
Regional Economic Development in Eastern Europe: An Example from Poland

**by Raymond Struyk
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Preface

The idea for this paper grew out of a USAID-supported technical assistance project to the State Office for Housing and Urban Development (SOHUD) in Poland. The Office asked for assistance in developing the Communal Credit Program that would be designed to encourage smaller local governments to undertake badly needed investments in communal infrastructure. The broad aim of the investments is improving the quality of life and making these localities more attractive for private investment.

In the course of working with the Office, the importance of economic development in smaller communities in Poland for national economic growth and for accession to the European Union became clear. Discussions with representatives of the donor community reinforced this view and also indicated that the problem was general to the region. For this reason, we decided to expand upon and generalize the work done for the Office for a broader audience.

At this writing, legislation to implement the program that we helped design is under consideration by the Government of Poland. The final program differs somewhat in its structure from that outlined in the paper. Importantly, Polish authorities responsible for regional development support the program, and EU offices concerned with administration of the structural adjustment funds see the program as reinforcing their efforts to accelerate regional economic growth.

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Promoting Regional Development

Small cities and towns are rapidly being recognized as key actors on the road to sustained economic development in the countries of Eastern Europe.

Whether they are able to execute this central role will depend on their being able to undertake essential investments—which in turn requires the availability of finance and the strengthening of local administrative capacity.

The thesis just stated rests on four developments during the transition from the state-socialist economic model. First, there has been a substantial decentralization of public responsibilities from national to lower-level governments. In some cases the reassignment of responsibilities from national to regional and local governments has not been accompanied by adequate financial resources and in some cases the receiving governments do not have full control over their new functions. But the pervasive nature of the reallocation is indisputable.¹ Among the functions most commonly assigned to local governments are housing, water supply, sewage services, district heating (where applicable), and solid waste removal. Responsibility for economic development has been allocated to both regional and local governments. In Poland, for example, regional economic development is the principal responsibility of the revamped regional governments (*voivodships*).

Second, sustained economic growth among countries in the region will generally require improved efficiency in the agricultural sector, especially increasing the productivity of farm labor and machinery. Among countries applying for entrance into the European Union, 7 of 10 reviewed in a recent article are defined as having substantial agriculture sector and/or regional development problems.² Improved efficiency and productivity in turn requires the creation of nonfarm employment for the large number of farm workers who will be released as a consequence of on-farm productivity increases. As a World Bank report states:

¹ See, for example, R.M. Bird, R.D. Ebel, and C.I. Wallich (eds.), *Decentralization of the Socialist State* (Washington, DC: World Bank. A Regional and Sectoral Study, 1995); E.J. Kirchner (ed.), *Decentralization and Transition in the Vizegrad* (New York: St. Martin's Press, 1999); and T. Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington, DC: International Monetary Fund, 1997).

² "EU Enlargement Process Keeps Rolling," *Transition*, October 1999, pp.13-15. The countries reviewed were Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Broad-based rural development ... enhances the competitiveness of farming. Rural sector initiatives which increase non-farm rural employment allow farmers to reduce labor use and so raise farm productivity. They also improve access to farm services, and raise domestic demand for farm products by boosting rural incomes. And investments in better roads, communications and energy supply improve market efficiency and lower transaction costs.³

Job opportunities must be created outside of the major cities, as the high job growth in these centers that has been key to national economic growth to date will not be sufficient to absorb these workers. Towns and small cities are very likely to be the drivers of nonfarm employment creation.⁴

Third, the towns and small cities where the needed job creation and economic growth should occur are typically places that exhibit the largest deficits among urban areas in basic infrastructure, quality of life, and government administrative capacity. In short, in many respects these are not attractive places for businesses to locate.

Fourth, local leaders do not know which investments would be most productive to make them attractive to outside business. More generally, they lack the capacity to prepare comprehensive investment plans, local economic development strategies, or even projects for presentation to possible investors or funders. The limited absorption capacity of local governments means that despite the availability of monies from the European Union (EU) structural adjustment funds and other donor assistance, progress will be hard to achieve unless there are substantial changes in the ways national and regional governments work with towns and small cities.

³ G. Christensen and R. Lacroix, "Competitiveness and Employment: A Framework for Rural Development in Poland." (Washington, DC: World Bank, Discussion Paper No. 383, 1997), pp. 2-3.

⁴ A comparatively recent argument goes beyond seeing towns and small cities as the principal sites of rural nonfarm employment creation. The idea is based on the observation that in a number of developing countries rural nonfarm activities carried out mainly in small-scale enterprises, including farm household enterprises, are a very important source of employment and income. Hence, a more dispersed form of economic development appears possible. In assessing the possibilities, special emphasis is given to developing conditions that allow "rational contracting" to become the dominant production organization. "Rational contracting" refers to long-term, continuous contract relations between small, rural-based manufacturers and traders or agents of large, urban-based firms, as well as between rural-based manufacturers and their workers. See the essays in Yujiro Hayami, *Toward the Rural-Based Development of Commerce and Industry: Selected Experiences from East Asia* (Washington, DC: World Bank, Economic Development Institute, 1998).

The necessity of spurring rural development in the very near future has become even more acute with the EU decision not to make direct payments to farmers in accession countries to cushion them from the full impact of competition from current EU members.⁵ Accession candidates will have to accelerate farm modernization and rural development or delay accession.

This paper describes a series of three actions, which together constitute a coherent program, that national governments could undertake to improve the absorptive capacity of smaller local governments and the attractiveness of these communities for private investment.

The justification for such a government initiative comes from two sources. First, investment in the stimulation of local economic development may well have a rate of return greater than many other government investments. The result should be a higher rate of national economic growth and reduced government compensatory payments to lagging areas. Thus, national economic efficiency is enhanced. Second, such government spending, properly targeted, is consistent with the general objective of a national government policy of horizontal equity (equal treatment of similar persons regardless of where they live). This is often defined as equality among regions in the capacity of each to provide regional services without having to impose higher taxes and charges than other regions—so-called “regional budget capacity equalization.”⁶

Successful Regional and Rural Development Programs

Two types of experience are relevant in considering the design of a national government program in Central Europe for stimulating rural, especially nonfarm, development. One is the experience of the European Community with the European Regional Development Fund. The other comes from the broader results drawn from regional and rural development programs in other parts of the world.

⁵ E.R. Drosin, “Farm-Subsidy Proposal by Poland Is Dismissed,” *Wall Street Journal Europe*, April 7-8, 2000, p. 6.

⁶ It is also sometimes defined as uniformity across regions in actual standards of service provision and in actual taxes and charges applied (termed performance-based regional government equalization. See E. Ahmad and J. Craig, “Intergovernmental Transfers,” in T. Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington, DC: International Monetary Fund, 1997), pp. 73-124.

