

# **Integrating Public Property in the Realm of Fiscal Transparency and Anti-Corruption Efforts**

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## ***1. Introduction***

Governments own an impressive range of property: real estate (land, public housing, water distribution systems, roads, office buildings, etc.); movable property (vehicles, equipment), and whole enterprises. While thinking about governmental property, it is useful to keep in mind two important aspects – legal and financial. The legal side is related to how governmental ownership of property is defined, documented, and protected. It also defines whether and how governmental property can be alienated (sold, leased, mortgaged), what kind of limitations exist on uses of governmental property, etc. The financial side is related to a very broad area of how governmental property is (or isn't) incorporated into financial reporting (accounting) and financial planning (budgeting). In accounting terms, from the balance sheet viewpoint, real estate and movable property constitute fixed (or capital) assets that are, as a rule, the main part of non-financial assets on governmental balance sheets. Such particular types of capital assets as land, buildings, infrastructure, and equipment are usually distinguished as separate lines on the balance sheet, while other types are often added, depending on local specifics (for example, a specific asset type can be “art work” or “municipal housing”).

Asset management of public property is understood as the process of making and implementing decisions about property acquisition, use / management, and disposition. Until very recently, public property asset management had been very non-transparent, inefficient, and not sufficiently integrated in public financial management even in the most developed countries and their cities. Over the last decade, however, new approaches to public property have emerged that apply standards of economic efficiency and effective organizational management.

This paper discusses a specific range of issues related to integration of public property asset management into fiscal transparency and anti-corruption efforts. The paper considers issues related to property owned by all levels of government (central, local), but also focuses on some specifics associated with municipal property (property of local governments).

## ***2. Why Is Integration Important?***

Fiscal reasons. To appreciate importance of government-owned property, it is useful to look at governmental balance sheets. This would immediately demonstrate a fundamental fact: public property represents the largest portion of public wealth even in countries that slimmed down their property holdings. For example, the federal government of Australia, which is among the world's few advanced reformers of public asset management and privatized very large portfolios of governmental property (Conway 2006), by mid 2003 still had 48.3% of the value of its assets held in non-financial assets, mainly infrastructure, equipment, land, and buildings. At the level of local governments, at least urban, the share of non-financial assets among all assets is normally even higher. It varies from 50% to 99% of the total balance sheet, as examples below demonstrate:

<i>City:</i>	<i>Value of capital assets, as % of total assets on city's balance sheet:</i>
<i>Dallas, Texas, USA (2003)<sup>1</sup></i>	<i>81.4%</i>
<i>Varazdin, Croatia (2000)<sup>2</sup></i>	<i>60% (plus 8.3% in shares in companies)</i>
<i>Ostrava, Czech Republic (1996)<sup>3</sup></i>	<i>93.3% (plus 6.2% in shares in companies)</i>

In post-socialist countries, there are additional specifics that magnify importance of public property, especially for local governments. First, value of public property compared to an annual public budget can be substantially higher than in developed market economies. Second, authority of local governments over municipal property is often higher than their authority over budgets. This happens because fiscal decentralization is not completed yet in many countries. Local governments do not have truly independent local budgets and taxes, but they can acquire and dispose of municipal property quite independently.

Unfortunately, there are endless examples illustrating that governments of all levels in all types of economies often under-use a fiscal potential of their property. A common systemic problem is that principles of good financial management are not applied to public property assets, except in a few most advanced countries (Australia, New Zealand). As a result, the following weaknesses are typical for property asset management:

- ❑ Property related expenses are not monitored and not managed in any systematic way. High administrative costs are usually not recognized, not monitored, and not managed (for example, administrative duplication and fragmentation of asset and property management and low productivity of public employees)
- ❑ The revenue potential of public properties is substantially underused. This is a problem world-wide, and not just in former socialist economies (for example: obsolete properties are retained in governmental ownership instead of being privatized; public property is leased out to private tenants at prices below market; etc.)
- ❑ True market value of assets is not recognized and not maintained (there is huge deferred maintenance and repair associated with public property everywhere, which leads to loss of public wealth concentrated in real estate).

On the other hand, some local governments (for example, in some Chinese cities) have been very entrepreneurial and managed to unlock market value of their lands and leveraged this value for raising capital investment in urban infrastructure, sometimes using their monopolistic position in land supply for going further than would be prudent (Peterson, 2006).

