] In Sofia, the prolonged economic recession in the 1990s made poverty rates in the City of Sofia slightly higher (about 38 percent) than the average of 36 percent for the country by 1997.[5] Split has suffered additional stresses of war on the population, especially minorities and refugees.

Both the economic strains from lengthy recessions and the environmental legacy of socialism affect the health of urban residents, especially the citizens who are least mobile within the changing labor market. These cities do not face growth in their population (rather, decline in the case of Budapest and St. Petersburg) [6], but changes in population structure such as aging, increased household formation, unemployment, and the sharply rising expectations of a better life from the promises of market integration and EU accession combine to create new social demands on local governments. Political accountability to the electorate is a still-fresh reality since the legal reforms of local government in the early 1990s. The local authorities in these four cities face many exogenously-imposed constraints but also have considerable motivation and opportunity to exercise creativity in making the most of their municipal assets and financial resources in service to their constituents.

Why focus on strategies for cities?

Cities, whether in the developed, transition or developing countries, are increasingly aware that they need to take a proactive role in making their local economy able to compete internationally and domestically and in improving residents' quality of life. Initiatives of local economic development in many market economies have often consisted of very narrowly-focused (but still very costly) efforts of local authorities to attract specific investors with offers of tax breaks, or campaigns to achieve specific, highly visible improvements (a metro system, sports stadium, cultural complex, corporate headquarters, etc.). Experience in developed countries which have had a long and documented record of such initiatives yields the lesson that one-off investments or measures by the authorities such as tax breaks to "buy" local economic revitalization often fail to meet expectations and can even be counterproductive when they result in a fiscal drain and widespread public disillusionment. Local governments' economic development efforts are more effective if focused on efficient provision of the public services for which they are responsible and on easing red tape and excessive regulation—

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[4] *Strategic Plan,* p. 26. *Rehabilitation of the Center of St. Petersburg: Investment Strategy,* p. 80.
[5] *Bulgaria: Poverty During the Transition,* Report No. 18411, 1999, Human Development Sector Unit, Europe and Central Asia Region, World Bank.
[6] The Sofia administrative region has a negative rate of natural population change (-4.7 per 1000 inhabitants) but a positive in-migration from other regions, resulting in a slight overall population increase (0.76% growth in 1998). Territorial Statistics Bureau of Sofia City, March 2000.

creating a favorable climate for a range of industries rather than firm-specific benefits.[7] Another basic task is to ensure the collection and wide sharing among all interested parties of information and analysis on features and trends of the city-region. With this knowledge base, proactive measures can be identified that have good prospects of being successful and cost-effective in promoting local economic development by catalyzing partnerships and leveraging resources from many levels of the public and private sector.[8]

How can successful local development policies and programs be identified and carried out? International experience reveals that many good examples have issued from a **strategic process** that that can take different forms but is characterized by:

- *informed analysis* of strengths and weaknesses, opportunities and threats affecting the city (this may often need to encompass the region outside municipal boundaries but economically integrated with the city, as well as international influences),
- *vision-setting* and *consensus-building* exercises among concerned stakeholders, including government at different levels, the private enterpreneurial sector, civil associations and citizens groups, to define shared goals and priorities over a medium-term horizon,
- formation of *partnerships* to carry out a specific, time-bound *action plan* in pursuit of the vision, including measures to obtain the necessary resources and to remove obstacles, such as needed policy or institutional reforms,
- plans for continued *feedback* to the stakeholders on the progress of the action plan, and provisions for *evaluation and revision* of the plans as circumstances change.[9]

Budapest and St. Petersburg have both undertaken recent development strategy initiatives which provide good examples of aspects of the above general approach, and set a strong basis for concerted action to set the cities on a firm path of sustainable growth. The city of Budapest produced in 1998 a comprehensive exercise called "Budapest Town Development Concept" which provided the basis for a more focused but longer term vision enunciated as the "Strategic Development Concept of Budapest" (hereafter both referred to as the city *Concept*). In addition to broad goals such as to "increase economic competitiveness of the region", the *Concept* contains quite specific objectives including: maintaining a high level of economic activity in the city core; reducing social regional differentiation within the city; encouraging the use and improving the standard of public transportation; recycling underutilized land in the

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[7] *Entering the 21st Century: World Development Report 1999/2000,* chapter 6. World Bank, Oxford University Press, 1999.

[8] This emphasis on improving the overall business climate through broad-gauged strategies and partnerships is described as the "third wave" of local economic development efforts in Europe and North America introduced in the 1990s, as contrasted with a former "first wave" emphasis on attracting inward investment in the 1970s, and later approaches emphasizing other single solutions such as SME development (the "second wave").. References cited in Gwen Swinbum, "Local Economic Development: Good Practice from the European Union (and beyond)", Urban Development Division, World Bank, forthcoming working paper, 2000.

[9] Based on summary analyses by the Corporation for Enterprise Development for the US Department of Commerce, Economic Development Administration ("Strategic Planning for Economic Development"); by OECD Best Practices in Local Development; and by the Local Employment Development Action Program of the European Commission. References cited in Swinbum, op. Cit..

immediate periphery of the core area; and protecting green areas of the city. The Budapest strategy process has involved extenstive public participation and has been accompanied by concerted efforts to improve the city's financial management capabilities in order to create a sound capacity for implementation.

St. Petersburg's "Strategic Plan" (SPSP here), which was formulated between late-1996 to end-1997, is a first such effort for a Russian city. Compared to any prior planning experience in the country, the SPSP represents a strategic and participatory process that was unprecedented in its openness and inclusiveness. The activity included public conferences, working committees with diverse public and private sector representation, media oversight, and culminated in formal endorsement by the city's political authorities and their commitment to its implementation and continual review. The SPSP identifies one overriding goal—"sustained improvement of the quality of life of all categories of St. Petersburg citizens"—and four strategic objectives: i) establishment of a favorable business climate, ii) integration of St. Petersburg into the world economy, iii) improvement of the urban environment, and iv) establishment of a favorable social environment. Drawing on a careful analysis of relevant data and trends affecting all aspects of the city, the strategy includes a medium-term (4-6 year) plan of action detailing dozens of more specific derivative objectives and over 200 measures to be carried out by specified parties and partnerships. An investment strategy for the city center was a further offshoot produced in 1999.

The World Bank's newly issued "Urban and Local Government Strategy" (2000) places a new emphasis on support to city-led efforts to define and realize "holistic", or comprehensive, "city development strategies" (CDS) that address the interrelated nature of economic and social transition issues for specific cities. The Bank's ongoing dialogue with Budapest and St. Petersburg on the implementation of their strategic initiatives, and with Sofia and Split on their interest in beginning such strategic exercises, provides the framework for the remainder of this essay. The following section discusses in some detail the main issues that confront these and other transition cities in the ECA region, and that would be integrated into such strategic visioning exercises. The closing section discusses the nature of the Bank's potential assistance to cities for CDSs.

II. Main Strategic Issues for ECA Cities through the Medium – Term

The most characteristically defining feature of the four cities of focus for this essay, along with others in the ECA region, is **the socialist legacy**. The first major area of challenge is establishment of a competitive urban market economy, which implies transition in the spatial development of the city (land use), in the productive structure (sources of employment), and in social conditions (poverty and inequality). All of these requirements would also enhance the cities' performance in terms of meeting competition globally and within the EU. But it is important to stress that the transition economies need to think not only in terms of external markets, tradable goods, and attractiveness to international companies. Even more importantly for their longer term economic sustainability and for broadly shared income growth, they need to improve their internal markets, including for so-called "nontradables" including housing, urban transport, and

other infrastructure, and to create conditions supporting smaller domestic enterprises. These latter requirements are very much in the portfolio of city governments to affect, through policies and regulations that they either set or administer.

The second main challenge is posed by **the decentralization of political and fiscal authority to the cities**, and the further actions required to implement these changes consistently and with adequate capacity. The reforms in legal frameworks and actual practice regarding municipal public finances also need to be complemented by measures to increase access to private capital market funding for the priority investments that would improve the cities' competitiveness and quality of life.

A. Issues in the Transition from a Socialist City to an Urban Market Economy

1. The Spatial Transition[10]

The spatial character of a city's development has important implications for economic efficiency and for the quality of the urban environment. Since a city is essentially a labor and consumer market, the larger this market and the lower the costs of its transactions, the more prosperous and competitive the city can become. However, an inappropriate spatial structure fragments labor and consumer markets and raises transactions costs by unnecessarily increasing the effective distances between people and places (or jobs and workers). A deficient spatial structure, moreover, increases the length of the city infrastructure network and thereby raises capital and operating costs; it also reduces the quality of life and aethestic enjoyment that urban life can afford.

Urban form evolves in response to complex interactions among public investment, regulations, taxation, and market forces. In socialist cities, planned investment and regulations were the defining instruments that created distinctive patterns of land use which are inefficient from the perspective of an evolving market economy: these characteristics include too much land occupied by industries within the city, high density residential areas spread at the periphery, well-located sites without adequate infrastructure, and insufficient space for commercial and service activities. In Sofia, for example, industrial areas occupy 27 percent of the built-up area compared to between 5-8 percent in market economy cities; and land-intensive activities such as warehousing occupy valuable locations inside the city while services and commerce are scattered and relatively absent in the CBD. [11] Coupled with distortions in housing that hamper the matching of supply and demand for residences under the new conditions of an urban market economy, and the lack of urban transport policies to balance changing demands for public transport and for private cars (both sectoral topics discussed in section 4 below), the spatial legacy of socialist cities has aggravated social and labor market imbalances, and added to pressures on the urban environment.

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[10] This section draws heavily on work by Alain Bertaud: "The Spatial Development of Budapest", Note on World Bank mission to Budapest of January 18-28, 1999; and sections of "Sophia Urban Development Initiative: Assessment Report", August 18, 1999 draft. ECA Region, Infrastructure Sector Unit.
[11] CBD= central business district. Sophia op cit., p. 8.

The spatial character of formerly socialist cities can be seen in data on distributions of population density and location of industry. What is most typical is a relatively high density of residential settlement in the city core; an adjacent band of low density settlement where industry was located—often large and highly-polluting factories that would have been considered unacceptable urban investments in more democratic and less centrally-planned societies; and a swath of increasing residential density at the periphery, commonly in high-rise apartment blocks built to a standard design.