EU Experience. The European Regional Development Fund (ERDF) has been strongly oriented to supporting infrastructure investments as a tool for regional development. For example, for the 1975-1988 period 80 percent of committed funds went to infrastructure investments.⁷ Other elements included investment in priority industries and service sectors and, more recently, upgrading human capital in a target region. A series of evaluations indicate that the ERDF was successful in stimulating growth in lagging regions, as measured by per capita income, and helping close the gap between the targeted regions and the rest of the Community.⁸ Moreover, because accelerating growth is a cumulative process, it is likely that these gains will be sustained.⁹

Another review of the experience of Western Europe reaches several conclusions relevant for this discussion. In particular, the principles for successful rural development not addressing on-farm actions are:

1. The highest returns occur when expenditure is directed to the provision of infrastructure to make areas more attractive to businessmen looking for a location and more pleasant for people to live. Infrastructure programs should thus have priority for the use of additional resources.
2. The government's job is to improve the general conditions in rural areas, not to target particular types of enterprise or to try and pick "winners."
3. The most sustainable increases in rural employment and business activities occur in rural areas that are located close to major urban centers. These centers provide a larger client base and markets, and stronger and more stable access to labor, communications, and services.
4. Efforts to locate rural development around growth points have been unsustainable, while deliberate programs to relocate major governmental institutions or bodies close to rural areas have had a sustained impact on rural development.¹⁰

⁷ Peter Nijkamp and E. Blass, "Comparative Regional Policy Impact Analysis: Ex Post Evaluation of the Performance of the European Regional Development Fund," *Journal of Regional Science*, vol. 35, no. 4, 1995, p. 580.

⁸ P. Goybet and Bertoldi, "The Efficiency of the Structural Funds," in J. Mortensen (ed.), *Improving Economic and Social Cohesion in the European Community* (New York: St. Martin's Press), pp. 229-40; and B. Seidel, "The Regional Impact of Community Policies," in J. Mortensen (ed.), *Improving Economic and Social Cohesion in the European Community* (New York: St. Martin's Press), pp. 211-27. Nijkamp and Blaas, *op. cit.*, pp. 579-97, find that private investment has also been stimulated in targeted regions.

⁹ Goybet and Bertoldi, *op. cit.*, p. 236.

The EU has built upon these findings in designing its pre-accession assistance program to stimulate rural development in the Central and Eastern European countries. Among the non-agricultural elements in SAPARD¹¹ are: the development and improvement of rural infrastructure, renovation and development of villages, and the development and diversification of economic activities with a view to creating multiple activities and alternative incomes.¹²

Finally, the EU has devoted substantial effort to examining the efficiency of the use of the structural adjustment funds. A range of studies has documented a variety of absorption problems. Absorptive incapacity means that the receiving region is unable, given its administrative skills, to devote all the transfers it receives to productive investment. For a lack of management skills, a considerable part of the transfers is wasted.¹³ A recent comprehensive assessment of the EU absorption problems with the structural funds gives the following conclusion about the likely situation in the accession countries:

... at a low level of development administrative bottlenecks are a major impediment to transforming transfers into productive capital. The CEEC [accession countries] definitely exhibit such bottlenecks due to unfinished administrative reforms (e.g., decentralization and the reinvention of regional and municipal entities), problems with age structure (limited possibilities for recruiting young and productive staff because of job guarantees for the elderly employed and the need to reduce the number of civil servants), retraining of staff and low pay (as a result of severe budgetary restrictions). This situation is unlikely to change quickly....¹⁴

This point is discussed further in the section on project preparation facility.

Regional Development in Developing Nations. The lessons garnered from efforts to promote regional development in developing nations are substantially parallel to those from Western Europe. In particular, a

¹⁰ Christensen and Lacroix, *op. cit.*, p. 51.

¹¹ SAPARD is Special Accession Programme for Agriculture and Rural Development.

¹² From the website, "Enlargement-SAPARD: The pre-accession agricultural instrument, at www.rural-europe.aeidl.be/rural-en/euro/p15-1.htm.

¹³ These studies are reviewed in Y. Herve and R. Holzmann, *Fiscal Transfers and Economic Convergence in the EU: An Analysis of Absorption Problems and an Evaluation of the Literature* (Baden-Baden: Nomos Verlagsgesellschaft, 1998). The definition in the text is paraphrased from a statement on p. 68.

¹⁴*Ibid.*, p. 167. A similar argument is made by H. Chenery and W. Stout for developing countries in, "Foreign Assistance and Economic Development," *American Economic Review*, vol. 66, 1966, pp. 679-733.

recent World Bank review indicates the following.¹⁵ In terms of the general environment, the key factors are education of the population and provision of adequate infrastructure. A better-educated workforce is necessary to promote employment into higher-income, nonfarm occupations. With respect to infrastructure, the summary notes that numerous studies have documented how constrained access of enterprises to power, transportation (especially roads), and telecommunications has restricted growth.¹⁶

With the promotion of small industry, ensuring access to credit is key. The most successful projects are those that are locally based, lend to groups of firms, disperse small initial loans with additional lending conditional on repayment, and charge realistic interest rates. Projects aimed at strengthening small enterprises have in some cases been successful but because of the dispersal of firms in the countryside, such service delivery tends to be expensive. A related finding is that industrial estates targeted at small firms have a poor record of success, often because the sites and services are too expensive for start-up firms. Finally, the summary states that because of the diversity of local conditions, decentralized decisionmaking for setting priorities for government action to relieve bottlenecks and take other initiatives is usually appropriate. This in turn calls for development of competent local planning and administration.

The foregoing indicates that a national program to foster regional and/or rural development should pay particular attention to ensuring adequate infrastructure investments and the availability of finance to small and medium enterprises on market terms. Other important points are developing an adequately educated labor force and upgrading the administrative and planning skills of local officials.

The Communal Credit Program

The specific program presented in this paper builds on the lessons and findings cited above. The Communal Credit Program consists of three closely related and mutually reinforcing elements targeted at smaller communities.

¹⁵ P. Lanjouw, "Policy Options for Employment in the Rural Non-Farm Sector" (Washington, DC: World Bank, Rural Development Note No. 4, 1999).

¹⁶ See, for example, G. Ranis and F. Stewart, "Rural Nonagricultural Activities in Development: Theory and Application," *Journal of Development Economics*, vol. 40, no. 1, 1993, pp. 75-101.

1. *Project preparation facility.* Because many smaller communities lack the technical capacity to prepare investment projects, funds are made available on a matching-grant basis to them to prepare projects for financing. These funds are then allocated to regional governments, which determine which local projects ought to be supported.
2. *Bond financing facility.* While in some countries the private sector is demonstrating interest in providing bond finance for investment projects of smaller communities, this is often not the case. Moreover, it is not clear that even where some bond financing is available the private sector will be able to respond to a large increase in the demand for bond financing. Such a surge in demand could come from local governments raising funds to provide matching shares for investments mainly financed from European Union pre-accession grants. Therefore, a Government Bond Bank (GBB) could be founded to finance viable investment projects of smaller communities. The GBB will raise funds to lend to these local governments by selling its own bonds in the open market.
3. *Matching grants for priority projects.* To further encourage smaller communities to undertake investments and, where necessary and prudent, to borrow funds to finance them, grants for up to 20 percent of a project's cost are available to local governments. To ensure that all localities have an opportunity to access these funds, the grants funds are allocated to groups of counties on a formula basis, with the formula allocating more funds to county groups with greater demonstrated housing and communal development needs. The funds will be available for a one-year period for commitments to localities within the county group. Funds not committed in a year will be redistributed to other county groups. Regional governments will be responsible for allocating funds to localities within their borders.