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<sup>1</sup> According to G. Peterson (2006)

<sup>2</sup> According to O. Kaganova et al (2001)

<sup>3</sup> According to O. Kaganova, R. Nayyar-Stone, and G. Peterson (2000)

Corruption and conflict-of-interest related reasons. Another fundamental reason for integrating management of public property assets into systematic anti-corruption efforts is that this area or public management has been traditionally known as prone to corruption, abuse, and conflict of interest. Cases vary widely – from legal, but bad practices (for example, political parties that won local elections providing free-of-charge municipal premises for themselves (Serbia)) to direct corruption associated with allocation of municipal vacant land, built-up properties, and contracts to private sector actors.

Moreover, this traditional reality turns to be reinforced by the existing regulatory environment. A recent study by Barbara Kudrycka (2004) in six countries (Bulgaria, Latvia, Poland, Romania, Russia, and Slovakia) revealed that the use of municipal property is among the least protected from conflict-of-interest abuses, comparing to other areas under the jurisdiction of local governments.

### *3. Causes and Channels of Forgoing Public Benefits*

It is important to recognize that inefficiencies in public property asset management take place for many various reasons, and not necessarily because of corruption. At the same time, inefficiencies of all types unavoidably translate into forgone public benefits, regardless whether or not this loss is evaluated in financial terms. Therefore, measures for mitigating inefficiencies should aim for removal or reduction of all types of inefficiencies, and not only the criminal part of the “inefficiency spectrum.” The following classification covers most causes and channels of forgone public benefits:

- Honest incompetence. Managing highly diversified portfolios of public real estate requires quite sophisticated professional qualifications, while governmental employees tasked with property asset management usually don't have even basic background in property and portfolio management.<sup>4</sup>
- Lack of proper incentives for public sector agencies and staff. One of the most common examples is a direct disincentive for governmental agencies or levels of government to privatize surplus real estate: proceeds from property sales go fully or by a substantial part into budgets of other agencies or levels of government. This situation has been typical for both developed countries and transitional economies. In addition, local governments in countries in transition often have another disincentive for property privatization: they do not have much control over the property tax imposed on privatized properties, but may define lease rates if they retain properties in municipal ownership and lease them out.

Another universal disincentive is that compensation of governmental employees in most countries does not depend on their performance. In particular, it does not depend on whether they manage their properties and property portfolios efficiently or not.

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<sup>4</sup> Very interesting examples of innocent but costly mistakes that can be caused by lack of professional expertise are provided by John Hentschel and Marilee Utter (2006) regarding the City of Baltimore (USA).

- Inadequate legal and regulatory environment. As a rule, until efficiency-oriented reforms of public asset management are introduced, historically-developed laws and regulations are simply not relevant for efficient asset management. This is true for most developed countries, including the USA and Roman Law countries (France, Switzerland, etc.), where the body of law has been developing historically based on social values and principles that are different from economic efficiency in the public sector. In other words, from the efficiency viewpoint, this area of public management is either over-regulated or under-regulated, or both at the same time. Only recent, consciously-designed reforms (for example, in Australia, New Zealand, the UK, and, to some extent, France) started introducing economic and financial efficiency as a basis for the regulatory regimes related to public property. In transitional and post-transitional<sup>5</sup> countries, the regulatory regimes are far from being balanced as well.
- Influence of politics. Politics are very much at the heart of government decision-making when it comes to managing real property assets. Politics set this area apart from the private sector and make it difficult to apply asset management models from the private sector. As Hentschel and Utter (2006) acutely noted, eliminating political influence from governmental decisions “is like removing sand from the beach.” Politicians often have legitimate and appropriate concerns about the management of public property, from promoting economic development to responding to concerns of their constituents. As a result, policy priorities may lead to solutions regarding governmental real estate or investment not optimal from purely financial and real estate viewpoints. At the same time, there are numerous examples all over the world when politics lead to decisions that do not represent - in any sound way - public interests or public policy. In addition, there is an obvious timing gap between a relatively short political cycle and a substantially longer time needed for strategic asset management.

So, what should emerge as a subject of public debate is whether it is feasible and desirable to introduce binding policies, rules and regulations related to asset management that would reasonably protect public property from decisions stemming from partisan or biased politics. It seems that regulations regarding federal property in Australia provide a promising illustration that evolution in this direction is feasible (Conway 2006). Also useful to note that countries and cities in Eastern Europe can become a major world laboratory in this area, because their asset management practices are less loaded with historically rooted approaches.

- Legitimized conflicts of interest. Quite often, legal actions of governments or governmental officials constitute what certainly can and should be recognized - from the public interests and efficiency viewpoints - as bad practices or direct conflict of interest. For example, in Serbia, political parties that win at local elections, headquarter themselves in business premises in municipal buildings (usually, at prime downtown locations), as free-of-charge tenants. In Croatia (at least, until recently), local officials could legally own up to 25% shares in municipal companies.
- Corruption and favoritism. Corruption and favoritism in the area of public property is such an old story that it has made its way into literature classics.<sup>6</sup> No doubt, societies across the

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<sup>5</sup> Those ex-socialist countries that have been admitted into the European Union.