- Figures 1 portrays this archetypal rising density profile, or "camel back", for St. Petersburg. St. Petersburg and Budapest demonstrate very high residential density in the inner core, matching absolute rates in Paris where downtown land values are extremely high. Residential density drops off very sharply early on, at a radius of only four km, in St. Petersburg and then rises consistently to 14 km from the center. This pattern, seen even more extremely in Moscow, represents a high degree of urban spread with resulting demands for transport of workers to jobs, and for extension or maintenance of infrastructure networks, over large distances.

- Budapest's density plummets at about four km from the center as well, but stays evenly very low for a considerable distance; this outcome also indicates very inefficient use of close-in land and high costs for developing and maintaining public transport and infrastructure to the outer suburbs. In a traditionally market economy, high land prices in the radius of a few km from the CBD would have prompted factories to move to the city perimeter or even to a smaller town, while services and commercial establishments would appear in proximity to residential concentrations. The lack of a "camel back" in Budapest reflects the authorities' more liberal policies (compared to Soviet cities) regarding private housing investment and much lower reliance on high-rise public housing estates.

- Sofia shows more of a mix of high and low densities at all distances from the city's center. Industrial areas are dispersed quite near to the CBD while there are large patches of very low density settlement in close proximity to the center.

By contrast, cities in longstanding market economies generally show a smooth and declining density gradient, although the steepness of the drop and extension of relatively high residential densities over considerable distances from the city center still vary considerably among cities as a function of regulation, tax and investment policies affecting the land market.

As the formerly socialist cities have seen the emergence of real estate market transactions during the 1990s, their density gradients are gradually flattening the "camel back" and showing a more declining slope. As would be expected, housing and land in close-in locations become more costly and demand shifts towards plots in the middle radius that are relatively underused, while residents in the outer periphery who can afford to, move closer-in for convenience or to obtain better quality or size of housing. The real estate markets are still too thin and underdeveloped in most of the cities, and many

households are too financially constrained in the transition period, to make all of the expected adjustment in land use through market transactions in the medium term. For example, in Sofia, the currently small variation in land prices between central and peripheral locations indicates the immaturity of the real estate market and inadequacy of information. But even with a well-functioning market, urban land use requires a continued role of government to reflect public preferences regarding urban form and to take account of externalities such as environmental and social impacts of land use. The ECA cities therefore need to define clearly their objectives for the spatial transition and what these imply for actions by the city and national governments and by the private sector.

Budapest's *City Development Concept* gives central emphasis to spatial development objectives, as noted earlier. Although Hungary's more flexible application of centralized planning permitted Budapest to avoid the starker spatial distortions of other formerly socialist cities, there is still a legacy of large tracts of idle commercial property and formerly industrial sites. The *Concept* places great importance on stimulating the development of this so-called "transition zone" lying between the city's historical core, which is extremely densely populated and expected to lose population as households relocate, and the outer suburbs. A key strategic objective is to mobilize investments and a favorable policy framework to revitalize and redevelop the middle zone in order to slow the growth of the outlying areas. This approach will preserve the monocentric nature of the city radiating from its historical core, while at the same time maintaining the strong reliance on public transport and slowing the growth in use of private cars for commuting. The framework of land use regulations in place is generally consistent with these spatial objectives—unlike in some cities, where zoning and floor-area ratios, for example, tend to discourage the densification of underutilized areas and perpetuate sprawl.[12] To achieve a more balanced dispersion of population density within the city, the *Concept* stresses land conversion and redevelopment of underutilized commercial properties in the middle ring of the city area, through rezoning to permit higher residential densities and mixed land uses, and through lead public investments in pivotal sites to stimulate private investment. Further key elements of the *Concept* in the shorter term are renewal of areas in the inner city and along the Danube through traffic improvements, rehabilitation and investment in infrastructure, and public spaces to improve the environmental quality.

The St. Petersburg *Strategic Plan* identifies the need for "enhanced rationalization of use of the city's functional belts and reduction of the size of the industrial belt" (the latter some 30 percent of the territory) as key elements in improving the city's competitive potential.[13] The availability of unused land inside the city is an asset for development. The SPSP recognizes that rezoning is needed to permit residential and mixed uses of formerly industrial areas and that those with potential for commercial development should then be put up for sale or lease at market prices. The strategy's objective of improving the urban environment calls for concentrating investment

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[12] See analysis illustrating inconsistencies in land regulations for Cracow in Alain Bertaud, "Cracow in the Twenty-First Century: Princes or Merchants?" Paper prepared for the World Bank and Cracow Real Estate Institute, November 14, 1997.

[13] *Strategic Plan for St. Petersburg*, p. 31.

(especially infrastructure improvements) in "zones of active redevelopment", including the historical city center, and a municipal website posts detailed information on over 7000 such sites. However, the local enterprises cite among their many constraints major problems in land regulation (difficulties in identification of plot boundaries, registration of land rights, unclear procedures for sale or leasing of property, etc.). Uncertainties regarding preconditions for public consultation on proposed land use also create risks for potential investors.

In Sofia, spatial development objectives have not been articulated but a city master plan is under preparation. In addition to uncertainty about the future course that urban planning will take, a real estate market is inhibited by a complicated and incomplete land registration, titling and leasing system.[14] It is important that strategic directions be formulated in the near term, through a widely-shared and open process, so that future investment and change in land use regulations which have long-term effects can be consistent with broadly-accepted goals for the city.

In Split, urban planning is geared to preserving the historical core and current residential areas while limiting increases in commercial use and avoiding the expansion of peripheral settlement. However, the city has little information on changing demand for land use and undeveloped tools at its disposal to steer rather than control market responses. It is expected that expansion of areas devoted to retail and services will be inevitable as the market economy picks up. The urban planning department needs to play a more active role by modifying land use regulations along corridors well served by urban transport to allow expansion of commercial establishments, and make an inventory of undeveloped land parcels in public ownership which might be suitable for commercial purposes.[15]

An essential component of reforms to achieve a more efficient and environmentally appealing urban spatial character will be to develop the institutional basis for a working real estate market in the cities. Such reforms include, as identified in the *Strategic Plan*, simplifying planning processes and construction permits for development projects; reassessing and updating zonal regulations; expanding the supply of land plots for sale; improving land registration and guarantee of property rights; monitoring real estate transactions through public notice; and making widely available information on real-estate use and any planning restrictions.[16] The planners' spatial

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[14] FIAS, "Bulgaria: Administrative Barriers to Investment", February 2000 draft.

[15] Alain Bertaud, "Croatia, Split – Historical Core Rehabilitation and Urban Issues", December 29, 1999.

[16] A study of the costs of rehabilitating housing in the historical core of St. Petersburg, as compared to those of new construction on the city outskirts, finds the former considerably more costly because of the need for relocating residents, time delays and high restoration standards. Present city practices regarding privatization and approval of historic rehabilitation projects are subject to costly delays, subjectivity and uncertainty, to a much greater extent than is the case for new construction. The study recommends coordinated changes in a number of policies, including some reduction in redevelopment taxes and fees, clarifications in resettlement and land use policy, and more active marketing of investment opportunities to the private sector. Stephen B. Butler, Ritu Nayyar-Stone and Sheila O'Leary, "The law and economics of historic preservation in St. Petersburg, Russia," *Review of Urban and Regional Development Studies*, Vol. 11, No. 1, March 1999, pp. 24-44.

development objectives need to be reviewed against the evolving real estate market performance, by careful tracking of building permits and changing land values in locations targeted for transformation or densification. Modernizing procedures and information flows on urban real estate is a prerequisite for municipal authorities to extract a potentially buoyant source of revenue through property taxation. However, further reforms in municipal finance may be needed to permit this—for example, federal legislation does not permit St. Petersburg to use betterment levies that would yield additional tax revenues from land development.

2. The Productive Transition

The spatial legacy of socialism mirrored the structure of production, which favored industry and large firms while de-emphasizing the services sectors and small-medium sized enterprises. These imbalances are changing under the emerging market economy, and cities need to support these changes as well to increase their competitiveness in the global arena. Strategies for the productive transition in cities will therefore entail creating an attractive climate for modern services including cultural and tourist activities, fostering a healthy small-medium scale enterprise sector, and promoting the relocation of many factories that remain viable to the metropolitan periphery or to smaller cities. These outcomes need to be defined for each city in ways that reflect their comparative advantage and increase employment for as wide a segment of the urban society as possible.

Developing the services sector. The importance of services, or the "tertiary sector", has grown in share of GDP and employment in both traditionally market economies and in the transition economies as a result of changes in technology, information use, and consumer demand.[17] The higher value-added end of this services expansion is primarily a big city phenemonon. St. Petersburg's gross regional product currently registers a considerably higher share devoted to services (62 percent) than the national average for Russian GDP of just over 50 percent.[18] The shift to services has occurred as a natural result of readjustment from socialism, which unleashed pent-up demand for services, and the easier growth of private enterprise in services than manufacturing. It also reflects the service sector's relatively greater resilience to cyclical recessions and macroeconomic crises compared to manufacturing. The tertiary sector comprises highly varied activities (both publicly-funded, such as health and education, as well as personal and commercial services), but generally is characterized by considerable interaction and proximity between consumers and providers, and by large informational and quality requirements, especially as compared to traditional manufacturing industry.[19] These features make the development of a competitive services sector dependent on good

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[17]Between 1980 and 1998, services in Middle Income Countries as a group rose from an average of 46 percent to 58 percent of GDP (and from 59 to 65 percent in High Income Countries). In the same period among transition economies, Hungary led the rise from 34 to 60 percent of GDP for services; Bulgaria and Russia had identical surges, from about one-third to just over half; and Croatia registered a 59 percent share in 1998. World Development Indicators, January 2000 draft, Table 4.2.

[18] *Strategic Plan*, Table 1.6, p. 27.

[19]Metka Stare and Judit Vanyai, "The increasing importance of the service industry in countries in transition," *Development and International Cooperation*, Vol XI, No. 20-21, June-Dec. 1995, p. 335-362.

infrastructure and communications (both also service outputs in their own right), and on flexible market response capability. These are advantages that cities can affect through strategies favoring reliable urban public services, and careful modulation of municipal regulations affecting enterprises and labor, including policies on the availability of land and real estate.

