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PRICE AND SUBSIDY POLICIES
FOR URBAN PUBLIC TRANSPORT AND WATER UTILITIES
IN TRANSITION ECONOMIES

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PRICE AND SUBSIDY POLICIES
FOR URBAN PUBLIC TRANSPORT AND WATER UTILITIES
IN TRANSITION ECONOMIES

Slobodan Mitric

Summary

The paper in hand reviews the pricing issues faced by urban water services and public transport agencies in countries of Eastern Europe, Russia and Central Asia after the collapse of the former Soviet Union. It does so by drawing on the experience gathered under recent projects financed by the World Bank. The projects were initiated to help develop a suitable response to the difficulties besetting urban utilities as these countries started to change their economic systems in the early 1990s.

Under socialism, services such as these had been provided to citizens by public-sector organizations, at low or even zero prices. Low-priced services were generally considered as non-cash components of wages and pensions; some groups were given further discounts. The gap between service revenues and costs of provision was made up from the government budget or more directly from turnover taxes on local enterprises. Subsidies were endemic, the public sector controlled the greatest part of the national income, and cash wages were low. As the 1990s decade began, accumulated pathologies of a system in decline intersected with consequences of the first wave of reforms to produce difficulties, even crises on both supply and demand sides of urban services.

On the macro scale, the key developments were a multi-year fall in the aggregate output of goods and services, and high inflation. Measured at its lowest, relative to 1987, the real GDP had fallen by 15% in Poland (1991) and 35% in Russia (1995); in the latter country, GDP fell for 7 consecutive years. This reduced considerably the overall public expenditure capacity, with complicated downstream effects on different levels of government, sectors of economy, and splits between investments and current expenses. A concurrent decentralization meant that city governments suddenly had huge expenditure responsibility with ill-developed funding sources and mechanisms.

On the demand side of urban services, there was a dramatic fall in real wages and pensions. In the 1988-1993 period, real per capita income fell by 12% in the Czech Republic, 26% in Hungary, 42% in Russia, and more than 60% in some Central Asian Republics. Poverty increased from 14 million (region-wide) in 1989 to 140 million in 1996. Especially affected were unemployed workers with large families and some retirees. Concurrently, poorly implemented privatization and the rise of the gray economy led to much higher inequality.

On the supply side, there were several pre-existing structural problems. Technological backwardness of urban utilities was evident in equipment with high levels of
energy consumption and spare parts consumption. Also in evidence was strong preference for building large structures. Organizations were unwieldy and overstuffed with low-skill workers. In an enterprise, core functions were often swamped by in-house auxiliary ones, reflecting a drive for self-sufficiency typical of rigid economic systems. When the funding squeeze came, expansion and replacement plans were affected first, then maintenance and repairs, and eventually services provided by utility enterprises. The adjustment processes and the outcome for services varied widely between countries, cities and utility types, depending on the initial conditions and the depth of the crisis. At the high end were cases such as Budapest Transport Company, which in the short term was operating smoothly and providing a high level of service, but at about 30% cost recovery. This was unsustainable in the medium and longer term. Indeed, spending cuts on both state and city level started early in the transition process and still continue. At the opposite end would be the water company in Odessa, with intermittent service, low pressure, low-quality water, and leakages in both system and end-user sides. The residents have had to store and home-treat water, and/or buy bottled water, if affordable. Funds from all sources had run out much before the transition started, and the situation has not improved much since.

In this context, the objectives of the World Bank lending program have been twofold: first, to sustain services deemed essential for the population and local economy; and, second, to help implement regulatory, organizational, technical and financial improvements that would promote the commercial viability and sustainability of the service providers and to reduce their dependence on funding from the Government. Between 1994 and 1997, a dozen lending operations were undertaken in urban water and public transport sectors, in addition to other programs with a city focus such as housing, district heating, waste collection and processing, education, health, environment, and municipal administration.

In the realm of prices and subsidies, the projects had two key objectives: to move service providers towards financial health, greater independence and sustainability; and to shift the revenue burden from subsidies to user fees. A set of standard indicators, such as net operating income, return on assets, operating or working ratios, or simply percent cost recovery from user revenues, were used to measure financial performance. Time-specific targets for overall financial performance, revenue collection and price increases were negotiated and included as covenants in loan and credit agreements. Covenants were also used for actions to reform price structures or price setting processes, introduce new accounting systems, and carry out asset revaluation exercises. Price increase targets were checked for affordability to households, typically by checking whether the resulting water or public transport expenditure would fall above or under a benchmark proportion of household expenditures at average or sub-average income level.