<sup>6</sup> For example, *All the King's Men* by Robert Penn Warren.

world are trying to curb this area of corruption, in particular by introducing laws on competitive and transparent public procurement. However, corruption associated with public property, and, in particular, with sales, leases and other forms of allocating rights in public property to private economic actors is still alive in many countries. It remains a major problem in most post-Soviet countries, some transitional countries in Europe, and China.

#### ***4. Approaches to Protecting Public Interests, Increasing Efficiency, and Reducing Corruption***

Obviously, increasing efficiency in such complex area as property asset management and curbing corruption requires actions along many lines. Furthermore, there are specific tasks associated with different levels of government. Finally, a focus on protecting public interests brings to the forefront the public debate on specific issues.

#### **4.1 Reform Framework for Central Governments**

The issue of increasing overall efficiency of asset management has been the focus of asset management reforms undertaken in several countries. The generalization of their experiences allows the creation of a “composite image” of the reform framework applicable to property assets of both central and local governments (in the latter case – with some modifications).<sup>7</sup>

##### **Explicit Public Policy**

Reform measures must be driven at the highest level of government by a clear, explicit policy framework applicable to all public real assets under control of a particular level of government (central, local).

##### **Recognition of the Cost of Fixed Asset Ownership and Use**

It is no longer acceptable to view public property as a “free good”; there is a cost associated with its use and this cost must be recognized and managed explicitly. There is broad consensus that the cost of operating and maintaining fixed assets—especially office accommodation, infrastructure, vehicles, and office equipment—should be recognized and addressed explicitly. Occupancy costs—implied or actual rent—also tend to be recognized, but some countries do not apply this to all publicly-owned office space. There is more variation in the approach to recognizing and managing the costs associated with the ownership of fixed assets. This includes three separate issues: valuation of the asset, depreciation, and cost of capital. Consistent with the focus on the opportunity cost of holding a fixed asset, most of the country-reformers have instituted a continuing process of identifying assets that are no longer needed or where ownership is no longer justified on economic grounds. In these cases, there is a process for disposing of the assets, usually at or near market prices. Finally, life-cycle costing is used as a practical and effective way to manage the costs of asset ownership and use. This technique looks at all phases of ownership of an asset, encompassing

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<sup>7</sup> Draws upon F. Conway, O. Kaganova, and J. McKellar (2006) who generalized the reform experiences of Australia, Canada, France, and New Zealand.

acquisition, ownership, and disposal and includes not just the production or acquisition costs, but also costs to operate and maintain the asset.

### Information Systems

Lack of data or incomplete data is a major impediment to launching any reforms. Not knowing exactly what government owns, the occupancy levels associated with each property, property characteristics, operating costs, and maintenance requirements is an immense barrier to progress. Information should be relevant to overall approaches to reformed asset management and has to be effectively managed. However, specific approaches to asset management information (in particular, its centralization or decentralization) vary across countries- and cities-reformers.

### Accountability Mechanisms

Accountability involves overall stewardship of assets, and this means effective mechanisms to measure results and an accounting system that will drive effective decision-making at the level of the custodian. Government must be able to hold asset managers accountable for the assets in their custody and be assured that these assets are serving their intended purposes and achieving targeted results.

### Decentralization of Management Responsibilities / Strengthening Central Leadership Role / Incentives

In general, countries-reformers have delegated a lot of authority to individual institutions and agencies. However, this decentralization is carefully paired with various incentives and penalties (or performance benchmarks) built into the system along the whole chain, to stir decision-making at and performance of asset managing entities toward effective implementation of policies and principles established centrally.

Concurrently with the decentralization of management responsibilities, these countries have moved to strengthen the role of the central policy and monitoring and evaluation functions. As much of policy oversight is accomplished through an overall budget process, it is often a central institution that assumes the policy function, such as the Ministry of Finance in Australia or Treasury Board in Canada. Audit agencies, such as the Auditor General in Canada or the National Audit Office in Australia, have an important role in advocating the need for the reforms and program monitoring, although the audit function has no decision-making or policy formulation responsibilities. Both the budget and audit processes maintain a continuing process of evaluation, as all countries recognize that their reforms are breaking new ground where there are no sure and proven performance benchmarks.

Another important instrument for leading reform, especially on technical issues, is involvement of professional organizations that often help the central government entity that leads reform to identify technical issues that should be addressed and develop related guidance and standards.