The dramatic growth in services has not been sufficient to absorb workers released from agriculture and industry in the transition countries, so unemployment has increased. This has been the outcome in particular for workers who are less equipped to compete for high-technology and information-intensive service jobs, even though the Central and Eastern European countries have a generally highly educated labor force. It will be particularly important for city strategies to be geared to attracting a diversified array of services activities, including those such as construction, cultural and personal services that are relatively labor-intensive and are not oriented only to the "high end" of global competition. In Sofia, services represented 71 percent of total employment in 1998 of which the large private sector component was accounted for overwhelmingly by trading activities, many with fairly low sophistication (described by one local observer as a "flea market"). The challenge for cities is to raise the productivity and value-added of services while absorbing—and upgrading—the available labor force.

Supporting SMEs. "Micro", small and medium-sized enterprises (SMEs for short) are important sources of jobs and entrepreneurial dynamism in market economies. The OECD estimates that SMEs account for 95 percent of firms and 60-70 percent of jobs, and a disproportionately large share of new jobs, in member countries. SMEs are particularly well suited to respond to the rapid changes in technologies, product niches and market demand. However, many of the traditional problems facing SMEs—including access to debt and equity financing, difficulties in exploiting technology where that is not the speciality of the firm, constraints in management capabilities, low skill development, productivity and product quality, regulatory burdens and access to international markets—become more acute in the globalized, technology-driven environment.[20] SMEs therefore form a major focus of local economic development efforts in industrial countries and should be a key focus in strategies of the transition economies as well, since all of the above constraints are even more serious in contexts where experience with private entrepreneurship is quite recent.

SMEs have, in fact, proliferated in transition economies with the removal of ownership restrictions and downsizing of public sector firms. In the four Visegrad countries (including Hungary), the numbers of self-employed grew by 150 percent between 1989-1994, and in Russia employment in SMEs increased 120 percent in 1994 alone.[21] Most of the growth has been in microenterprises (with fewer than five employees, often family-run). Enterprises with less than 10 employees represented 71 percent of all companies in Sofia in 1998, yet accounted for only 7.5 percent of all employees in the city and most are extremely small (averaging only three employees).

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[20] "New Directions for Industrial Policy", OECD Policy Brief No. 3, 1997.

[21] A. Gibb (1995), "Entrepreneurship in Transition Economies: Back to the Future", cited in Council for Urban Economic Development (CUED), chapter 6, p. 4.

The middle-sized tier of firms, who operate beyond the local market, is singularly absent in the transition economies. A particular challenge in these countries is to provide the more sophisticated level of support required by firms capable of growing into the missing middle-sized tier. The Budapest *Concept* identifies the need to "ease the dual structure of the economy", that is, the current chasm between the few large foreign companies acting as drivers of investment on the one hand, and micro/small/medium-sized enterprises, on the other hand—most of which are domestically-owned and represent the majority of firms and employment. A healthy "home-grown" small enterprise sector provides a high income multiplier for the local economy and can be a strong marketing advantage for a city in attracting external employers as well, since small enterprises can only thrive in a stable economic and regulatory climate that is favorable to business generally.[22]

Initiatives to support the SME sector in Europe and North America have a long experience and many of these are relevant to the transition countries and cities. Measures can be summarized under several main categories (box 2).

Box 2: Measures to support Micro, Small and Medium Sized Enterprises [23]

1. **Financial Assistance** – mainly grant aid and microlending to promote expansion and to help strengthen productive capacity.
2. **Financial Engineering** – newer types and varieties of financing instruments (seed and venture capital, mutual guarantees, factoring and leasing, etc.)
3. **Physical Infrastructure and Sites** – investment in small-scale infrastructure and support facilities (e.g. business and innovation centers, incubators (physical facilities providing new firms with affordable space and on-site management support, often geared to technology start-up companies), managed workshops (more modestly serviced facilities for small firms of mixed types, often located in redundant buildings refurbished for this purpose)[24]
4. **Business Advisory Services** - various types of advisory support (e.g. advice on business plans, financial management, marketing, exporting and internationalization)
5. **Innovation and Technology** - measures to promote innovation of firms and the absorption of new technology and know-how, together with the development of knowledge infrastructure and technology transfer mechanisms.
6. **Training** - support for entrepreneurship skills development, training for managers and employees, initiatives to help SMEs adapt to new technology, etc.
7. **Other Measures** – including development of networking forums and information dissemination among SMEs, measures to promote SMEs in particular sectors, initiatives designed to assist women entrepreneurs, and schemes aimed at young people going into business.

[22] CUED, "Local Economic Development in the CEE/NIS Region", Overview Paper, Draft prepared for USAID, February 2000.

[23] Box taken from Swinburn, op. cit.., based on *Thematic Evaluation of Structural Fund Impacts on SMEs*. Ernst and Young. Synthesis Report for the European Commission (DG XVI). July 1999.

[24] OECD experience with these various related types of facilities is summarized in "Technology Incubators: Nuturing Small Firms", OECD/GD (97), 202, and cited in Swinburn, op cit.

In the 1990s there has been a shift in the EU away from direct intervention to assist SME development (e.g. through financing and physical infrastructure (items numbered 1-3), towards an emphasis on more knowledge intensive measures (points 4-7) and interventions to improve the business environment for SMEs and their internal competencies. However, the transition economies have weaker financial systems and physical infrastructure in place to begin with, especially for SMEs which are particularly affected by general weaknesses in the markets for credit and real estate. Therefore the full array of supportive measures may need to be considered in the transition economies. Some of these will be beyond the reach of individual cities to provide at scale, and some may be appropriately designed as part of national programs. Municipalities can also pool their business support efforts. (Box 3)

Local governments, in partnership with business support organizations such as Chambers of Commerce, can play an important role in providing assistance to new and growing SMEs. This can include, in addition to the "other measures" listed above, "one-stop shops" which reduce the number of different agency interactions required of businesses by providing a single point of contact, e.g., for licensing transactions. In the EU and OECD countries, recent SME promotion initiatives have given increasing attention to facilitating networks of companies. These networks can work both horizontally as business relations among SMEs themselves, and vertically as supply chain interactions between SMEs and other organizations.[25] The Budapest *Concept* calls for promotion of subcontracting schemes between large companies and SMEs, the creation of incubator facilities and information centers, and conversion of land and real estate for mixed uses suitable for SMEs. St. Petersburg's *Strategic Plan* recommends liberalizing the city's procurement policies so that firms can compete for business opportunities through public contracts.

Box 3: Some small enterprise support programs to date in the region

Hungary. The Government of Hungary collaborated with several non-governmental organizations to create the Hungarian Foundation for Enterprise Promotion (HFEP) in 1990 in order to promote small enterprise development. HFE's core activities are to create a network of **local enterprise agencies** (LEAs) in small towns and cities to promote small enterprise and to manage the financing provided by domestic and foreign sources (including the European Community) for promoting the small enterprise sector. LEAs are independent agencies formed through partnership with private industry, county governments, municipal governments, labor unions, business associations, local employment offices, and state enterprises. Most staff members of LEAs have direct business experience. The agencies are set up to provide technical assistance to businesses meeting the following criteria: no more than 10 employees; not older than 2 years; and no more than $60,000 in annual sales with the owner/entrepreneur having no more than $200,000 of net worth.

Currently the majority of LEA activities focus on providing small businesses with adequate finance. To date, the Hungarian **microloan program** is in high demand, with eighty to

[25] The EU evaluation (op. Cit.) suggests that networking or so-called clustering is one of the most innovative and promising aspects of SME programs supported by the EU Structural Fund, with good examples cited in the Report including in Sweden and the Netherlands.

ninety per cent of the LEA sub-agency clients interested in a microloan. The staff at HFEP states that microloans are helping small start-ups survive and stabilize. In addition, HFEP funds are filling an important credit gap by helping to launch new enterprises that banks perceive as too risky to justify the high transaction costs and low revenues. [26]

Russia. Eight cities, including St. Petersburg, have established **business assistance centers** to provide core counseling and training services to existing small business owners. In addition, they are involved in building industry coalitions and providing other types of business support services. The Voronezh Business Assistance Center, in partnership with the investors of the Russian-Swiss Fund, identify viable but ill-prepared entrepreneurs and link them to capital. Since these centers opened in September, 1993, they have helped over 2,000 small business owners . [27]

Bulgaria. The Smolian Regional Development Agency in Bulgaria is a non-profit organization started in 1993 and founded by local municipalities and local associations and agencies for **business training and assistance**. It offers entrepreneurial training courses including computer usage, how to start a business, and language training. In addition, the agency provides consultancy services such as business planning, marketing, promotion and management, assistance in accessing financial resources, business information, business translation services, and participation in trade fairs.

Business centers in Bulgaria not only support SMEs but provide important community building functions as well. The business center in Mesta, for example, also serves as a community assistance center in many ways. As the only center with Internet access, the local residents use the center's e-mail system and also use the center as a meeting place and informational resource.

The first **business incubator** in Bulgaria was developed in the city of Rousse. The incubator started with four companies, which have each created, on average, 13 jobs. Two more firms are now in the incubator. The incubator offers loans for short periods with good interest rates and intends to develop a start-up fund as well. The businesses in the incubator also receive technical support provided by a consultant working at the local business center.

Source: Council for Urban Economic Development (CUED), "Local Economic Development in the CEE/NIS Region", Chapter 6, Draft prepared for USAID, February 2000..

Besides investing in proactive SME support mechanisms, however, the transition economies need to take the most cost-effective step—ensuring that they "do no harm", by removing unnecessary administrative hindrances to private enterprises. For example, a recent survey of licensing requirements for private companies in trade and transport in three cities of Bulgaria, including Sofia, revealed that various institutions at different levels of government impose multiple and often overlapping restrictions on the companies. Local authorities were found to introduce and apply licensing rules with wide discretion and without appropriate justification based on valid public health, safety or other externalities. These practices imposed heavy financial costs and time delays on the

[26] OECD (1996). *Microcredit in Transitional Economies: LEED Programme on Local Economic and Employment Development*. Paris: OECD. Cited in CUED, Chapter 6, p. 16-17.

[27] A. Conte (1996) 'Business Centers Create Entrepreneurs, Develop Climate', *Economic Development Abroad*, Washington, D.C.: Council for Urban Economic Development. Cited in CUED, Chapter 6, p. 8.

firms, particularly in Sofia.[28] Recognizing similar problems, the SPSP gives high priority to the elimination of numerous legal and regulatory constraints on business.