Most projects approved in the 1994-1997 period are still under implementation. The intermediate results are that the progress in maintaining essential services and generally improving the supply side has been much better than the experience with price/subsidy actions. The progress in financial recovery of companies has been mixed, and is often subject to reversals. In the urban water sector, companies such as in Bielsko-Biala (Poland) have increased tariffs as agreed, and are on target as concerns the overall financial indicators. In
countries where the transition process has been less successful than in Poland, e.g. Romania, Bulgaria or Azerbaijan, water companies have fallen behind in both price increases and financial health. In urban public transport, the Russian Public Transport Project has so far met expectations: starting from cost recovery levels well under 20% of direct operating costs, 9 out of 13 companies reached the target 60-65%; a few reached 90% and even the worst made it to nearly 50%. This is, of course, still far from a financially healthy and sustainable state, which might be the target of the next batch of projects. Budapest Transport Company, a large multi-modal operator, has implemented fare increases regularly, increased revenue collection, and slimmed down its organization, staff and service network. The company managed to meet its 1997 cost recovery target of 43%, only to see it slide back towards 40% in 1998. The objective of overall financial health has proven elusive, indicating that further painful adjustments will be needed. In Riga (Latvia), with three companies at relatively high cost recovery levels (60-75%), considerable Bank pressure was required before the agreed fare increases were implemented. The companies are far from achieving financial stability.

Behind persistently low rate of increase in cost recovery, on the cost side, lie obsolete technologies and practices, and difficult downward adjustments in staffing and service standards. On the revenue side, it has proven quite problematic in many countries to raise service charges drastically to a population whose real cash incomes have collapsed, especially if at the same time the service levels have also fallen. More than that, this has happened not just in one service sector, but in all of them at about the same time, a bitter pill to swallow for most households. This simultaneity had not been reflected in affordability studies done in the context of preparing Bank-financed urban utility projects, which has contributed to less than realistic cost recovery targets. Project-based affordability checks have been limited to individual sub-sectors covered by a given project, and most often relied on aggregate income data and rule-of-thumb affordability benchmarks.

Quite apart from general price levels, many service users still pay sharply discounted prices, or even get free services. These discounts and exemptions are mandated by law, but the matching compensation to service providers is often not paid. Some groups enjoying special price privileges (e.g. retirees in Riga) have been successful in organizing to resist the loss of these, using political pressure methods normal in the democratic process. Other problems on the revenue side include non-payment of fares and service charges, which is still widespread and difficult to eradicate. On the supply side, obstacles against price reforms and better revenue collection include also short-term technological constraints, e.g. the absence of water meters at the household level, or obsolete ticketing systems in the case of public transport. In some services, such as district heating, the technological issue poses a formidable barrier as it is not feasible to measure consumption by apartment units or provide these control over how much service they will receive. In urban public transport, yet another factor limiting fare increases has been the concern for the loss of patronage, whether to other public transport operators, or to other modes (private auto).

The failure to increase cost recovery from service revenue means that the pressure on public budgets throughout the region is still unsustainable and blocks economic recovery. The national governments having by and large reduced their involvement, the load has fallen
on municipalities. These, in most cases, could not pay subsidies needed to get accounts of service companies into the black. The persistence of the funding gap means that the process of renewing facilities and adjusting services to sustainable levels is not proceeding rapidly enough and not in a planned manner. Instead, there is further deterioration in the physical assets and non-selective decay in the quality of services provided. (Even in the cases where the nominal funding gap has been closed for a year or two, the utilities are still in danger, given that the accounts typically have underestimated asset replacement costs and there was in any case a lot of catching up to do for years of neglect). In public transport, which unlike water is not a natural monopoly, the deterioration in public-provided services in some cities has been accompanied by a rise of alternative service providers, working with or without public sanction, offering typically better services, at higher prices, without discounts or subsidies. These have brought relief to some passengers, though most often at the price of breaking up the hitherto integrated service and fare systems.

We conclude that the approach followed until now has achieved as much as can reasonably be expected and propose an agenda for future urban utility projects meant to remove the more obvious shortcomings of the current approach to pricing issues. Its key features include: (i) avoidance of un-funded commitments by establishing the financial capacity of the local government to pay its overall subsidy load, as opposed to the current practice of checking only its debt repayment capacity; (ii) enhancing political feasibility of price & cost reforms by using self-selection, which lets client cities negotiate price increases with their own constituents directly (as was done under the Russian transport project): (iii) expanding the scope and depth of project-related studies to assess affordability and other demand characteristics, better to forecast impacts of price increases on households, including the impact of simultaneous price increases and links to wage policy; (iv) improving the subsidy system, by identifying subsidy objectives and beneficiaries, then choosing the best available transfer mechanism, coherent with the existing or planned social assistance programs; and (v) focusing on the supply side of utilities, especially as regards the rationalization of service standards, the reduction in operating costs, and helping overburdened local governments implement efficient systems of franchising and concessioning for involving competitive private operators in the provision of public services.
1. Context and objectives

This paper addresses price and subsidy policies for urban public transport and water utilities in transition economies of Europe and Central Asia, seen in the context of the World Bank (WB)'s assistance program to the region. The term “transition economies” covers countries from Eastern Europe (EE) and those that came into existence by the break-up of the former Soviet Union (FSU), which since the late 1980s have undertaken a set of economic and political reforms away from socialism and toward liberal capitalism. The aggregate population of these countries is about 360 million, about 9% of the world population. In terms of 1995 gross national product per capita (with equivalents in purchasing power parity given in parentheses), they range from Tajikistan at $340 ($920) and Georgia at $440 ($1,470), to Poland at $2,790 ($5,400) and Hungary at $4,120 ($6,410).