In new systems of decentralized management, the central institutions with broad functions of asset management do not necessarily disappear, but their procedures have been modified and adjusted to be more consistent with a system of decentralized management. For example, in Australia, the Property Management Branch within the Department of Finance and Administration also works in a

competitive market since the governmental tenants are not forced to use the services offered by Branch's asset manager, United.

### Privatization Initiatives

“Privatization” involves two separate initiatives: asset disposition and private asset management. Asset disposition is the identification and disposal of assets not required for government programs and functions (surplus property), and private asset management is the engagement of the private sector in managing government-owned assets, where cost savings and efficiency in the delivery of services by the private sector are clearly demonstrated.

Asset Disposition. For varying reasons, governments are prone to retain control over economically or functionally obsolete assets (such as military bases that date back to World War II or, in transitional countries, assets from social and commercial activities that are no longer under government control) or engage in acquisition / investment projects not needed for their core activities and programs. These surplus assets are an important case, and experiences of the countries-reformers have common threads that provide examples of possible approaches to the issue:

- Clear policy guidance to help identify what assets fall into the surplus category. Identification can be according to a broad statement of principles as in the case of Canada, or more specific quantitative or detailed guidance as in the case of Australia. The point is that a government must explicitly declare that it will not retain ownership of assets that are not required for its programs. Typically, these policies will also apply to the acquisition of new assets so that the government does not continue to accumulate surplus or unproductive assets.
- Clear, written rules for the disposal of surplus assets. These rules can be a specialized law that assigns responsibilities and defines procedures for asset disposal. In the four Western countries studied, the disposal must be at market prices, except in the case of explicit circumstances that require special authorization.
- Some countries have established a special agency that is responsible for putting the assets on the market. In some cases, this agency may take some preliminary steps to prepare the asset for the market in the expectation that this will enhance its value.

Private Asset Management. Reform governments have sought not just to import best practices for management of the real property assets from the private sector, but to actually turn over management responsibilities to private sector firms and to sometimes remove themselves from these tasks completely. This removal ranges from outsourcing of selected services, such as property management or brokerage, to wholesale transfer of asset management and property management responsibilities such as done in Australia.

## New Accounting Practices

Traditional cash accounting may have served the central requirements of public budgeting but it did not enable sound decision-making among asset managers. The move to accrual accounting and the requirements for asset valuations began to address a number of weaknesses typical for cash accounting.

Experience of advanced reformers demonstrates that implementation of comprehensive asset management reform at central governments takes substantial time (years, if not dozens of years) even in countries with a strong and consistent political will to proceed. The biggest challenge – and perhaps biggest differences among countries – is related to sequencing the elements of reform.<sup>8</sup>

## 4.2 Municipal Asset Management Framework

Guidance on municipal asset management is an urgent necessity because in former socialist countries, public property has been decentralized on a grand scale as a part of government decentralization. Among 26 countries in Eastern and Central Europe and former Soviet Union, about  $\frac{3}{4}$  have legally established a separate form of property – municipal property (Kaganova 2006). There is no comprehensive statistical or fiscal information on property transferred into municipal ownership (Peteri 2003), but all empirical evidence shows that local governments in most countries became owners of huge property portfolios – directly and through ownership of communal and utility companies. A useful framework for municipal asset management was suggested in the Urban Institute publications (for example, Kaganova, Undeland 2006) and is reproduced below (Table 1).

It is important to emphasize that effective use of this framework implies that municipal property has reasonable autonomy and legal and regulatory base established by central government. Also useful to notice that the frameworks in the previous section and in Table 1 overlap conceptually to a very large extent (for example, both recognize the need to have explicit policies, incentives for asset managers, inventory records, etc.)

### *Table 1: Framework for Municipal Asset Management*

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<sup>8</sup> This subject is discussed in the chapter from which the above reform framework is drawn.