To make the discussion concrete, Poland is used to illustrate the points made and is generally treated as the case study. There are several reasons why Poland is a good choice for this purpose.

- Like most countries in the region, Poland is a unitary state that has implemented substantial decentralization of expenditure responsibility, although local governments still have little direct taxing authority.
- The country is among those in the first group for EU accession and is beginning to receive a large amount of funding from the EU to assist with accession preparation.
- Poland is struggling to define a regional development strategy. On the other hand, it has broadly allocated this responsibility primarily to regional governments (voivodships); but the national government still

retains a significant role. How the sharing of responsibility for strategy development will work in practice remains to be seen.

Throughout the paper we will use the Polish and American designations for the three levels of subnational governments interchangeably. The three levels, beginning with the highest level, are states and *voivodships*, counties and *powiats*, and local governments and *gminas*.¹⁷

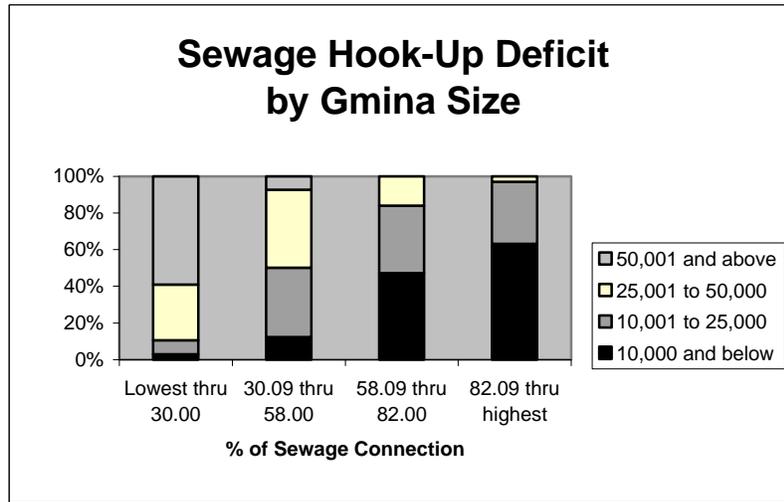
The presentation proceeds as follows. Next we present information on the status of towns and smaller cities with respect to infrastructure services and their access to national financial markets compared with larger cities. The balance of the paper describes the program, explaining and justifying each element in turn.

Greater Investment Needs of Smaller Places

We asserted above that smaller cities have greater investment needs for communal infrastructure than larger urban areas. Here, using Poland as the case study, data are presented to support this point. Towns and smaller cities are defined in this case as places with populations under 50,000. Three basic indicators of communal investment need are employed: the percentage of the population in each community not served by piped water service, piped sewage service,¹⁸ or gas service. The basic service patterns are displayed in the following three charts. Data are for the 871 urban and urban-rural *gminas* (local self-governments). Each chart has the same format: the vertical bar shows the situation for a certain range of deficits. One-quarter of local governments is in each deficit group, i.e., each vertical bar represents 25 percent of all *gminas*. For example, the left-hand bar in chart 1 is for sewer hook-up deficits up to 30 percent. Each bar displays the percentage of *gminas* in each of the four population size categories, ranging from under 10,000 to over 50,000. The sum of each bar is 100 percent.

¹⁷ The present structure of subnational government in Poland came into effect only at the beginning of 1999. The *powiats* were installed as a new level of government between the *voivodships* and *gminas*. In addition, the *voivodships* were reduced in number from 49 to 16. For commentary on these changes, see Z. Gilowska *et al.*, *The Systemic Model of the Voivodship in a Democratic Unitary State* (Budapest: Open Society Institute, Local Government and Public Service Reform Initiative, Discussion Paper No. 7, 1999); and A. Levitas, "The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland, 1989-1999" (Warsaw: Research Triangle Institute, processed, 1999), pp. 14-15.

Chart 1

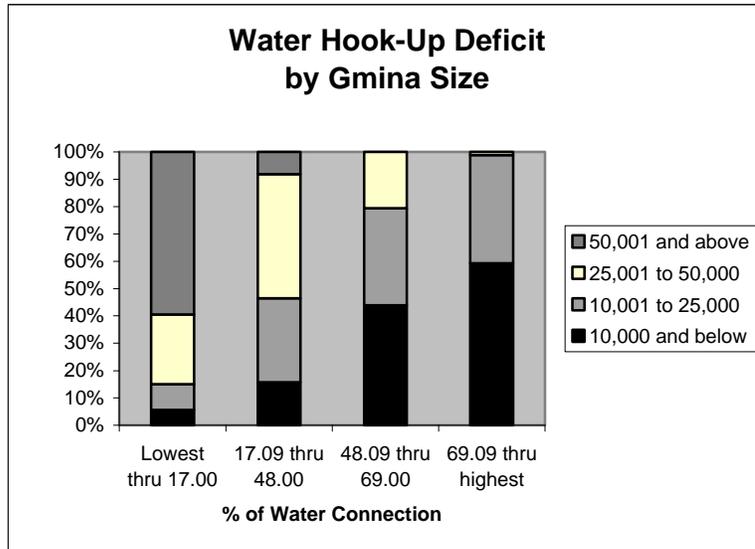


From the chart on sewage connection deficits, one can see that gminas with populations of less than 10,000 have the highest incidence of this problem, followed by gminas in the 10,000 to 25,000 population category. Indeed, the two vertical bars for the highest deficit categories (on the right side of the chart) contain almost exclusively gminas under 25,000 population. Of the 90 gminas with populations of 50,000 and above, 84 are among those with the highest ratios of sewage hook-ups to the population. This can be compared to the 49 percent of all gminas with populations of 10,000 and below that have the largest deficits in sewage connections. Only 5 percent of the smallest gminas exhibit the lowest deficit rates.

A potentially serious limitation of the sewage deficit indicator should be noted: in low-density areas, septic tanks can provide fully adequate service at a cost far below that of a piped sewage system. A similar argument can apply to piped water and gas systems. Thus, to some degree, the deficit figures overstate the effective deficits in low-density, typically smaller gminas.

Chart 2

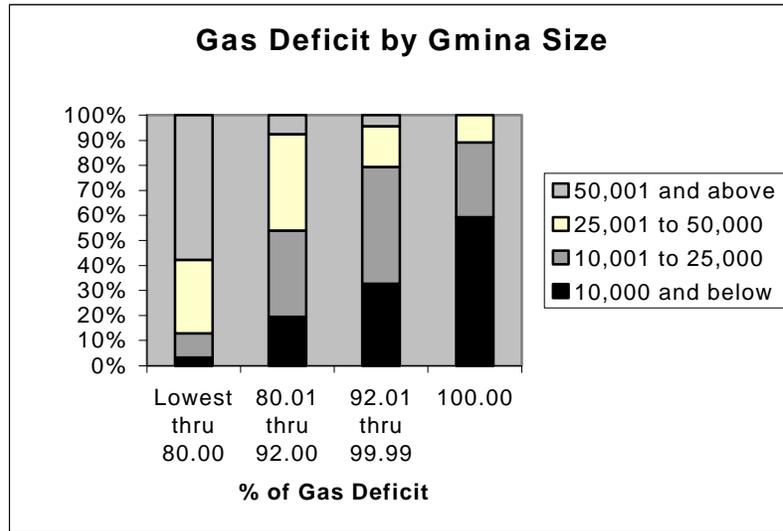
¹⁸ This measure has the obvious limitation that in low-density areas, sewage may be more economically handled through septic tanks rather than piped sewage. No data are available that include septic tank service.