Continued reforms in the general business environment, including clarification or streamlining of laws, taxation and regulations by all levels of government affecting companies, are basic prerequisites to any targeted efforts specifically for SMEs or other investors. A broad-based strengthening of the business climate and deepening of the market economy will also be a precondition for the pre-accession countries to take advantage of EU Structural Fund support for SMEs when they eventually qualify. In Croatia, faster progress in privatization and reducing the State's role in the economy will be particularly important to stimulate private job growth in Split and elsewhere.

Reclaiming derelict sites – "brownfield" redevelopment. Both the Budapest and St. Petersburg strategy statements give priority to rehabilitating underutilized land within the city, much of which was or still is occupied by declining industry or other obsolete structures. In many cases these sites are heavily polluted and qualify as so-called "brownfields"—in contrast to sites for potential new "greenfield" development at the periphery. Lessons from the market economies are of relevance here.

In North America and Europe, experience with brownfield development originated in programs in the 1970s to meet environmental standards for hazardous waste reduction. Many of the programs were in "rustbelt" areas where heavy industry was in decline and in neighborhoods suffering from overall social and economic distress—as in the transition cities. The hazardous waste laws were found to create strong disincentives for brownfield clean up and to encourage the flight of investment to greenfield suburban sites, exacerbating the loss of jobs and population in older city centers. Governments more recently have begun to view brownfield cleanup as a factor in broader strategies for central city revitalization efforts, and indeed as a tool for stimulating local economic development. Newer legislation in the 1990s in several U.S. states aims to make urban brownfields more attractive to developers by limiting liability for clean-up. Purchasers and lenders are afforded liability protection if they did not cause the environmental pollution. Elements of the newer legislation also include financial assistance or incentives for purchase and clean up (sometimes based on the jobs created), flexible standards for remediation (clean-up of contaminated sites) linked to future land use, and streamlined review processes. City programs, such Chicago's Brownfield Redevelopment Initiative, are working with potentially interested investors to help them identify sites, facilitate and provide assurances, including by reducing distrust and increasing information among the community, developers and lenders.[29]

The emphasis of brownfield redevelopment in the OECD has also shifted from an environmental issue (the process of remediation) to finding complementarity between

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[28] "Licensing in Retail and Wholesale Trade and Commercial Road Transport", *Bulgarian Institute for Market Economics Newsletter*, Jan-Feb. 2000, Vol. 7, No. 1-2.

[29] Rhonda Hise and Arthur C. Nelson, "Urban brownfields: Strategies for promoting urban brownfield re-use at the state and local level," *Economic Development Review*, Schillar Park, 1999. Vol 16, issue 2, p. 67-72.

environmental and urban regeneration policies. As experience with clean-up has increased, the costs of remediation have fallen and enforcement of "polluter pays' regulations (when the polluting parties can be identified and held liable) has become more common. However, the broader problem of urban decline has increasingly been recognized as a continuing challenge requiring dynamic responses. Strategies of integrated urban regeneration, which include objectives of restoring brownfield sites to economic and social vitality through comprehensive approaches to problems of unemployment, business development, housing and safety affecting the neighborhood, are found to have the best potential for attracting partnership, finance and community support. Brownfield redevelopment is therefore seen in OECD countries as part of larger efforts to address land use problems throughout the urban area (for example, to control urban sprawl), to improve social cohesion and environmental sustainability, and to create conditions favorable to local economic growth. Use of brownfield areas for housing and mixed-use development is seen as particularly desirable to reestablish a residential presence in wasted areas and reinforce communities; however, it is recognized that converting formerly polluted areas to housing can be contentious and requires effective public communication and community participation. Turning brownfields into parks through an "ecosystem" approach to regeneration, by incorporating recreational and cultural functions, can also be a viable alternative when viewed through an integrated strategy that considers social, environmental and economic outcomes for the derelict area.[30]

A recent OECD review of cases of comprehensive urban regeneration efforts involving brownfield redevelopment found that independent private sector initiatives are rare and that most private financing was attracted to partnerships with the public sector. This combined financing did manage to leverage public funds very highly (both national funds and, where applicable, the EU Structural Funds directed to lagging regions or regions of industrial decline). In countries where public financial incentives were not provided (e.g. in Canada), private financing for brownfield redevelopment has been more readily found for the better-off zones than for the more depressed areas of a city that have attendant social and economic problems.

The OECD report notes that specific roles of the public sector in regeneration projects are to develop the vision of redevelopment for the area, assemble land, commence the reclamation/remediation process, provide significant funds and attract private sector participation—in addition to general policy-making and coordinating functions. The national government (and supra-national, in the case of the EU) have been very supportive players in most regeneration activities, but the local and sub-regional authorities take major initiative in seizing opportunities and forging partnerships. Sometimes local area development corporations are established to carry out the actual projects. Glasgow, Scotland is an example with a long history of urban regeneration based on brownfields. It has been estimated that the city has 12 percent of its land in derelict condition, compared to about 5 percent for Scotland nationally, and 10 percent of

[30] OECD, Territorial Development, *Urban Brownfields* (http://www.oecd.org//tds/bis/brownfields-chap3.htm). Chapter 1: Strategies for Brownfield Regeneration and Chapter 2: Environmental and Urban Policies and Brownfield Redevelopment.

its land is deemed contaminated. The Glasgow City Council, Glasgow Development Agency (a partnership between the local authorities and the private sector), regional government council, national Scottish economic development agency (Scottish Enterprise), and national housing agency are all involved. Since 1991 the urban renewal program for the city has given particular attention to reusing brownfield sites (former steelworks, coal and gas works) for housing, with a subsidy for developers of around 30 percent.[31]

Minimal preconditions for successful brownfield redevelopment include clear legal frameworks regarding property rights, assignment of liability for clean up as part of the privatization process, and provision for litigation or dispute resolution mechanisms. Equally critical is a functioning land market that can signal to investors the potential value of well-located sites. The transition economies discussed here have been developing basic environmental and privatization legislation to permit brownfield development by private investors.[32] Action can still be constrained by practical uncertainties regarding how remediation costs will be born and financed, and by limitations on real estate transactions, as discussed earlier, which make the potential returns to redevelopment difficult to determine. The cities also need to inventory the condition of polluted sites as a first step to possible sale, rezoning, and projects for clean-up and re-use. Considerable efforts have been made in Budapest to identify a redevelopment program for the former Csepel steel works in the city. However, the rapid privatization which created over two hundred owners for the site has been a major complicating factor in getting the program underway.[33] St. Petersburg's *Strategic Plan* advocates giving developers "maximum freedom" to rework the inner industrial zone of the city for new uses. The experience of other industrial countries and cities indicates that a public-private partnership approach to mobilizing private investment in brownfield redevelopment may be needed as well.

3. The Social Transition

One of the defining characteristics of socialism was the objective of avoiding stark inequalities in income and living standards among the population. This aim was partly achieved through greater reliance on nonincome (in-kind) transfers, such as through "social housing" and other services, financed either by government or enterprises. In the socialist city, the relatively better-off and less well-off populations were also more physically integrated in mixed residential areas than has been the case in most traditionally capitalist cities. The economic transition has increased rates of absolute poverty in virtually all the countries because of attendant recessions which have reduced formal wage income. Many households have become more dependent on social income transfers (e.g., family allowances), yet governments at all levels have been unable to sustain the high rates of such transfers or of service subsidies, such as for public

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[31] Ibid., Chapter 3: Case Studies and Results, p. 5-6.

[32] The Bank has assisted in this process, e.g. under the Bulgaria "Environmental Liability Pilot Project (1997) and the follow-up "Environment and Privatization Adjustment Support" loan (FY00), and through the Environmental Management Project for Russia.

[33] OECD *Urban Brownfields,* Chapter 3, op.cit., p. 6.

housing maintenance and utility tariffs. The extensive job loss in the public enterprise sector has also created greater hardship for households less equipped to compete in the new market economy. Consequently, poverty and inequality have become a pressing issue in all of the countries and especially in the cities of the transition region, given the heavily urban location of population and of declining economic activities. This outcome is also becoming very visible as increasingly the poor and disadvantaged are spatially concentrated in areas of economic decline and deteriorating housing. Local governments are perceiving the social dilemma particularly acutely, especially since they have been accorded responsibilities for social welfare policies since decentralization. Crime is seen as another growing side effect of social disruption, as noted in the strategic documents of Budapest and St. Petersburg.

Formal unemployment rates are reported to be lower in Budapest, Sofia and St. Petersburg than the national averages, and for Split to be about equal to that for the country (20 percent). The major cities are relatively well placed to attract what investment occurs and to foster private job creation—in particular, the private enterprises best connected to global competitive markets are sprouting in the larger cities where information resources and international connections are best. But many workers are unable to take advantage of these promising opportunities.

The SPSP points to high levels of "hidden unemployment" as one of the city's key weaknesses. Inequality, as measured by the share of income held by the two lowest quintiles, deteriorated during the 1990s (falling from 23.3 to 17 percent between 1991-1995), with an increase in the top quintile from 37 to 44.3 percent.[34] Although the SPSP notes some ironing-out of acute differences in salary levels in the latter 1990s (until the 1998 crisis) as the private economy has expanded, the continued threat of overt inequality is potentially destabilizing to any society, especially one that had prided itself on the relative absence of such outcomes. The main groups at risk are seen to be the aging, who are a large share of the population (old-age pensioners comprise 25 percent of the permanent residents of the central districts of St. Petersburg).[35] Although dependent on the fixed incomes from social transfers and having high demands for social services, the aged (except for females living alone) are not necessarily poorer than large families in the transition cities. In Budapest, nuclear and extended families, with one wage earner and large numbers of dependents, are more vulnerable to economic distress and have higher poverty incidence.[36]

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[34] *Strategic Plan*, p. 26.

[35] At the same time, this district is also home to the very wealthy—42 percent of the total city residents paying the maximum rate of income tax. The City Plan envisages maintaining this combination of income groups in the city center, which may be very difficult as the land market develops. *Rehabilitation of the Center of St. Petersburg: Investment Strategy*, City Administration of St. Petersburg, 1999, p. 14-15.

[36] The national urban average incidence of poverty was 17.3 percent for active households and 14.5 percent for inactive households in 1987 (the economic transition began earlier in Hungary than in other ECA countries). Average incidence was much lower in Budapest (4 percent) but highly variable by district. Caroline Moser and Cathy McIlwaine, *Household Responses to Poverty and Vulnerability*, Vol. 2. Urban Management Program Policy Paper No. 22, 1997, p. 29-31.