<p><b>Inventory Component</b></p> <ul style="list-style-type: none"> <li>— Develop and maintain comprehensive records of properties owned by the local government (including properties managed and used by various municipal departments and enterprises)</li> </ul>
<p><b>Property Management and Accounting Component</b></p> <ul style="list-style-type: none"> <li>— Develop and maintain a property management and accounting system on a property-by-property basis (including all revenues, costs, and occupancy / tenants records)</li> <li>— Include the value of each property in the accounting database, and include financial liens against each property</li> <li>— Formalize in writing the relationships regarding property with all tenants/users of municipal property</li> <li>— Use private-sector property management approaches for improving public property management</li> </ul>
<p><b>Asset (Portfolio) Management Component</b></p> <ul style="list-style-type: none"> <li>— Formulate a strategic role of real estate in attaining municipal goals</li> <li>— Develop classification of property by its role in performing governmental functions and apply this classification while conducting an inventory</li> <li>— Develop and use class-specific financial tools and performance standards</li> <li>— Monitor property and portfolio financial performance</li> <li>— Implement a portfolio management approach, including proactive management of social use and surplus portfolios</li> <li>— Make transparent rules on how municipal property (including land) is allocated to third-party (private, nongovernmental) users</li> <li>— Develop and implement policies aimed at rationing property demands and consumption by governmental departments and social users</li> <li>— Make asset management accountable through regular reporting</li> </ul>
<p><b>Strategy Implementation Component</b></p> <ul style="list-style-type: none"> <li>— Establish a centralized real estate authority with overview or direct control over asset management</li> <li>— Devise written policies and decision-making roles for the acquisition/holding/disposition of assets</li> <li>— Develop in-house real estate expertise and use outside real estate professionals as needed</li> <li>— Set up incentives for more efficient use and management of municipal property assets</li> </ul>

Again, as in the case of the central government reform, the framework in Table 1 is quite ambitious and requires time to implement. However, any local government can select items from this “menu” that have the highest priority in local circumstances and are politically and administratively feasible to start with. This “tailored to local realities” approach proved to work well in a number of transitional countries (Croatia, Kyrgyzstan). For example, a sub-set of activities from the above list implemented, to various degree, by several cities in Croatia (Varazdin, Split, Rijeka, Karlovac, and others) as “Initial Asset Management Model” included 11 elements (Box 1).

### 4.3 Focus on Transparency, Anti-Corruption, and Overall Efficiency

Even for countries with established democracies and developed economies, improving management of public property assets represents multiple challenges. Is the task

daunting and impossible for countries with emerging democracies and transitional or developing economies, and in particular, for their local governments? Not really -- there are approaches, instruments and techniques (some of them relatively simple) that can truly improve the anti-corruption climate and overall efficiency.

Many violations of public interests on the corruption and conflict-of-interest end of the “inefficiency spectrum” take place at specific moments in the property life cycle: (i) property acquisition (or other capital investment, such as reconstruction), (ii) property disposition, and (iii) allocation of partial rights in property to third parties (use, lease, transfer to municipal enterprises). This is where anti-corruption mechanisms should be built into the asset management process (Peteri, Schaeffer 2007).

Some of main anti-corruption and efficiency-oriented approaches are suggested and discussed below, with a focus on applying them to municipal property.<sup>9</sup> However, similar approaches are applicable to property owned by other levels of government as well.

#### A. Introduction of systematic transparency into municipal property

This, in turn, should proceed along a number of directions:

##### *Transparency of information*

Pure facts about municipal property, if properly disclosed, constitute a very powerful instrument of making local governments accountable (Box 2).

#### **Box 1. Croatian Cities: “Initial Asset Management Model”**

1. Introduction of an information system on the property-by-property level
2. Transitional issues
3. Property classification
4. Real estate and business appraisal
5. Operating statements for income-generating properties or portfolios
6. Intensive financial analysis of portfolios, properties, and projects
7. Deregulation of business Rentals and Improvement of Rental Practices
8. Quantification and monitoring of direct and indirect property-related subsidies obtained by tenants and users of local government’s real estate
9. Reporting on property
10. Management consolidation
11. Comprehensive asset management plan

#### **Box 2. Power of Information Transparency**

An inventory of municipal land in one of Kyrgyzstan’s cities revealed that 86 hectares of municipal land were allocated to 178 various private land tenants (legal entities and physical persons) free-of-charge, which was against the law and also represented a really large portion of land, given that land leases made up only 11.5 he. When this information was presented to Mayor, he paled, literally, because he immediately recognized negative legal and public relations implications – in addition to forgone revenues for the city budget.

<sup>9</sup> Readers will easily recognize that all anti-corruption and efficiency-oriented approaches listed below in items A-F are fully compatible with the framework of good asset management suggested in Table 1. These approaches can be interpreted as specific justifications or technical solutions for the framework in Table 1.

Specifically, for the transparency of information, we recommended:

- Inventory municipal property assets (buildings, land) directly controlled by local governments and budgetary organizations. Open the inventory records to the public and mass media
- Establish, maintain, and open to the public and mass media:
  - A directory of all tenants (users, lessees) of public property (including land), with key characteristics of tenancy (for how long, at what price / payment)<sup>10</sup>
  - A directory of all acquisition and disposition transactions with public property (from whom acquired, for which price, and through which procedure; similar for dispositions)
  - Quantitative, project-by-project information on municipal capital investment and borrowing
- Introduce at least annual reports on municipal property, which would be presented to local elected councils, published and made available to the public; they should be quantitative and specific and summarize information on property portfolios, transactions, and investment.