In the chart for water connections by population size, gminas with populations under 25,000 again clearly have the greatest deficits. Further analysis reveals that of the 213 gminas that occupy the lowest ranks of water service, 105 fall in the population category of “10,000 and below” (while an additional 107 are in the “10,000 to 25,000” range). Out of the 89 gminas that represent the population category “25,000 through 50,000,” only one gmina suffers from such a low connection rate.

Gas connection deficits demonstrate a similar pattern as well:

Chart 3



Overall, the deficits for gas service are higher for all gminas; only a quarter of gminas have deficits under 80 percent. Still, the highest deficits—gminas with no gas service—are concentrated among gminas with populations less than 25,000.

Less Borrowing by Smaller Cities

It is common practice in the West for local governments to borrow funds to finance investments. Borrowing permits quicker realization of the improvements and spreads their costs more equitably between the current and the next generation of users. National governments in the region have consistently placed and enforced limits on local governments' borrowing, in part to prevent their incurring excessive debts, i.e., those that may be beyond their ability to service.¹⁹ Another factor at work in countries with highly stringent limits is that such limits make it easier for national governments to manage a country's overall debt position.

While municipal bond finance is in its infancy in Poland and gmina (local self-government) borrowing from banks is still not common, the

¹⁹ On the other hand, a number of local governments in Ukraine and Russia made commitments that were beyond their financial resources. See J. Dunn and D. Wetzel, *Fiscal Decentralization in Former Socialist Economies: Progress and Prospects* (Washington, DC: World Bank, processed, 1999)

following tables illustrate that both bank borrowing and bond finance are much less common for smaller gminas than for their larger counterparts.²⁰

With respect to bank borrowing at commercial rates, a useful measure is the debt per capita of gminas of different sizes.²¹ Gminas with populations under 50,000 have about one-half the bank debt that gminas in the next larger size group have.

A similar pattern holds for bond issues. As the figures show, only about 1 percent of gminas with populations under 50,000 issued bonds during the 1995-1998 period, about one-eighth of the rate of gminas with populations in the 50,000 to 100,000 size class. Because smaller gminas raise smaller amounts when they do issue bonds, the per capita bond debt figures are even more extreme than the simple incidence-of-borrowing figures in the table.

Table 1
Gmina Bank Loans on Commercial Terms, End 1997²²

Population Size	No. of Gminas	Debt per Capita (PLN)
<50,000	2,390	6.82
50,000 - 100,000	52	12.47
>100,000	44	28.90
total	2,486	13.80

Table 2
Gmina Bond Issues, 1996-1998

Population Size	No. of Bonds	No. Bonds/No. Gminas
<50,000	28	1.2%
50,000 - 100,000	5	9.6
>100,000	16	36.6
total	49	1.9

²⁰ Data from S. Kudron, "Borrowing by Gminas, 1996-1998" (Warsaw: State Office for Housing and Urban Development, 1999).

²¹ Commercial borrowing excludes below-market interest rate loans made by the Environment Bank (BOS).

²² Both the bank loan and bond figures are the most recent available that permit disaggregation by gmina size.

In summary, towns and smaller cities in the region are likely to have lower endowments of infrastructure services and, more generally, a lower quality of life than larger places. Additionally, they exhibit much lower rates of borrowing in order to finance improvements that would make up these deficits. Lower debt is associated with both a lower willingness and capability to structure applications to borrow *and* a relative neglect by commercial banks, which both extend loans and, at least in Poland, are pivotal in preparing bond issues. We now turn to a program designed to help smaller communities make up their deficits and become more attractive for outside commercial investment.

The Communal Credit and Development Program

The objective of the CCDP is to improve the quality of life in towns and smaller cities (under 50,000 population), particularly with respect to housing and community development, by stimulating local government spending on badly needed investments. Of special importance are investments that advance localities' economic development.

Project Preparation Facility

Lack of financing is certainly a reason for low investment. But the absence of funds can arise from several different reasons. First, local governments have a very limited own revenue compared with its operational responsibilities. Most local governments in the region have very little latitude under existing law to increase taxes and fees, thus constraining their ability to initiate investments if they choose to impose higher taxes. A second reason is that although some localities do have an operating surplus, the surplus is not sufficient to pay for substantial investments from current revenues. In the absence of readily available debt financing—either through bank loans or bond issuance—little investment will occur.

Most gminas in Poland have realized operating surpluses during the transition period.²³ On the other hand, as we have seen, they have not had much access to debt finance. A general conclusion is that the reason gminas are not borrowing to finance badly needed infrastructure investments is at least as much a problem of the gminas not asking for loans (or arranging bond issues) as it is a matter of banks not making funds available to them.²⁴ The main problem, besides small gminas' general reluctance to borrow, is the limited capacity of gmina staff to prepare projects for approval by the gmina's governing board and for bank scrutiny.

²³ T. Levitas, "The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland, 1989-1999" (Warsaw: Research Triangle Institute, processed, 1999).

²⁴ Based on responses from surveys of Polish banks in 1998 and 1999. See A. Kopanska, *Municipal Capital Market in Poland* (Warsaw: Education and Banking Research Foundation, 1999).

The general limitations on local government capacity for decentralization are emphasized by Ter-Minassian in her review of recent developments. She states that

Overstaffing, poor technical skills and training of employees, and the inability to formulate and implement effective spending programs to fully exploit potential financing resources characterize many regional and local jurisdictions in a number of countries worldwide.²⁵

Further, we have already noted that limited administrative capacity has been identified as a factor leading to less efficient use of EU structural adjustment funds than might have been the case. In recognition of this fact, donor-financed regional development projects in Eastern Europe routinely include a component for upgrading the capacity of local governments to engage in strategic planning and to define investment projects.²⁶

The general problem is certainly exacerbated in smaller communities where governments cannot afford to employ specialists for many specific tasks related to investment planning and execution.²⁷

Project preparation facilities have been used in a number of countries to address the problem of limited capacity of smaller local governments. The basic idea of creating such facilities is to overcome the expertise gap at the local level and to help local administrations get accustomed to contracting for assistance in preparing projects. It is not economically rational for smaller communities to employ a staff capable of preparing projects because the volume of projects is too low.

Typically preparation facilities have been one part of a government development bank charged with responsibility for providing long-term loans to localities for infrastructure investments. Such banks were created in response to the lack of interest of commercial banks in making such loans.

²⁵ T. Ter-Minassian, "Intergovernmental Fiscal Relations in a Macroeconomic Perspective: An Overview," in T. Ter-Minassian (ed.), *Fiscal Federalism in Theory and Practice* (Washington, DC: International Monetary Fund, 1997), p. 6.