While residents of Sofia are over-represented among the poor relative to their share in the national population, they are under-represented among individuals who are found to be "persistently poor". This suggests that the poverty rates observed in Sofia may be a particular result of the economic crisis and could change if the economy turns around, since Sofia residents are relatively better-educated than other groups and are thus well-placed to take advantage of economic growth. For the country as a whole, the poor are more likely to be those with low and unmarketable skills, members of ethnic groups, large families and children.[37] Young households are also identified as a vulnerable group in Split because of their difficulties in affording housing, and resolution of refugee status is a particular problem.

The fear of broad decline in social welfare and social cohesion underlies the city strategy efforts to date. The Budapest *Concept* states as one of its main goals the achievement of "an equitable, socially sensitive and open city":

> The town development policy must also face the problems of certain social groups which lag behind and certain parts of the city which are in a disadvantageous position.…One of the most important elements of this (balanced development) is the struggle against poverty which, in addition to aid funds and benefits, also could involve job creation, very important programmes launched for young people, the development of a social housing policy and the consideration of the social aspects of town rehabilitation.[38]

The *Strategic Plan* likewise states the overarching goal as improved quality of life for "all categories of St. Petersburg citizens", with the fourth main strategic objective being "establishment of a favorable social environment".

The most overt evidence of social ruptures is seen in the housing status of residents in the transition cities, and other location- or residence-related hardships resulting from increased costs and deteriorating quality of transport and public services The next section focuses on these subsectors, whose improvement is a key element of achieving the cities' spatial, productive and social transitions smoothly and efficiently. Reforms and investments in these areas need to be core elements of a socially sustainable city strategy, supplemented by targeted physical rehabilitation programs for the most depressed and deprived areas of the cities as discussed earlier, and by reforms in the social transfers and social services systems to ensure adequate safety nets to the poor and disadvantaged residents. The wide participation of civil society in the process of preparing city strategies enhances the opportunity to mobilize the associative sector, which was neglected or even proscribed under socialism, as a critical partner with government in addressing the social stresses of the market transition.

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[37] *Bulgaria: Poverty During the Transition*, Report No. 18411, 1999, Human Development Sector Unit, Europe and Central Asia Region, World Bank.
[38] *Budapest Town Development Concept*, Full Volume, chap. II, p. 2.

4. Implications for Transition in Urban Services

Housing, public transport and infrastructure issues in the transition cities affect fundamentally their evolving spatial, economic and social character and therefore need to be viewed within a holistic strategic perspective.

(a) Housing

How the housing sector functions is fundamental to any city's spatial development, its economy and use of capital (since housing is a major focus of savings and capital investment), and the quality of life for residents. Key characteristics of the socialist urban housing sector are described in the introductory paper (*Buckley paper*) to this note, and the four cities discussed here shared these features to varying degrees.

- Hungary's urban areas retained more low-rise housing than the high-rise panel flats prevalent in other socialist countries, and it tolerated privately-owned and –constructed housing to a high degree (about 80 percent of the country's housing was owner-occupied in 1990)[39]. However, public rental (social) housing was a strong feature in Budapest, and the very deteriorated condition of this segment under municipal ownership remains a major problem. The Budapest *Concept* note even speaks of a growing reality of "ghettos" in the city.

- State control of urban housing was the dominant situation in Russia (80 percent of the total stock in cities) until the transition. Communal (shared) housing remains very common in St. Petersburg, with 24 percent of residents still living in such accommodations owned by the municipality.[40] The communal residents are among the lowest income groups and represent a large backlog on official waiting lists for relocation to improved publicly-provided housing.[41]

- Bulgaria had even less state-owned housing than Hungary in the socialist era, and currently all but about 16 percent of the stock in Sofia is in private hands.[42] In the currently primitive housing and real estate market, very limited information is publicly available on transactions and participants face high risks due to inadequate legal protections. There is a large unsold inventory of properties on offer while many units are overcrowded, prices and rents remain high, and effective demand is limited by low purchasing power and lack of finance. As in other ex-socialist cities, low income pensioners often hold rights to increasingly valuable flats but in the existing market conditions these

[39] Amy Osborn, "Decentralization and Selected Urban Issues in Transition Socialist Economies", Note prepared for TWURD, 1997, p. 29.
[40] *Strategic Plan*, p. 33.
[41] Technical Annex to Russia Federation St. Petersburg Center city Rehabilitation Project, Report No. T-6998 RU, February 27, 1997, Annex 13.
[42] World Bank mission findings, March 2000.

assets are effectively illiquid. An important issue therefore is to accelerate the turnover of housing in the city so that better-off households can move out of existing, lower quality units to make them available for the less well-off.[43]

- The housing stock in Split was constructed to better quality standards than in many other ex-socialist cities, and the great majority of apartments have been privatized. However, rent control continues to apply for an estimated half of the residential space, contributing to poor incentives for maintenance or upgrading of the physical stock in the historical core and creating a problem of managing mobility for the current residents of rent-controlled apartments.[44]

The decline in population of the cities gives a breathing space for measures to improve the quality of housing available for the remaining residents, but the main issues are to improve the matching of supply and demand and to overcome past backlogs in adequate housing arrangements.

The housing situation is undergoing rapid change with the liberalization of sectoral regulations, privatization, and the impact of emerging consumer demands. The rapid privatization of the housing stock has been dramatic in St. Petersburg. The municipality is the largest single owner of housing in the center city, and remains an owner of large shares of land in the city even where the housing structures have been privatized. Cooperative housing associations are an important stakeholder group in the market. Residential density is shifting in both Budapest and St. Petersburg from the inner city to outer areas as households choose more space in newer construction. The Budapest *Concept* fully assumes that this reallocation will continue as consumers express pent-up demand for larger and better housing; at the same time, the document underscores the need to provide options for households to resettle themselves inside the city boundaries rather than at the periphery, so as to avoid requirements for new infrastructure and reliance on motorization rather than public transport. Because of the "camelback" density profile of St. Petersburg discussed in section 1, the city faces a double issue of concentrations of poor residents both in the inner core as well as in the vast high-rise blocks along the outskirts of the city. These latter installations are increasingly seen as potential "vertical slums" because of both physical decrepitude and surrounding economic decline. These residents have lost employment opportunities with the closure of state industrial enterprises in the city, which often provided services and housing as well as jobs, and remain relatively isolated from the more vibrant areas closer to downtown.

Social housing and the affordability issue. The evolving housing market in the cities is constrained by land use controls and nontransparency in real estate transactions, as discussed earlier; by the state of financial (mortgage) market development; and by the persistent problem of the social housing segment. While the overall affordability of housing and functioning of the housing market may actually be helped more by advances in the financial sector than by the "social housing" policies, the local governments have

[43] "Sophia Urban Development Initiative Assessment Report", p. 19.
[44] Alain Bertaud, "Croatia, Split – Historical Core Rehabilitation and Urban Issues", p.

relatively little influence on housing finance but do face direct responsibilities for the problems of the social stock and housing subsidies. The issues of developing mortgage finance systems, although critical to the cities' housing outcomes, depend essentially on national-level policy and institutional actions.

In St. Petersburg and other cities, the municipality heavily subsidizes maintenance for social housing, which is provided overwhelmingly by municipally-owned house management agencies. These agencies are also the main providers of such services to privately owned (condominial) apartment buildings. Some cities, including St. Petersburg, have given residents' associations legal authority to contract competitively for maintenance services as an incentive for reducing costs and increasing efficiency, and this trend has strengthened both the associations and maintenance outcomes.[45] Further promotion of a competitive, commercial housing maintenance and management industry is recommended in the *Strategic Plan.*[46]

The transition cities all face the need to restructure subsidies for housing, including their expenditures on social housing, because of reduced fiscal resources and because the inherited system is poorly targeted and inequitable. In Bulgaria, current policy debates surrounding a new national housing strategy concern the introduction of vouchers or construction of more affordable housing. An analysis of subsidies based on minimum floor space norms, taking account of current construction costs and incomes, indicates that providing new stock would be much more costly to the public purse than freeing up more of the existing stock for the low income households.[47] Increasing liquidity through a better-functioning housing market is therefore essential to a program of improved affordability. Similarly, reforms of rent control and other measures to facilitate private rental would foster better matching of supply and demand for existing housing space. Subsidies based on income eligibility criteria, in the form of vouchers permitting households to purchase (or rent) housing units in the market, would be more effective in meeting this objective than subsidies attached to a type of housing unit.

Russia has such a "housing allowance" program which affected some 7 percent of all households in 1996 and is administered at the municipal level.[48] The system was introduced along with legislation in 1992 to raise rent and utility fees over a five-year period (later extended to ten years) to meet current costs in full, and local administrations are responsible for implementing the allowance scheme. Charges for housing maintenance and utilities have been sharply increased, as have underlying costs, and are close to international levels in most Russian cities (although there is considerable scope for continued improvements in the efficiency of maintenance and utility services). In St.

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[45] Raymond J. Struyk, ed. *Restructuring Russia's Housing Sector, 1991-1997*, The Urban Institute, 1997. chapters 4 and 6.

[46] *Strategic Plan*. The plan also proposes increasing the provision of housing for low income and disadvantaged citizens by creating a new municipal housing stock through acquisition of apartments on the secondary market and reconstruction of other buildings into flats. The value of this approach is debatable as it would perpetuate the role of the city as landlord/owner. (p. 59).

[47] "Sophia Urban Development Initiative Assessment Report", p.19.

[48] Alexander Puzanov, "Rent Reform and Housing Allowances", chapter 5 in Struyck, op cit..

Petersburg the allowance system was started very modestly, with only one percent of households receiving allowances in 1996, but had to be expanded to accommodate greater demand after rate increases in 1997.

In all the ECA cities, solving the problems of housing affordability will require a long transition period. As real incomes rise households will increase their ability (and willingness) to cover higher charges for rent and utilities. Efficiency in system maintenance and services needs to improve, and the existing housing stock more readily turn over to expand the supply of lower cost housing through market transactions.