### ***Transparency of procedures and decisions***

All rules regarding allocating public property to non-governmental users should be in writing and made available to the public. Further, the public should have access to key events related to public property, such as meetings of city government and auctions or opening of sealed bids.

It's impossible to overestimate a leading role that mass media and watchdog groups can play in building public demand and expectations regarding transparency. At the same time, a requirement of public disclosure of information and opening procedures to the public should not be left to journalists alone and should be codified in law, as discussed further.

Further, broad awareness and education campaigns are needed: even for formulating requests for information or disclosures or asset management reports, some technical knowledge is needed, which is lacking in most countries in general. Hence, a need to educate governments, the public, watchdog groups, and mass media.

### **B. Use of competitive procedures**

All real property purchases, sales, leases to non-budgetary tenants should go through competitive procedures and at market prices. It is important to notice that here lies one of the important

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<sup>10</sup> A lot of corruption, favoritism or conflict of interest happen through allocating public property to various users under “preferential conditions,” which often implies free-of-charge or for below-market prices. Disclosure of information on conditions

differences between countries with low corruption (such as New Zealand or Australia) and countries more prone to corruption. In non-corrupt countries, it is sufficient to require that public property is disposed at market prices estimated by independent appraisers, but not necessarily through open competitive procedures. In countries with high corruption, use of independent appraisers does not work well, and open auctions or sealed bids are an absolute necessity.<sup>11</sup>

### **C. Adherence and enforcement of existing laws**

A common problem is that even laws that already exist and should protect public interests are often not followed in local government practices. Specifics vary broadly, but here are some examples:

- Competitive procedures of leasing and selling properties are required but not applied
- Income from property sales (capital income) has to be used for capital investment, but instead is used to cover deficits of operating budgets
- The public is not informed and not admitted to local government meetings approving property decisions.

### **D. Attention and spotlight on municipal enterprises**

Municipal enterprises are the least monitored and supervised part of local government asset management (Hegedus 2004; Kasso and Pergerne-Szabo 2004). This has led to massive loss of potential revenues for public budgets and loss of assets, as reviewed by Olga Kaganova (2006). Improving governance of public enterprises and finding alternatives to them (such as outsourcing service provision to the private sector) is one of central challenges of asset management. Discussing this topic would go well beyond the scope of this paper. However, some general directions are: inventorying assets, improving financial management and reporting (in this case, to a founder, local government), and fully disclosing to the public the assets and financial performance of the enterprises.

### **E. Improving financial management of public property**

This is a broad technical issue. The core idea, however, is that a large portion of honest inefficiencies in asset management originates from the fact that financial management of property assets does not exist in local governments. For example, as indicated in the beginning of this paper, local governments do not know and even don't try to know full operating and maintenance costs associated with each property (building, facility). Rational and efficiency-oriented decisions are impossible in such a situation.

### **F. Creating competitive pressure, deregulating property use and prices, attracting professionals and the private sector**

These elements are all important for increasing efficiency.

Given enormity of work that should be done to improve efficiency of asset management, it is important to start some key efforts – such as monitoring operating expenses on property-by-

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<sup>11</sup> For example, comparison of prices obtained for municipal land sites sold through “direct sales” at estimated market prices and on auctions in one of Kyrgyzstan’s cities with a very active real estate market demonstrated that auction prices were, on average, at least 40% higher than “appraised” prices for similar sites.

property basis or outsourcing municipal services to private providers – from properties and services where most fiscal benefits can be expected, without high risks involved.

## 5. *Issues for Further Public Debate*

Reforming management of governmental property assets is a clearly growing area within public sector reforms. It has a broad span, from policy and technical debates to experimentation with various instruments and techniques, including such advanced instruments as public-private partnerships and private finance for public infrastructure. Some issues have been revisited over time, due to evolution of broader views on the public sector role and accumulation of new evidence. Furthermore, reforming public property asset management is an ongoing process that brings new challenges as it proceeds. For countries in transition, several issues should be discussed within the specific context of this paper.

1. ***Should devolution of property from central to local governments take place, especially given multiple evidence that local governments often do not do good job of managing property assets?*** Regarding real estate, the answer seems to be “yes”, from both viewpoints: efficiency and anti-corruption. Real estate is always a local matter, and it is impossible to manage properties efficiently from the capital. Besides, holding local officials accountable for property mismanagement is easier than faceless somebody in the capital. A couple of recent examples can illustrate this point (Box 3).

An important caveat, however, is that governments (of any levels) should not be encouraged to retain surplus properties and should be de-incentivized to do so.