²⁶ This is true for rural development projects in both Latvia and Poland, for example. See "Project Appraisal Document on a Proposed Loan ... to the Republic of Latvia for a Rural Development Project" (Washington, DC: World Bank, Europe and Central Asia Region, processed, 1998), p. 12; and "Poland-Rural Development Project: Project Identification Document" (Washington, DC: World Bank, Europe and Central Asia Region, processed, 1998).

²⁷ Exactly this problem was identified, for example, in a comprehensive review of the performance of local governments in Colombia when service delivery responsibilities were sharply decentralized. See *Local Government Capacity in Colombia: Beyond Technical Assistance* (Washington, DC: World Bank, Country Study, 1995), pp. 19-20.

Frequently, these development banks were established with donor support and had the preparation of projects for donor financing as one of their missions. The record of such facilities created in the 1970s and 1980s was not strong in terms of rigorous project analysis or collection of loan repayments.²⁸

The Municipal Infrastructure Investment Unit (MIIU) in South Africa represents the new form of preparation facilities. Its operations are strictly organized around market principles, and project preparation is rigorous in both technical and financial design. Unlike the development banks, the MIIU is preparing projects to attract private financing through BOT and other arrangements. The MIIU also provides grants to localities to purchase the expert services needed to prepare the project.²⁹

The British have taken another approach to confront the lack of financial specialists in smaller local government councils to develop infrastructure projects for private financing. With funding from the central government, the local councils created the Public Private Partnerships Programme to provide a coordinated approach and expertise across several hundred local authorities in the country.³⁰

The donors have promoted project preparation facilities in some transition countries. In Poland, the Municipal Development Agency was set up to provide assistance to local governments. With the demise of outside funding, this aspect of its operations evolved into a consulting service. The other example is from Lithuania, where the World Bank has been active in establishing the Housing and Urban Development Foundation that will help local governments prepare projects for financing available through a World Bank loan.

In the case of the CCDP, Project Preparation Units (PPUs) would be created at the voivodship level to address the problem of the limited capacity of gminas to design infrastructure projects, particularly the financial aspects, and to structure projects for capital financing. Their task is to help

²⁸ See Wm. Dillinger, *Decentralization and Its Implications for Service Delivery* (Washington, DC: World Bank, Urban Management and Municipal Finance 16, 1994).

²⁹ M. Hlahla, "The Municipal Infrastructure Development Unit: The Government's PPP-Enabling Strategy," *Development Southern Africa*, vol. 16, no. 4, 1999, pp. 565-84.

local governments package projects for market-based financing, implement collection systems to repay capital investments, and design and regulate public/private partnerships. Groups of gminas would be eligible to apply for a grant where the project would serve the territory of all applicants. This is important because of the large economies of scale possible from many infrastructure projects and because it would foster greater coordination for some types of projects, like road construction. Grants to gminas to assist with project preparation would come from the national budget and would be administered by the voivodship, actually the voivodship self-government.³¹

The exact scope of the type of preparation that would be eligible for assistance could differ depending on the needs of local governments. At a minimum it would include analysis of the gmina's finances, its ability to repay the loan, and the utility of alternative debt structures. Other areas that might be included are assistance with technical aspects of project design and development of a multiyear capital improvement plan for the gmina that would guide all of its investments over the next several years.

The fundamental premise behind the creation of the PPU is that financing for infrastructure investments will be available to local governments should they prepare good projects. The creation of PPUs at the voivodship level would address this problem directly and would permit close coordination between this program and other regional development programs. This program would be included in the formal contract between the Government and the voivodship local self-government that regulates the tasks to be undertaken by regional self-governments on behalf of the national government (consistent with the contracting process envisioned in the draft law on regional development³²). The operations of the voivodship PPUs would be financed from the voivodships' own resources; grant funds would come from the national budget. Participation of the voivodships in the program would be voluntary, but the creation of the PPUs seems very

³⁰ F. Sader, *Attracting Foreign Direct Investment into Infrastructure: Why Is It So Difficult?* (Washington, DC: World Bank, Foreign Investment Advisory Service, Occasional Paper No. 12, 2000), pp. 96-97.

³¹ The voivod is the appointed representative of the national government in the region. The voivodship self-government consists of the elected administrative and legislative bodies responsible for actual day-to-day administration at the regional level.

³² "On the Principles of Assisting Regional Development and on Modification of Other Acts," Fall 1999.

likely.³³ The State Office for Housing and Urban Development (SOHUD), the cognizant national government agency, and the Government's representative in the region (the *voivod*) would oversee the use of funds disbursed by the PPU.

The budget funds available for financing project preparation would be allocated by SOHUD to the voivodship self-governments on the basis of the percentage of the total population in small gminas living in each voivodship.³⁴

The tasks of a PPU, patterned loosely on those of the MIIU, can be summarized as follows:

- Publicly solicit proposals for assistance from gminas consistent with any priorities set by its Board of Directors;
- Screen the proposals in terms of agreed priorities and other established requirements;
- Approve applications for funding from its Preparation Fund;
- Liaise with gminas to develop terms of reference for technical assistance in preparing the projects;
- Provide preliminary technical assistance to ensure appropriate selection of consultants;
- Provide management oversight to ensure that municipal/town contracts for services generate high quality support and advice;
- In exceptional circumstances assist in packaging of project finance proposals to possible funders and assist in the review of project finance proposals; and,
- Allocate grant funds for project implementation under this program, following priorities and procedures defined by SOHUD.

³³ Two large regional development projects are in the process of creating or enhancing agencies that could easily take on the role. One is the World Bank's Rural Development Project, which will establish Project Implementation Units in every voivodship. The other is the Phare program's operations in support of the use of the EU regional structural funds. Phare will work with the existing Regional Development Agencies, which are subordinate to the voivodship self-governments. Note, however, that under Polish law only the voivod (governor) can make grants to gminas using national government funds. So coordination between the self-government and the voivod's office would be essential.

³⁴ An alternative possibility under Polish law is for the funds to be allocated to the voivod, which would be responsible for their dispersal. Legislatively this would be an easier option, but the result might be less coordination with other voivodship-level economic development programs.

The specific charter of the PPU would be developed by SOHUD in consultation with the voivodships. The charter would define the types of projects whose preparation can be supported with funds provided under this program and the extent to which the voivodship can set its own priorities within this set of project types.

The PPU would commit funds to a gmina for project preparation following a standard procedure. The PPU would fund up to 50 percent of preparation costs (covering allowed costs defined in the PPU charter).

To stimulate gminas to request grant funds for high-priority and realistic projects, payment of the grant funds would be made only when the project implementation begins, i.e., a gmina would have to provide initial finance for project preparation. Gminas would have 18 months from the date of the commitment of grant funds to begin project implementation. If implementation has not begun, the funds are de-committed and returned to the pool available for the PPU to commit to other gminas/projects.