(b) Public Transport

Along with planning the spatial locations of industry and of housing, the socialist cities emphasized public transport to move workers between them. The positive legacy is represented by the highly-developed mass transport systems of Budapest and St. Petersburg. The extensive infrastructure and services were put in place to support the distinctly monocentric structure of the cities through radial networks to move large numbers of workers from residential concentrations in the outer rings of the city into the core area and to the major industrial sites within the city limits. However, the public transport systems have deteriorated in quality since the economic transition, and burgeoning demand for private cars has let to rapid rates of motorization that have already, in the case of Budapest and Sofia for example, reached Western European levels (around 300 cars/1000 population).[49] (Table 1) Public transportation still accounts for the vast share of trips to work in St. Petersburg and Sofia (89 and 75 percent, respectively), but private vehicles now make one-third of work trips in Budapest.

The ongoing revolution in urban transport has critical implications for the spatial structure of the cities in transition, and for social equity. The Budapest *Concept* explicitly recognizes that the goal of retaining a compact city is threatened by continued deterioration of public transport and by untrammeled growth of private car traffic; therefore, spatial redevelopment plans need to proceed in concert with a vision and action plan for revitalizing public transport and managing motorization. Preserving a socially-integrated city also requires efforts to ensure that no residential areas are left physically segregated from access to growing sources of employment. The low income population would be particularly disadvantaged by failures of public transport since they are least able to take advantage of private vehicles. Continuing the current pace of motorization also poses environmental risks from increased pollution, and the traffic congestion already in evidence handicaps the city's economic activity. St. Petersburg is experiencing average driving speeds of only 12-15 km/hr during the daytime, reflecting both the increase in vehicle traffic as well as worsening condition of the city's roads.[50]

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[49] The rate is reported to be even higher (500/1000) by some observers in Sofia; however, given the large dependence on public transport for work trips it is likely that a considerable share of the registered car stock is not actually in use. (World Bank mission notes, March 2000)

[50] *Strategic Plan*, p. 31.

Reforms and renovation in urban transport would therefore need to take a central place in development strategies for the transition cities. The Budapest *Concept* accords a strategic priority to "maintaining the weight and quality of public transport as far as possible"; this objective is to be pursued by making public transport part of an integrated urban transport system that fosters smooth and convenient intermodal connections.[51] The SPSP calls for restructuring public transport and improving road maintenance as a key objective under the major goal of "establishing a favorable social environment".

Urban transport solutions for the transition cities may need to combine multiple areas of action, including[52]:

- **Internalizing the externalities from private vehicle use:** Cars impose costs on society through increased congestion, pollution, accidents, and absorption of public infrastructure (road space). Shifting more of these costs to the vehicle users through taxes or charges is the trend in the EU countries and the transition cities would do well to consider moving in this direction, although this is a politically sensitive topic in all countries and needs to be balanced with potential impacts on competitiveness. Fuel taxation is the most obvious tool to adjust to ensure that motor vehicles are charged at least the costs of road provision, and eventually cover some of the costs of social externalities as well.

- **Parking planning, controls and taxation:** Traffic flows and use of road space can be improved by strategic management of parking space and by limiting parking capacities.

- **Land use policies to encourage in-fill development and deter sprawl:** As discussed in section 1, promoting the redevelopment of underutilized sites within the city would help to discourage excessive movement of population to outlying areas which are difficult to serve with public transport and require additional road investment. However, some deconcentration of the population and movement of industries to lower priced land at the urban outskirts is inevitable with the economic transition. The transport impacts can be reduced by ensuring that the private developers provide, or share the costs of providing, the associated public infrastructure such as road space. Planners also need to provide clear notice of the rights of way for main tranport arteries and zone the land accordingly in the areas of new development.

- **Rationalizing public transport subsidies:** Subsidies to public transport users represent high costs for municipalities (e.g., more than $150/year per resident of Moscow) yet are poorly targeted to the most needy users and drain funds needed for maintenance and system renewal, while weakening

[51] *Concept*, p. 20.
[52] Adapted from Christopher Willoughby, "Eastern European Cities and Motorization", World Bank, ECA Region, draft note, 11/2/99.

incentives for efficient service delivery. Sofia has already taken the positive step of shifting from a general budgetary subsidy for the public transport companies, to providing the subsidy based on categories of eligible users. This change allows for better allocation to those in need (once the eligibility criteria are narrowed—currently half of all passengers ride free) and contributes to a more commercial orientation for the providers. Refining the public transport subsidy system may best be pursued as part of the overall improvement of means-tested social benefits, including allowances for housing, utility costs and other public services. As part of a comprehensive set of public transport policies, limited use of subsidies can also be appropriate for a very different purpose, that of discouraging use of private cars inside the city.

- **New investment in public transport and road infrastructure:** The ex-socialist cities invariably will require rehabilitation, upgrading and extension of their transport facilities and infrastructure, and the Budapest and St. Petersburg strategies outline numerous needs. It is important that such investments, for which private and public financing are sought, be pursued within a broad framework for public transport policy reform. The experience in traditionally market-based cities indicates that improving road infrastructure in a context of unconstrained motorization tends to encourage further vehicle use and only buys some time in a cycle of increasing congestion. At the same time, investments in the public transport system will only be financially feasible with improvements in operating efficiency and tighter use of fiscal subsidies.

(c) Infrastructure and Environment

The socialist legacy provided a relatively high level of access of other public infrastructure services (water supply and sanitation, electric power, heating, solid waste disposal) to households, but the quality, reliability and operational efficiency were often low and many systems have deteriorated under the conditions of economic recession. As is typical of other transition cities, almost all utilities in St. Petersburg, Sofia and Split are owned or directly run by the municipalities. High levels of waste in the production of water, power and heat have been typical, because of technical failures such as poorly maintained distribution networks and the lack of incentives for conservation by either operators or consumers. For example, average water consumption by St. Petersburg residents is 270 liters/day, compared to 180-200 in Western Europe.[53] As noted earlier, subsidies to utility companies have absorbed large shares of municipal budgets—e.g., 15 percent in Split in 1997[54], and the subsidy for home heating alone absorbed over 8 percent of the city budget of Moscow in 1996[55]. Tariff increases have been burdensome for low-income consumers.

[53] *Strategic Plan*, p. 32.
[54] "Croatia Fiscal Decentralization…". p. 8.
[55] Struyck, op. Cit., p. 58.

Improving the quality of service and mobilizing increased financing for new investment are likely to require a broad set of policy and institutional reforms of infrastructure. These include measures to restructure the public utility providers and put them on commercial terms with hard budgets, introduction of more businesslike management practices, use of competitive bidding for contracted services, and/or privatization through concession arrangements or sale of ownership shares. Sofia now has seven private companies doing solid waste collection by contract with the city, several bus lines are contracted-out, and road maintenance is being privatized similarly. However, some the transition cities such as Split do not yet benefit from a basic legal framework at the national level clarifying rights and responsibilities for potential private partners.

Hungary has been a leader among the transition countries in bringing private sector participation into municipal infrastructure (the water works, gas and sewerage companies) through a carefully designed approach that takes account of the differences in the nature of services and objectives that can be served by different forms and conditions of private sector involvement. For activities with little "public good" character, the Budapest government has aimed to maximize revenues from privatization; for others, the arrangement was geared to attracting the capital and expertise of new partners, developing a more competitive organization, and improving efficiency of services. For the utilities services with strong public interest, the municipality carries a multiple role in regulation and (to a limited degree) price-setting, as well as retaining a dominant ownership share at least for the time being. Designing and executing infrastructure reform and privatization programs that provide adequate incentives for new private partners to improve services, while protecting the public interest of vulnerable consumers, is a major challenge for the transition cities. These changes require broad public concensus regarding the objectives to be served as much as they demand technical skills and capacity. According to the mayor of Budapest, the transfer of ownership and management rights to the private sector "was not only an economic transaction but an act with a symbolic meaning too, a firm step breaking up the old links and networks of the socialist period and adjusting our work to new sets of rules." [56]

The aim of EU accession has particular implications for environmental infrastructure improvement in the cities affected. The Budapest *Concept* identifies sewage treatment as one of the highest priority investment indicated by the EU conditions. The Municipality of Sofia has launched a three-year solid waste management program to address growing problems, within the EU framework, and investment alternatives such as further landfills or new incinerators will have important impacts on charges to users. Bring the existing services to higher levels of cost recovery has already required sharp tariff increases for users in all transition cities. Municipalities in the accession countries will have to plan for compliance with EU standards over a sufficient period of time to permit the investment needs to be financed, adequate safety nets put in place for the most vulnerable consumers, and for acceptance and understanding by the public to be assured. All of these conditions call for making the infrastructure investment

[56] Gabor Demszky, Mayor of Budapest, "Financial management and reform in the Municipality of Budapest", Presentation to Toronto Conference on Urban and City Management, May 6, 1999.

programs of the cities part of a widely-shared process of consensus-building and prioritization of actions through the formulation of city strategies.

B. The Implications of Decentralization

Alongside the socialist transition, the second major sea change that the cities in the ECA Region are experiencing is political and fiscal decentralization. Whereas devolution of government responsibilities to subnational levels is a global trend affecting both developing and transition countries, in the latter group it has added significance as part of the movement away from centralized control of the economy. Political and fiscal decentralization has tended to proceed faster, in terms of both legislative change and actual implementation, in the countries such as Hungary that have advanced farther in their general development of market forces. But even in the latter cases, refining the new frameworks of intergovernmental relations, ensuring that local governments have financial authority to match their new functional responsibilities, and putting in place newly-required capacities and processes of municipal governance, remain major challenges. This section describes the issues to be addressed in improving the ability of cities to meet the financial requirements of responding to demands from the local electorate. In EU accession countries, strengthening the financial performance and capacities of local governments will be critical for them to meet the public investment implications and to use efficiently the resources of the EU, whose funding mechanisms are directed in large part to subnational regions.

1. The Evolution of Decentralization and its Political Context

The four countries and cities reviewed here fall along different points on a continuum of structural arrangements, reforms and implementation[57]:

- Local governments in Hungary became among the most autonomous in the ECA Region since the 1990 Act of Local Government, which nominally granted them a broad range of responsibilities and wide discretion in carrying out duties, including for financing deferred capital investment. However, there is still relatively limited fiscal decentralization and lack of clarity in relationships with other levels of government. The large number of small municipalities created (3200 averaging 3250 residents) poses issues of economies of scale; however, cities and towns frequently combine in associations for delivery of services and to finance infrastructure. The potential introduction of a middle layer of government remains an open issue. Budapest is managed by a two-tier public administration system combining 23 districts and the Municipality of Budapest; both tiers have equal status, with the Municipality exercising coordination in matters that affect multiple districts or the whole city—an arrangement that is simpler in principle than in practice.