### ***Box 3. Is Central Government Better Owner than Local Government?***

Serbia. Municipal governments have to request permission from the central government agency to terminate any lease agreement, even if it is just for 15 square meters in a basement, and tenants chronically do not pay rent. Such requests go unanswered for months, if not years. This nullifies any economic efficiency of surplus rental property.

Kyrgyzstan. One city government was asking the central government to transfer a movie theater into municipal ownership, which had been non-operational for several years<sup>1</sup>. The local government was going to convert the building into multi-functional public center. However, the central government continued to retain the property, without providing any maintenance or security. When the city mayor took the author of this paper to the site, building was deconstructed and stolen brick-by-brick down to its foundation.

Regarding municipal services, such as water supply, the answer is not obvious, and the issue is a subject of hot international debates. In many low-income countries, local governments do not have expertise and capacity to govern and operate water companies, and other models can be more efficient.

2. ***Is a special legal regime for public property justified?*** Many Western European countries have a special legal regime applicable to property used for public purposes – property in “public patrimony” in France or “administrative” property (“patrimoine administratif”) in Switzerland. The property of this type is, in general, not alienable, i.e. cannot be disposed of or used as collateral and

also may have limitations on use and management arrangements. However, there are special procedures that allow removal of property from the public patrimony. For example, in France, this can be done by either enactment of special legislation or through two-step process of declassification from the public domain (Bizet 2006). Governments in most such countries may also own properties subject to a private sector law (i.e. regarding these properties, rules are the same as for private property owners). Which particular properties are included in the public patrimony varies by country. For example, in France, market places are in public patrimony, while in Switzerland they are not.

In the beginning of transition in Eastern and Central Europe, some experts from Western Europe strongly discouraged use of the “public patrimony” concept in transitional countries as highly inefficient economically. Their reasoning was that economic realities require regular changes in property use (for example, due to changing demographics, a school building might be not needed any more), while the declassification from public patrimony is a long and expensive process, largely reducing economic efficiency associated with governmental property.

Nevertheless, some countries in Eastern and Central Europe (at least, Bulgaria, Czech Republic, Hungary, Romania, and Slovakia) reproduced this concept, in one form or another, while introducing laws on municipal property. Some researchers later discussed that in Hungary this concept did not seem to add to the security of public property, because declassification can be easily performed by local governments (Kasso, Pergerne-Szabo 2004).

The question for further debate is: Given intrinsic economic inefficiencies associated with asset management decisions regarding properties in “public patrimony,” is the use of this legal form justified by gains in property protection? Can sufficient protection of public interests be achieved under more flexible legal arrangements? For example, should law require that any disposition or mortgaging of public property be pre-approved by elected local council?

3. ***Lease of public property as a potential source of losses for both public and private sector.*** Many local governments in transitional countries tend to retain surplus properties (commercial space, housing) and use these properties for income generation through short-term leasing. Furthermore, some governments prefer retaining urban land in public ownership. It is important to recognize that public ownership of land, with only partial rights (such as lease rights) allocated to private actors, is still dictated by law in some countries (China, Ethiopia). However, in most transitional countries private land ownership is recognized by law, and urban land is already substantially privatized. Nevertheless, retaining land in public ownership and allocating to investors long-term lease rights only continues to be a policy of choice for many local governments, with the City of Moscow being the most famous case. Though proponents of privatization are trying to argue about inefficiencies and other negative implications associated with the broad use of this leasing model, many local governments continue to grip onto surplus built-up properties and land.

No doubt that further education of local governments and the public is needed to demonstrate the types and scale of losses associated with this leasing model. The subject of splitting “legal rights” (retained by government) and “economic rights” (held by leases or investors) has been discussed internationally by real estate analysts, both conceptually (Barzel 1997) and practically (for example, Jieming Zhu 2002). They have demonstrated how the leasing model creates negative implications, including non-productive costs, reduced property values, and inefficient land usage. Examples of inefficiencies are astonishing (Box 4), but often not quantified. Governments – as mentioned in the beginning of the paper – do not know full financial results related to their rental portfolios. Hundreds of former socialist cities do not know how much it costs to them to operate portfolios of dozens or hundreds of even thousands of business rentals, many of which produce either direct losses or insufficient returns on investment. Cities also do not monitor how wealth accumulated in this real estate is dissipating (lessees, with their short-term leases, do not have any economic reasons to invest in maintenance and repair).