An illustrative list of the types of projects eligible to receive funding includes:

- Housing rehabilitation,
- Area revitalization,
- Water, wastewater, roads, and municipal transport infrastructure projects,
- Solid waste removal facilities,
- On-site infrastructure as the gmina's contribution in a public-private partnership project and other economic development investments, and
- Development of public facilities, including schools, sport complexes, and health facilities.

Multiple gminas could apply for grant funds for projects that would benefit several gminas jointly.

The PPU mechanism is conceived as a medium-term (five-year) intervention to develop a mature market for technical assistance to local governments. The PPU facility would cease operations or take on other roles after this time. It is envisaged that over the long term the costs of such technical assistance for packaging infrastructure for market financing will be recovered as part of the cost of the projects. For example, water tariffs would be set high enough to recover these "soft costs" as well as the direct investment costs.

Bond Finance Facility

There is a long history of governments providing finance for infrastructure investments by local governments. In many countries, national government has simply paid for it. In the state-socialist regimes of Central and Eastern Europe, as well as the Soviet Union, this was essentially the case. Often the state savings bank extended loans for infrastructure projects, as part of the national development plan, at interest rates that were administratively determined.

In other parts of the world, a number of countries created development banks or similar institutions that provided loans to local governments to finance such projects. The primary rationale for such facilities was to overcome market failure in that private banks were not prepared to extend longer-term loans to local governments. Often loans were made at below-market interest rates and loan underwriting was frequently lax. As a result of this experience, development banks have a generally poor reputation.³⁵

Interestingly, in both the Eastern Europe-Former Soviet Union region and developing countries, “rural finance projects” focus squarely on providing credit to farmers and small and medium enterprises. Infrastructure is almost totally ignored despite the central role of adequate infrastructure in promoting rural development.³⁶

The Government Bond Bank (GBB) described below would operate on market principles and would address the problem of the limited availability of bond financing to small communities. It is likely that there would be efficiency gains from the operation of the GBB compared with individual towns issuing their own securities. Broadly, the efficiency gains realized would be similar to those gained from the packaging of multiple bond issues by state agencies in the United States.

The discussion in this section proceeds in three parts. First, we outline the current situation with respect to local government bond financing

³⁵ Dillinger, *op. cit.*, pp. 32-34.

³⁶ See, for example, the following documents: “Project Appraisal Document on a Proposed Credit ... to the Republic of Moldova for a Rural Finance Project” (Washington, DC: World Bank, Europe and Central Asia Regional Office, 1997); M.S. Mudahar, “Kyrgyz Republic: Strategy for Rural Growth and Poverty Alleviation” (World Bank: Discussion Paper No. 394, 1998); O.J. Sacay and B.K. Randhawa, “Design Issues in Rural Finance” (Washington, DC: World Bank, Discussion Paper

in Poland. Next, we give a brief overview of the GBB. In the final section, we describe several key features of the operations of the proposed facility.

Current Situation. In some ways, bond financing in Poland is more developed than in other countries of the region. Several points are particularly relevant.

- As documented above, smaller gminas borrow funds to finance investments from banks or through bond issues considerably less frequently than do larger gminas. In part this is because a smaller share of smaller gminas seek to borrow funds and in part because they are less well served by existing sources.³⁷
- Borrowing by gminas from banks is more common than bond issuance. However, bond finance through private placements carries significantly lower interest rates than bank loans. So bond finance will be the preferred option.³⁸
- Overall municipal bond financing in Poland is in its infancy.
- Bond finance, in the form of private placements, has been obtained in the past three years by a small number of smaller gminas. Nearly always commercial banks have structured these deals, with the bank selected on a competitive basis; and typically the manager-banks hold most of the issues as an investment.
- Public placements carry large issuance costs that make this approach infeasible for small bond issues.
- Gminas are widely viewed as a good risk, as they have generally and consistently run operating surpluses of 20 percent or more, which have been used for investment.
- A large increase in the volume of bond financing demanded by gminas can be anticipated, in part stimulated by their need to generate matching funds for EU pre-accession regional development grants. It is not clear that the current mechanism of bank-organized private placements will be able to expand to meet the additional demands.³⁹

No. 293, 1995); and, J. Yaron, "Successful Rural Finance Institutions" (Washington, DC: World Bank Discussion Paper No. 150, 1992).

³⁷ Of course, the availability of funds from the environmental funds, either as grants or subsidized loans, discourages gminas from incurring market-rate debt. But to our knowledge, the distribution of these funds, which is done on a competitive basis independent of gmina size, has not particularly favored the smaller gminas.

³⁸ T. Cochran, M. DeAngelis, A. Levitas, "Continuing the Development of Poland's Subsovereign Debt Markets: Impediments and Opportunities" (Warsaw: Research Triangle Institute, Report to USAID-Warsaw, 1998).

³⁹ Currently about three-fourths of the placements of municipal bonds are to banks; the great majority of the bonds are held by the bank assisting with the bond issue.

Importantly, the lack of local funds to match EU structural adjustment funds has been identified as a significant potential problem for the states slated for accession (Herve and Holzmann, *op.cit.*, p. 168).

Overview. Under this program, such a facility will be created by the Government of Poland within an existing bank, possibly as a fund within the government-owned bank, BGK, to provide finance to gminas for projects for which the private-sector may lack the interest or capacity to organize bond financing in the near term. Two types of projects, identified as being less likely to receive private sector bond financing, could be financed by the facility:

1. Any project developed by a gmina with population of under 50,000, assuming the project meets technical and financial standards.
2. Small projects offered by gminas under 100,000 population that meet technical and financial standards; a small project is one costing no more that PLN 7.5 million in 1999 zlotys.⁴⁰

The law creating the facility would specify a “sunset provision”: privatization of the facility would be possible but not required after five years. The municipal bond market is expected to mature during the next several years, and private actors may then be ready to serve these clients/projects defined above as the target for the GBB’s operations.

Specific Features. Several features of the finance facility require amplification.

Project Finance. The GBB would sell its bonds in the capital market. Its bonds are guaranteed by the Government of Poland. After a year or two, these bonds might be offered on a regular schedule, perhaps each six months, which would provide better execution as investors could plan on their availability. The volume of bonds issued at one time would be based on the GBB’s forecast of the volume of loans it anticipates making over the next six months. A six-month issuance program naturally depends on the volume of loans demanded by gminas. By offering bond issues whose volumes are much larger than those placed by individual gminas, the GBB will realize a significant savings in issuance costs per zloty raised.

⁴⁰ Through November 1998, only 3 of the 18 bond issues by gminas with populations over 50,000 were for PLN 7.5 million or less. These gminas may have been discouraged from issuing a smaller volume of bonds because of the higher cost per zloty raised for smaller issues.

Formally, these would be general obligation bonds of the GBB, i.e., each bond issue would not be explicitly collateralized by a pool of loans. The loans, however, would serve as implicit collateral. To increase the quality of the collateral for the loans, the law will be amended to give the GBB the right to apply to the Ministry of Finance in the case of default on the loan. Upon review, the Ministry could provide for loan repayment from national government payments of shared taxes to the gmina.

The GBB will use the proceeds of the bond offerings to finance qualifying infrastructure and other projects (the same uses as listed in the last section). There are three options as to how funds would actually be channeled by the GBB to a gmina, and it may be wise to permit experimentation with all three.