[57] Amy N. Osborn, op.cit., p. 12-14.

- Russia is a three-tiered federal state in which local governments (e.g. municipalities) are subordinate to oblasts (regions), a status that St. Petersburg as a metropolitan city shares. The basic laws, administrative and fiscal, have been enacted for restructuring local government and municipal financial management, but in practice implementation of the reforms and institutionalization of changed practices remains uneven across the country. The western, more European-influenced cities such as St. Petersburg enjoy fuller political autonomy. Municipal dumas (councils) and oblast governors are elected since 1991, but their effectiveness largely depends on relationships between the mayor and governor (or in the case of St. Petersburg, between governor and national government).

- Local government reform is still in its infancy in Bulgaria. The national constitution establishes the municipality as the core entity of local administration, but a legislative framework for decentralization and local government empowerment remains incomplete despite the enactment of the Local Self-Government and Local Administration Act of 1991. In fact, the regulatory framework for local government is very restrictive in terms of decision-making authority, flexibility of expenditures and revenues, borrowing capacity and management of cash flows.[58] This framework has undesirable effects of inefficiencies, financial costs, liquidity problems and a clear implicit bail-out of the City of Sofia by the National Government.[59] Having the status of a region, Sofia combines responsibility for self-government of the urban community along with implementation of central government policies for the city. The 24 districts of the city are subordinate to the Municipal Council, the main self-governing body of the city, and to the Mayor who is directly elected.

- Croatia has a longer tradition of local government management, a strong monitoring system by the national government, and a reasonable legal framework for local government management and finance. However, the economy and government remain relatively centralized and became somewhat more so during the war. The public sector retains a higher share of the economy than in comparator countries of Central and Eastern Europe, and local government expenditures represent a lower share of GDP (about 6 percent) than in either Bulgaria or Hungary (8 and 10 percent, respectively). [60] Municipal governments are charged with providing public services of a local nature, but in fact share primary spending responsibility for essentially all services with national and county governments. The municipalities such as Split have more experience in local government management than many other

[58] Limits on capital investment and borrowing as a share of own-source revenue were further reduced, to five percent, for all municipalities in 1999. (Report of World Bank mission, March 2000)
[59] "Sophia Urban Development Initiative Assessment Report".
[60] Expenditures of the general government actually rose from 39 percent in 1991 to over 50 percent of GDP in 1998, while they fell from 61 to 45 percent of GDP in Hungary between 1994-98. "Croatia Fiscal Decentralization: Overview and Issues Concept Paper", ECSIN.

cities in the Region, but their capacities to manage are hampered by excessive and unpredictable restrictions imposed by the national level.

The political context presents continuing issues of **inter-governmental** and **intra-city (cross-jurisdictional)** relations that are not readily resolved even in countries that have not experienced such rapid and dramatic change. The exercise of political power by local authorities representing parties in opposition to the ruling national government is one common source of contention. The Budapest municipality has encountered strains with the national government over the latter's commitments to co-finance a major urban transport project. The governing party in Bulgaria performed badly in local elections in 1999, which were marred by charges of corruption and subsequent central government investigation of alleged misuses of municipal spending for showcase projects rather than for designated social welfare programs in the pre-election period.[61] Metropolitan-wide management is recognized in the Budapest *Concept* as an outstanding challenge to ensure necessary coordination. The *Concept* proposes that a permanent forum for improving communications and cooperation with district governments be set up as an outcome of the strategic discussions, possibly akin to the Budapest Agglomeration Development Council which was recently established to address coordination issues with the surrounding subregion. One offshoot of St. Petersburg's strategy has also been efforts to coordinate policies with neighboring oblast regions.

The SPSP outlines objectives and actions for general strengthening of local governance through greater transparency and accountability to reduce incentives for corruption, greater participation of citizens and civil associations in the business of local government, and more public access to information on city administrative functioning. These are all essential reforms that are part of the maturing of local government systems and would merit from broad public consensus–building through city strategy processes.

2. Municipal Financial Performance—Trends and Issues

A general observation about decentralization in the transition economies is that it has tended to shift a much larger share of government expenditures to the sub-national level than revenues. This has created considerable financial pressure on the relatively young and inexperienced municipal governments, making more difficult their task of sustaining basic services in an environment of overall economic uncertainty and austerity.

Functions and expenditures. A first issue is the assignment of functional responsibilities for service delivery and resulting investments; this should generally be in line with the principle of subsidiarity, but equally important is clarity and consistency in roles across levels of government. Even where the legal framework and political will

[61] Economist Intelligence Unit, "Country Report: Bulgaria", 4th Quarter 1999. The EUI also reports that the Ministry of Finance's reaction to the irregularities was to suspend government transfers, from which most local revenue comes, until the local spending could be corrected. The same issue states that the Prime Minister is reported to be considering proposing constitutional amendments to give local authorities tax-raising powers to match their authority to spend. The controversy highlights the large role of the Center in local financial decision-making and the consequent difficulty of holding municipalities accountable.

allows for a reasonably sound allocation of expenditure responsibilities, the cities face major challenges to manage their vast but deteriorating physical assets (including infrastructure systems and municipally-owned property), and to deliver essential social and economic services in ways that are responsive to users yet more cost-efficient.

Ensuring an adequate and coherent social safety net, which is usually administered if not wholly financed by local governments in mature market economies, should be a major emphasis of city financial reforms. Reducing the burden of housing and utility subsidies on municipal budgets is an essential step. This requires not only raising tariffs and revising subsidy criteria as noted earlier, but also devising more appropriate sharing of overall social welfare expenditures between local governments and national government, since redistributive policy objectives are better shouldered by the latter. Cities will remain largely responsible for social services, such as health and education, which (together with transport subsidies) absorb 70 percent of the Sofia current municipal budget—largely for salaries. In Sofia, social welfare expenditures currently represent only 4.5 percent of the current budget, and in St. Petersburg "transfers to the population" have grown slightly from about 9 to 13 percent of current expenditures between 1997-1999.[62] Yet needs for such will inevitably increase as the economic transition process continues.

Improving city financial management also requires measures to introduce more commercial practices and private sector participation in municipal services, discussed in section (c) above, as achieved to a considerable extent in Budapest and as proposed in the St. Petersburg *Strategic Plan*. In many cases, the cities should also divest themselves of inherited municipal enterprises that do not carry out essential public services and should be privatized—for example, the City of Sofia owns 95 percent of a bank which operates essentially as a commercial lending institution. In Split a significant source of contingent liabilities for the municipality is guarantees to municipal-owned enterprises.

For the remaining core expenditures of the municipality, further reforms and capacity building are needed to introduce improved procedures for recurrent and capital budgeting, financial reporting, investment evaluation and programming, and asset management. Public participation and oversight in the setting of expenditure priorities and monitoring the use of municipal funds are important institutional developments that can be initiated in the public discussions of the action plan (including a prioritized public investment program) emerging from a city strategy formulation.

Revenues. With functions appropriately assigned, finance can more adequately follow. On the revenue side, transition cities have a long term task of weaning themselves from central government transfers, which in the slower-reforming countries are still based more on negotiation rather than objective criteria. In Bulgaria, the transfer system is already formula-based, although this could be simplified and made more predictable by basing it on actual budget outturns rather than forecasts. Budapest has managed to reduce its dependence on central government transfers from 71 percent of total municipal revenues in 1991 to 36 percent in 1997. Although part of this decline

[62] "Financial Situation of St. Petersburg", December 1999, Slide # 17, City of St. Petersburg.

reflected a deliberate policy of the central government to let the city "fend for itself", the change also gives evidence of the city's efforts to acquire shared revenues, privatization proceeds, and additional tax authority. The Municipality used a seven-year financial forecasting model to develop a political consensus around a realization of the city's structural deficit and the need to make fundamental changes, such as divestiture of some enterprises, mobilization of privatization revenues and local taxes, and tighter expenditure controls.[63] The Mayor views these financial restructuring efforts, with the emphasis on improving creditworthiness and forecasting resources realistically, as an essential precondition for the city to implement capital improvements within a broader development strategy.

Budapest gained income from privatization amounting to 10-20 percent of the Municipality's total revenues between 1995-1997 and used these proceeds primarily for investment in infrastructure and for structural adjustments needed to carry out the long-term strategy for fiscal sustainability.[64] Sofia receives privatization revenues from the Sofia Municipal Privatization Agency, which has already sold 80 percent of municipal assets and is expected to provide proceeds in 1999-2000 amounting to about 10 percent of the 1999 total municipal budget revenues. However, these sales do not include the infrastructure companies (for heating, water supply, solid waste disposal, transport), nor major enterprises such as the municipal bank or construction company, so there is still scope for additional private sector participations.[65]

The transition cities have more own-revenue raising authority than they have begun to exploit, both because of continued political sensitivity to the imposition of taxes, user fees or charges, and because of administrative and information weaknesses. In Bulgaria, all the local taxes are collected, and tax rates set, by the national government. The City of Sofia thus has little autonomy with these as opposed to other nontax sources (rents, fees, fines, etc.), although the latter category is necessarily limited in scope. In Croatia, most of the tax revenues of local governments come from shares of national taxes, although they are permitted to impose their own surcharges on national tax bases (up to 30 percent of their share of income and profit taxes for the larger municipalities such as Split).

Taxation of real estate property has considerable potential as an efficient and buoyant source of municipal revenues. However, property taxation is minor in most countries of the ECA Region (e.g., generating only 8.3 percent of own-source revenues for Sofia) and requires land market reforms, and improved real estate registration and valuation data, as discussed in section A.1. The Budapest *Concept* proposes the introduction of a citywide market-based property tax that would be an integrated instrument of the city's spatial development strategy.

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[63] This financial projection exercise was assisted by the French Credit Locale International Conceil. Demsky, op. Cit., p. 9.
[64] Ibid., p. 14.
[65] As explained above in the case of Hungary, privatizations of municipal infrastructure cannot be viewed primarily as a source of revenue gain, however, since these reforms must meet multiple public policy objectives. "Sophia Urban Development Initiative…", p. 27.