**Box 4. Inefficient Portfolios of Municipal Rental Properties**

One of Croatian cities, when its government decided to improve its asset management, made an effort to figure out the full costs of leasing each of its 59 business rentals, estimated market values of these premises, and estimated capitalization rates for each premises. The result was shocking for managers themselves: it turned out, that 19 out of 59 premises had negative net income (the city was just losing money by leasing them!), and only 9 premises had the capitalization rate higher than 5%. In other words, only 9 out of 59 premises maybe made some sense as rentals, in the rational world! This city, figured it out and, hopefully, will act upon this knowledge.

Long-term land leases have their own specifics for transitional and developing economies, which makes their broad use a questionable public policy (Kaganova, McKellar 2006):

- *The land leasing model is more expensive and complicated to administer.* First, it separates rights in land from rights in improvements on the land (i.e., buildings), which requires establishing and maintaining separate systems for registering leasehold rights of land tenants and their ownership rights in improvements. Second, governments become holders of large portfolios of lease contracts, and these portfolios must be monitored and managed, which adds to the cost of land management. Third, a single property tax is not applicable because taxation of buildings and payments for land must be administrated separately. For transitional and developing countries just establishing their property registration systems and reforming taxation, this model imposes a double burden on both governments and property holders.
- *The land leasing model requires sophisticated legal knowledge on the part of participants.* The lease agreement is a binding contract, and parties entering in this contractual arrangement must be fully aware of their legal obligations under the terms of the lease. This is not something that relatively unsophisticated and small landholders will understand. The quality of the lease itself is crucial. Omission of key provisions—for example, who owns what at the date of termination, or renewal provisions—can lead to multiple cases of litigation or mass protests (there are examples of both). This model is heavily weighted in favor of lessees with good lawyers and shrewd negotiators at their disposal. As a result, the land lease system in less developed countries often unintentionally discriminates against

small domestic lessees and acts in favor of experienced foreign interests, quite the opposite of intended goals.

- *The land leasing model assumes a well-established institutional framework.* The success of contractual arrangements depends upon respect for the legal system and an institutional framework that can enforce compliance. However, contractual law is relatively new for many transitional and developing countries and property-related contracts are often violated by all parties including local governments, especially in large cities. Private investors are inclined to distrust lease rights granted by local governments and opt for ownership rights established by law, except where there are incentives attached to the leasing option. Corruption is also a threat to this model, as experiences in many countries, including China and Russia demonstrate.
- *The land leasing model is associated with higher transaction costs.* Trading and mortgaging land leases, where permitted, typically incur higher transaction costs than do trading and mortgaging owned land. Leasing also appears to limit liquidity, because governmental approval - in one form or another - is often needed.

For transitional and developing countries, the accumulated experience of the past 10 to 15 years poses this public policy question: Are there enough clear benefits with the land lease model to justify its use compared with the ownership model? What goals and objectives cannot be achieved with the relatively simpler, cheaper, and more corruption-resistant land ownership model?

4. ***Balance the regulatory regime for municipal property between the central government laws and local regulations.*** Does an optimum exist? This is a real challenge because tiny, but wrongly placed provisions can cause inefficiency. For example, a law on municipal property in Bulgaria required city mayors to sign all lease agreements on municipal premises. Don't mayors have more serious work to do? Would it not be more appropriate to require local councils to develop and approve leasing procedures, which would specify who signs these leases? This area certainly needs more work, and it would be useful to try to develop a prototype of a "rightly balanced" regulatory system. In author's view such a system would include three main components:

- Central government law(s), establishing basic principles and requirements about municipal property and local governments' rights and obligations as owners. This includes a requirement to have a local (municipal) Ordinance on Asset Management adopted by local elected body (council)
- A set of prototype documents to be adopted by local governments, including a prototype Ordinance. This set of documents should be developed by a central government or non-government entity and be offered to local governments as not mandatory to use
- Local Ordinance on Asset Management and other local regulations – all adopted as documents obligatory for mayor offices (executive branches) to follow.

5. ***Recognize importance of written policies.*** Good asset management as a sustainable process (vs. a push by one progressive person at local government) is not possible without explicit, preferably written policies. For example, to get rid of non-performing business rentals, asset managers need a mandate to privatize them, which should be established as a policy by the local council. The need for written policies brings up a whole host of challenges. First, there is no intrinsic culture at local governments to produce and implement written policies. Second, if such a policy is developed, what should be its legal status – should it be codified into a legally binding document (ordinance) or be a softer document? Third, in some cases it is not clear where to start – from policies or procedures.

6. ***How much is “de-politization” of asset management feasible and desirable?*** Is it feasible to reign the influence of politics on asset management decisions by introducing local Ordinance on Asset Management? If so, countries in transition might be a good place to try, as local governments there are still less swamped by layers of historically established ways of running the business of government than most of the developed countries.

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