1. The GBB makes a simple loan to a gmina.⁴¹
2. The GBB works with the gmina on a bond issue and then purchases the bonds.
3. A commercial bank works with the gmina to issue bonds to finance the project. The bank, however, receives a forward commitment of funds from the GBB so that it has a locked-in interest rate.⁴² The bank delivers the bonds immediately to the GBB when they are issued. The bank could simply act as the GBB's agent in originating the bonds (or a loan for that matter), using the GBB's funds, with the bonds being help by the GBB. In this case the credit risk, whole or in part, remains with the bank to encourage proper underwriting.

Where the GBB has a direct relationship with a gmina, loan repayments would be made to it directly.

Ultimately the choice among these options will depend on a combination of possible legal impediments to each and the all-in cost of funds to gminas under each option, including origination fees.

⁴¹ In some ways this looks to be the most efficient path. Origination fees on loans are generally smaller than on bonds (even excluding the cost of printing the bonds). In addition, selling securities to the GBB may be substantially more complicated than a simple loan. On the other hand, the market for municipal bonds is very thin at the present time and the relative cost positions could shift over time; in addition, legal impediments may exist to this type of transaction.

⁴² This commitment is only of interest to the bank and the gmina if the cost of funds to the gmina from the GBB is less than the cost from the commercial banks. The cost advantage of the GBB is an open question. In January 2000, five-year government bonds had a yield to 12.3 percent and one-year Treasury bills around 16 percent. Banks have priced municipal bonds at one-year Treasuries plus 100-150 basis points. So it appears possible (but not certain) for the GBB to be price competitive.

The GBB could make forward commitments to gminas or to banks for financing projects. The forward commitments would specify the interest rate as the interest rate obtained by the GBB on its bond issue (plus a stated mark-up). This arrangement minimizes the exposure of the GBB to interest rate risk. These commitments would serve as an implicit collateral for the bond issue. The term of the bonds and loans would be as closely matched as possible to minimize refinancing risk.

Because the GBB will issue bonds and then make loans, it will need comparatively little start-up capital.

Standards. The primary factor determining whether a gmina receives a loan from the GBB is its creditworthiness, i.e., its ability to repay the loan. Upon application for a loan from the GBB, this determination would be made by an independent credit rating facility under contract to the GBB and selected through a competitive process. This would be a determination of the general ability of the gmina to repay, not an analysis of the project's financial viability. In addition, a limited technical review of the project would be undertaken by the GBB to ensure that the project is technically feasible. The cost of these reviews is included in the price of GBB's to the gmina, i.e., the GBB's spread over its cost of funds.

Importantly, the operations of the GBB should serve to standardize the documentation and procedures for debt issuance by municipalities. This should make it easier for small gminas to participate and also improve the efficiency of such transactions.

Pricing. To ensure that the private sector is not "crowded out" by the GBB from serving larger gminas during the period the program is in operation, a dual pricing scheme could be used by the GBB.

- Gminas with populations of under 50,000 would receive funds at the GBB's cost of money plus its spread. The possible availability of below-market interest rate funds for a limited period of time would further stimulate gminas to borrow; most would be borrowing for the first time.
- Assuming the GBB enjoyed a price advantage for funding gminas, for projects in larger gminas the price of the GBB's money would be the same as that estimated the private banks are charging for larger loans (perhaps those over PLN 15 million). The "equivalent pricing" eliminates any reason for the gmina to seek finance from the GBB compared with private sources, except for the lower costs

associated with the GBB's issuance of comparatively large volume bonds.

The determination of the market interest rate or cost of funds would be made by the credit rating agency under contract to the GBB.

Conclusion. In short, the GBB would be a market-oriented institution operated on commercial principles. Its mission is to ensure the availability of finance to smaller gminas. But finance would only be extended to creditworthy gminas. Where a gmina fails to repay, the GBB would have access to national government grant funds that are to be transferred to the gmina. Finally, the sunset provision is designed to ensure that the facility does not unfairly compete with entities not enjoying the government guarantee on its bonds after the market is established.

Matching Grants

To stimulate small gminas further to implement badly needed investment projects and to reduce the financial burden on them of the investments, a grant program is a desirable part of the Communal Credit and Development Program. Grants covering up to 20 percent of project costs would be made under the program.

The logic underpinning the entire program is that smaller gminas are reluctant to undertake investments for a number of reasons. One is the lack of staff expertise to prepare projects; this is addressed with project preparation support. A second is the lack of finance for investments from current revenues. This is dealt with in part by the GBB. But the cost of an investment may nevertheless still be daunting. The matching grant program lowers the price of the investment to the gmina. This combined with the time limits on the availability of matching funds (see below) will push reluctant gminas to act on their investment plans. Once the gmina has gained experience in programming, financing, and managing one or two investment projects, it is expected to make further investments more readily, even without matching grant support.

As a general matter, the design of any new grant program should take full account of a country's existing system of intergovernmental fiscal relations. This includes the allocation of tax bases, the presence and extent of revenue sharing, the use of equalization grants, and the various categorical grants from higher to lower levels of government. The grant

program described below is in part shaped by the peculiarities of Polish intergovernmental fiscal relations.

A distinguishing feature of the matching program in the Communal Credit and Development Program is that the available subsidy funds are to be allocated annually *by formula* to local governments or groups of local governments. The allocation unit depends in part on the amount of funds available for allocation: allocations of very small grant amounts to individual localities are unlikely to have any effect on local decisions. In Poland, we envision groups of powiats (counties) being the allocation unit. The gminas in each powiat group would have priority access to these funds for a one-year period before they are returned for redistribution. The reasons for this mechanism are:

1. In a conventional grant program under which gminas must apply for funds, a few better-organized and -managed gminas will succeed in obtaining most of the funds. This is exactly the result the CCDP is trying to prevent: the primary objective is to stimulate the weaker gminas to take action.
2. The allocation of funds to groups of powiats will result in a much more equitable distribution of resources than an open competition procedure.

The funds would be allocated to powiat groups on a formula basis, with powiat groups containing small gminas with greater needs receiving more funds per capita. Groups of *contiguous* powiats are the allocation unit, rather than individual powiats or gminas, so that a meaningful amount of funds is received by each allocation unit. The specific definition of powiat groups will depend in part on the expected funding level for the program. If, for example, there were a decision to distribute funds from sources in addition to the budget for the CCDP, then powiat groups each containing fewer powiats could be defined as the allocation units. The type of formula that could be employed is discussed in detail elsewhere.⁴³

⁴³ S. Cooley and R. Struyk, "Allocation of Community Development Funds to Gminas by Formula: Illustrative Analysis for the Communal Credit and Development Program" (Washington, DC: Urban Institute, processed, 2000). Broadly speaking, there are two approaches to developing an allocation formula.

1. The *direct procedure*, which uses directly observed indicators of investment deficits in the allocation formula.
2. The *indirect procedure*, which uses proxies in the allocation formula that come from regression or other types of analysis.