Access to capital market finance. The municipal reform agenda described here will improve creditworthiness and greater access for the cities to credit and capital markets. In ECA countries the regulatory frameworks for local government borrowing remain weak, and there is a lack of specialized financial instruments and institutions. Local government finance markets are therefore small and lag behind the development of the financial sector as a whole.[66]

Despite these shortcomings, many cities/local governments in ECA have tapped the international credit markets. Among the cities of focus here, St. Petersburg was the first, raising $300 million through a 5-year Euro bond; Budapest issued a DM150 million bond in 1998, and Sofia followed with a 50 million Euro-denominated 3-year note in 1999. The costs of access can be very high, however: whereas Budapest received a 57-point spread over the relevant benchmark for its issue, St. Petersburg faced a spread of 280 basis points at launching, and Sofia had to pay 700 bps.

The transition cities will need urban finance systems to be based on diverse sources and forms of finance, including intermediaries such as banks and specialized municipal finance institutions for loans, revenue-based project financing (on a non-recourse basis), and on the availability of credit enhancement mechanisms such as tax intercepts and debt pooling arrangements. Many risk factors remain to be addressed– for example, in Russia, municipalities continue to own banks from which they borrow despite legislation to the contrary.[67] Hungary is advanced among the transition countries in providing for municipal bankruptcy. Cities of the Region will need to pursue a balanced approach of developing their own creditworthiness and borrowing capacity alongside efforts of national governments to strengthen the prudential and regulatory context for municipal debt.

III. Conclusions and Implications for the Transition Cities and the World Bank

A. Conclusions from Cities' Strategic Efforts to Date

This paper has reviewed a wide range of issues facing transition cities over the medium term, with particular reference to four cities. What is clear from this discussion is that the challenges of pursuing transition in the spatial, productive and social fabric of the cities, carrying out consistent policies on fiscal decentralization, and even prioritizing investments in physical infrastructure in the context of EU accession represent a highly interrelated set of issues. It is interesting that even the apparently simpler problems of achieving SME growth and brownfield redevelopment in OECD countries have increasingly led those countries to adopt holistic, multidisciplinary, and partnership-based strategies and programs of action. The need to articulate a vision of goals and objectives,

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[66] Samir el Daher, "Europe and Central Asia: Finance Component", Paper prepared for the Prague 2000 project on "Urban Policy in Transition Economies", World Bank, March 15, 2000 draft.

[67] Burcak Inel, "Looking beyond the Crisis: Establishing a Regulatory Framework for Subfederal Debt in the Russian Federation", February 1999, Annex p. 3. World Bank, ECA Region, Private and Financial Sector Development Unit.

and to set priorities through consensus-building processes, is likely to be even more valuable for the transition cities given the multiple challenges and rapidly changing context they face.

Budapest and St. Petersburg reached this conclusion a few years ago and embarked on their strategic exercises, while Sofia and Split are still at early stages of considering a strategic process. For residents of Budapest, the greatest shocks of the country's macroeconomic adjustment and structural reforms are probably behind them. The city faces the future with a clear vision focused on achieving a more spatially integrated city in order to achieve objectives of economic, social and environmental sustainability. The process of developing the strategic concept and action plan has involved a wide reach to public and private participants, and has been accompanied by concerted efforts to achieve strong city financial base. The main priority is now the actual implementation, in particular to focus on key actions that need to be taken in the short term, such as mobilizing public and private investment to begin redeveloping certain pivotal sites in the transition zone of the city, and redressing the decline of public transport, before certain options are lost to realize the desired medium-term spatial transformation.

St. Petersburg's *Strategic Plan* conveys the participants' justifiable pride and commitment to preserving and enhancing the city's historical legacy and pivotal role as a regional and international gateway. Alongside the production of the SPSP, essential actions to strengthen the city's financial and management capacity have been initiated with considerable technical assistance, and more needs to be done to put the city administration on a solid footing to lead the implementation of the strategy such as Budapest and St. Petersburg have already undertaken.

What is also evident from the review of issues facing the cities is that realizing strategic visions requires concerted action and collaboration by a range of actors both outside and inside the city limits. Three kinds of examples come to mind. First, because each city functions within a local region, reaching agreement with neighboring jurisdictions and understanding the impacts of developments within one urban zone or municipality on others is necessary for many issues, especially regarding transport, spatial shifts of population and environmental spillovers. Awareness of this regional context is as important for major cities such as Budapest that dominate their surroundings, as it is for small cities that are more dependent on them. Second, many actions can also not be undertaken by a single municipality because they would be too costly or inefficient to replicate—for example, providing major sanitation investments or setting up institutional support systems for SMEs. Therefore, associations of cities can be important partners both to implement certain concrete actions as well as to share information on innovations and experiences. And third, many of the policy reforms needed to undergird city transformation fall inevitably at the national level—especially concerning housing sector reforms, fiscal frameworks, private sector participation in infrastructure, to name a few. Thus, strategic efforts lead by city governments are valuable to establish priorities and gain widespread support for action but they need to be

supported by a broader political and administrative network in the country, and even from neighboring regions.

B. What a World Bank Role in City Development Strategies Would Imply

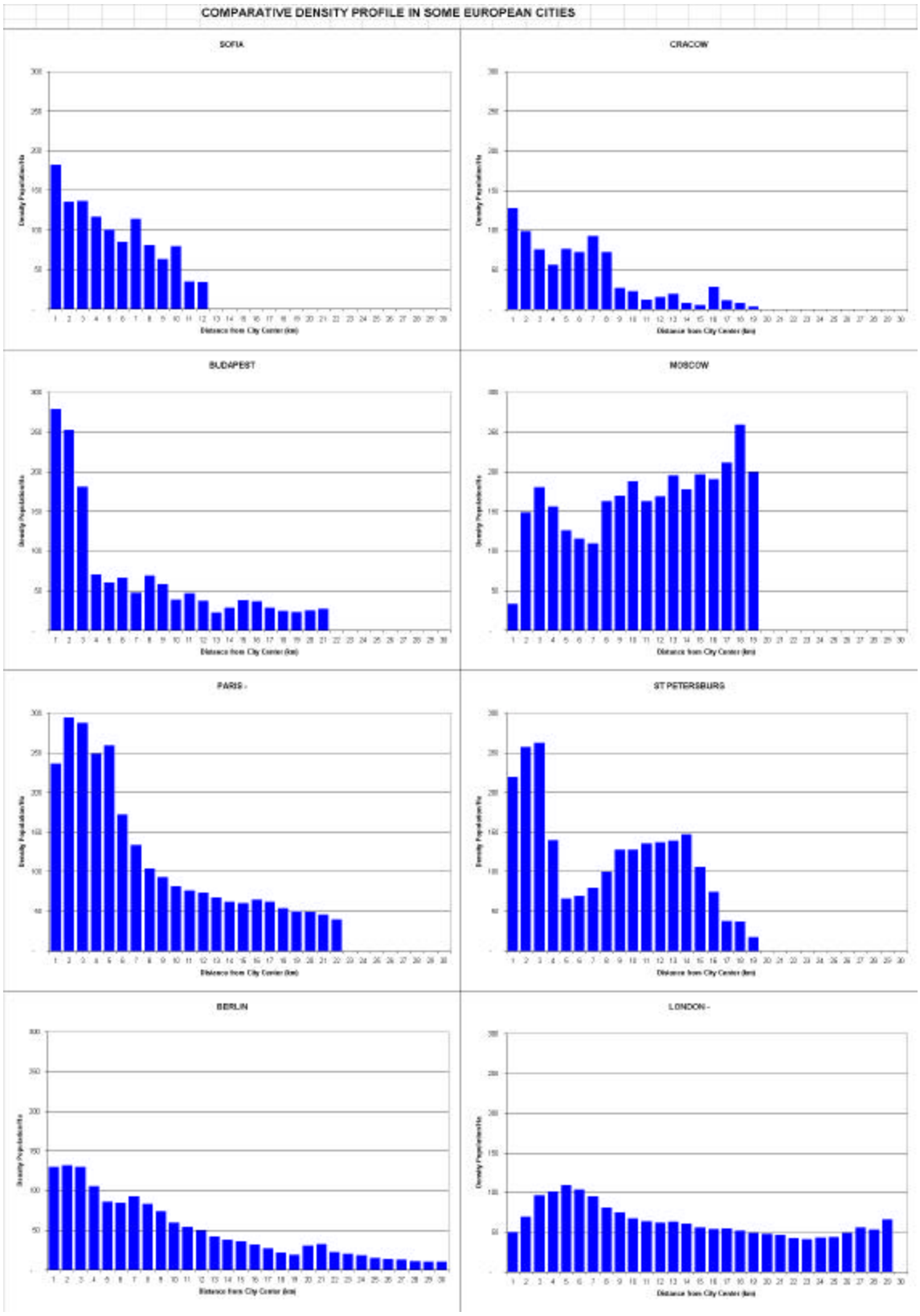
The World Bank's relatively new involvement in supporting city development strategies (CDS) presents a potential opportunity for local governments in the ECA Region. Although CDS must be locally-initiated and owned, the Bank can perform a useful role in CDSs at several points, both in terms of finance and of technical assistance.

- First, the Bank can facilitate certain elements of the participatory process, for example by acting as a neutral convener of discussions among stakeholders or by helping to connect the strategic working group with key external parties that may have useful experiences and perspectives to contribute.

- Second, the Bank can help with technical inputs on aspects of the information analysis that forms an important foundation for the strategy—for example, by assisting in the collection of relevant baseline and comparative indicators, or in design of stakeholder surveys. The Bank can also be instrumental in helping the local parties to identify appropriate policy issues and actions that pertain to the goals and objectives chosen by the strategic exercise. For example, a vision of spatial transformation for a city can be stymied by a combination of regulatory constraints (such as zoning details) that are not necessarily obvious to all local parties. A CDS should be seen as an approach for pointing out needed policy and institutional changes as much as for priority investments—and, where critical constraints appear at the national level, the Bank can add its good offices to seek changes.

- Third, the Bank can assist in creating the conditions for mobilizing finance for the resulting action plan, or for providing resources itself where appropriate. The Bank's ongoing dialogue with many cities and countries in the ECA Region on fiscal and capital market developments can therefore acquire a special impetus in the context of a CDS exercise. And, the Bank's traditional function as source of project finance could be more cost-effective when based on a widely-shared process of prioritizing investment needs.

Figure 1: Comparative density profiles in some European cities



Source: Alain Bertaud, Figure 6 in "Sofia Urban Development Initiative: Assessment Report", Draft memorandum.