Within the Eastern European region, there is very extensive experience with grant programs from the national government to local self-governments. Usually funds are allocated through competitions or on a discretionary basis, but experience with formula allocations is growing.⁴⁴ In Poland, for example, funds for several national government programs are currently distributed by formula. In one case, a formula is used to allocate national budget funds to gminas for housing allowances; in the formula, the size of the grant depends on the gmina's expenditures for housing allowances *and* its tax effort. But the practice is still somewhat exceptional, given national ministries' reluctance to give up control over the allocation of funds. Discretionary grants, including those allocated through competitions, dominate. The conditional grants to gminas from the national government are allocated by the voivods on a discretionary basis.⁴⁵

But formula allocation is not a panacea. Some formula allocations are not consistent with rational policies. Such cases often result from some combination of formulas inherited from the old regime and politically driven modifications. The grants to Polish gminas in the education sector have been a prominent example because of ad hoc adjustments to the base formula over a number of years. However, beginning in fiscal year 2000 a new, more efficient allocation algorithm is being employed. Another example

One might ask, if information on the community development needs of gminas, such as infrastructure deficits, is available for the application of the direct approach, when would the indirect approach be needed? The answer is that it is often the case that data on the direct measures of community development needs are only gathered infrequently. In other cases, reliable data on investments and deficits will be available only for a sample of gminas. Where direct and timely measures of investment needs are not available for all gminas, the use of variables known to be highly correlated with investment needs can serve as useful proxies. In the analysis cited, direct measures are used in one formula allocation procedure for distributing national government funds to gminas to assist them in meeting their communal investment needs. In a second procedure, regression analysis is employed to identify proxies to be used in constructing a formula that can be employed for the same purpose under an "indirect procedure." The indirect procedure is used in a variety of circumstances. An example very relevant to the allocation problem being addressed here is the formula used to distribute funds to U.S. cities under the national Community Development Block Grant Program. See, for example, H. Bunce and R. Goldberger, *City Need and Community Development Funding* (Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 1979).

⁴⁴ For a description of recent experience, see Dunn and Wetzels, *op. cit.*, particularly figure 7.

⁴⁵ See A. Levitas, *op. cit.*, pp. 14-15.

is the equalization grants to local governments from regional governments in the Russian Federation. An evaluation states that because they penalize local governments for cutting costs they "... create major disincentives for urban local governments to encourage economic growth and try to collect taxes more effectively." The housing and communal infrastructure sector is singled out as the sector most seriously disadvantaged by these incentives.⁴⁶

Few funds for investment are allocated on a formula basis.⁴⁷ In Poland, the grants and subsidized loan funds from the national and voivodship environmental funds are allocated through competitions in which the grantor's priorities and other criteria are announced to potential beneficiaries. The same pattern holds in Hungary and elsewhere in the region. Moreover, the project-by-project allocation of funds on a program-by-program basis means that local governments have little control over the type of investments they make if they want to make use of national or regional funds.

As Dunn and Wetzel (*op. cit.*) point out, in general the methods for targeting investment grants are weak and do little to ensure that the resources are being used well. Investment grants are often administered by a number of ministries all with differing criteria for targeting resources. In this case, it is unlikely that the grants taken as a whole are well-targeted on general objectives.

The general idea in the CCDP is for the formula to distribute the matching grants with explicit reference to communal investment needs and that gminas be able to propose the use of the funds for a range of investments geared toward improving the quality of life in the locality or fostering economic development. In effect, the matching grant program has a block grant structure, designed to enforce the national government's spending preferences geared to increasing local economic growth.⁴⁸

An important lesson from the experience with other programs using formula allocations is that the total amount of funds available for distribution must be large enough to provide significant funding to eligible

⁴⁶ L. Frienkman, D. Treisman, and S. Titov, *Subnational Budgeting in Russia: Preempting a Potential Crisis* (Washington, DC: World Bank, Technical Paper No. 452, 1999), pp. 57-9.

⁴⁷ Dunn and Wetzel, *op. cit.*

⁴⁸ The options for different grant designs and the justification for each are reviewed in Ahmed and Craig, *op. cit.*

beneficiary units—in this case, groups of powiats. Otherwise, the funds will have no impact on local decisionmaking.

The mechanics of the program are as follows:

1. Each year, funds are allocated to groups of powiats for use by the small gminas located within each group. If qualifying applications for all the funds allocated are not approved within 12 months after the funds are received, they are returned to SOHUD for redistribution to powiat groups in the same voivodship that did use their funds. (In fact, funds are not disbursed until expenditures have been incurred, as described below; until then, there is simply a set of bookkeeping transactions.)
2. Applications for funds are reviewed and approved, if appropriate, by the voivodship PPUs. SOHUD in consultation with the voivodships every two years will develop a set of priorities for the kinds of projects to receiving matching grants. To encourage initial applications, priorities may not be established for the first program year. SOHUD will also develop a narrow list of reasons that a qualifying application can be rejected and monitor compliance with this list. The PPUs will have 30 calendar days within which to make a decision on each application. Applications will be processed on an “order received” basis.
3. When an application is approved, the PPU will notify SOHUD so that the funds committed can be reserved for future disbursement from those allocated to the powiat group.
4. The PPU will monitor progress on the project for which funds were committed. When the gmina’s share of funds for the project has been expended (and the project has reached the corresponding stage of completion), then the PPU will notify SOHUD that it is appropriate for the subsidy funds to be disbursed to the gmina. In other words, the subsidies will be contributed only after the gmina has spent the funds it committed to the project.
5. If the funds are not disbursed within two years after the date of commitment, then the funds will be deobligated and returned to the pool for funds for the same powiat group.

Part II describes the development of the allocation formula itself through an analysis of infrastructure and housing needs at the level of the Polish gmina.

Conclusion

Experience has demonstrated that increased infrastructure investment is one of the key factors in driving regional economic development. Heightened economic growth in towns and small regional cities promotes greater on-farm productivity by creating jobs for underemployed farm workers, and farm incomes often rise because of linkages between farm production and the new economic activity in the urban places. Experience also shows that investment planning is best done at the regional or local level and that flexibility in the types of investment is essential.

The CCDP addresses the two principal constraints to the realization of investment projects to promote regional growth: limited capacity to define and prepare projects and lack of finance. The capacity constraint is addressed by the creation of regional-level project preparation units (PPUs) to work with local governments and to provide partial funding for contracting with consultants to prepare projects. Placement at the regional level is important because it facilitates coordination of regional development programs. At the same time, the creation of a Government Bond Bank (GBB), probably as a unit within an existing bank, will ensure the availability of project funding to creditworthy localities.

Importantly, this program is sustainable. A minimum of subsidies is involved and all parts operate on market principles. Indeed, the GBB might well be privatized within a few years after it begins operations. Private-sector organizations deliver the consulting services to municipalities.

Finally, programs like the CCDP may turn out to be critical in alleviating the difficult problem of the lack of capacity by local governments to absorb external assistance for regional economic development and increased on-farm productivity. Most prominently, this assistance will be coming from the EU's pre-accession funds. But the World Bank and bilateral donors also will continue with projects in this sphere. In any case, the evidence is clear that where absorptive capacity is limited, the effectiveness of donor spending is sharply reduced.