The two service sectors on which this paper focuses, urban public transport and water, are typically in the jurisdiction of city governments.

A standard feature of the socialist system was that services which were deemed to be essential were provided to citizens at low price, even for free. The flip side of this was that the government and the public sector controlled a very large share of the national income, and citizens received low wages. Reflecting this, urban utilities in ECA’s transition economies entered this decade with a revenue structure in which a smaller fraction came from users of the service and larger fraction came in the form of subsidy from various levels of government. The government also paid for most capital improvements. This arrangement has broken down, together with the system of which it was a standard feature.

The desired and intended direction of transition is that individuals and households would gradually command higher and higher shares of the national income, and that national income itself would grow. Households will have more income and more choice, but will have to pay much more out of their own pockets for many services than was the case under socialism. At the early stage of transition, however, the old ways are gone and the new ones are not yet in place. Many of the old benefits are gone, and cash incomes for many people have actually decreased. Subsidies to service suppliers have decreased, while some of their costs have increased. Many utilities are in a difficult position, and some are in financial crisis, lacking funds to replace infrastructure and equipment, buy spare parts and materials for proper maintenance, or even pay staff wages and energy bills. This is visible to citizens in the form of poor services, and higher prices.

In this context, the objective of the World Bank lending program has been to help maintain essential urban services and restructure the service supply sectors in their organizational, regulatory, technological and financial dimensions. The current WB portfolio of infrastructure projects in the ECA region has a dozen on-going projects which involve water and sewerage, urban public transport, or cut across several municipal activities including these two sectors. Projects combine investments in infrastructure, equipment and institutions with reforms in the management of service enterprises, and the organization and regulation of these service sectors by the local government.
The subject of this note is the three-way interaction among the suppliers (service companies), governments, and customers (primarily individuals and households) of urban public transport and water/sewerage services in transition countries. The focus is on the realm of prices, subsidies and revenues, seen mainly through the prism of WB assistance programs. The objective is to share experience across sub-sectors, and develop good-practice guidelines for the next batch of lending operations in urban utilities.

The paper starts with a brief section on the impact of transition processes on the economy, as a background to a section on initial conditions in water and public transport utility companies, as found at the diagnostic stage of Bank assistance efforts to these utilities. The approaches used in the current portfolio of such projects are then summarized, to provide the framework within which price and subsidy reforms were undertaken. Specific approaches to price and subsidy reforms are reviewed, as is the relevant implementation experience. The last two sections discuss the sources of resistance to change and reform, and present a proposed approach to the development of assistance strategies for the future.

2. The Transition

The key economic reforms associated with transition included liberalization of prices and foreign trade, removal of barriers against private sector economic activities, and fiscal stabilization. In addition to these, the fragmentation of the Soviet Union and the cessation of economic agreements between EE and FSU countries had an enormous impact on prices and availability of factor inputs and consumption goods, terms of trade, etc. Depending on the country, the reforms were introduced fully or partially, suddenly or gradually. Either way, things had to become worse before they could become better. The most important consequences of the breakup and reforms in this initial stage of the transition process were the following (Milanovic, 1998):

(a) a fall in the aggregate output of goods and services for several consecutive years; at the lowest point, and relative to 1987 (pre-transition base year), the fall ranged from 15% of real GDP in Poland (in 1991), to 35% in Russia (in 1995); negative growth rates were recorded for 3 consecutive years in Poland but 7 years in Russia, Moldova and Ukraine.

(b) a relatively modest rise of unemployment from near-zero levels beforehand to 3.2-9% in Russia (registered and actual) in Russia, and 12-15% in Eastern Europe, except the Czech Republic where it remained low until 1998; the exodus into (early) retirement, however, has been considerable in some countries.

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1 The source reference and other works in this field stress great difficulties with availability and accuracy of data. Generally, official economic data from the pre-transition period overstate output and employment, whereas data from the transition period underestimate employment, output and incomes from the private sector.
(c) a fall in real wages (a consequence of (a) and (b) taken together) of about one-third in Eastern Europe and one-half in Russia and other USSR successor states; from household-based surveys, the fall in real per capita income (measured between 1988 and 1993) ranged from 12% for the Czech Republic, 26% in Hungary, 42% in Russia, to 62% in Kazakhstan and 66% in the Kyrgyz Republic. To this should be added wage arrears, sometimes months long.

(d) a like fall in government revenue, given that tax systems were based on payroll taxes, reducing the capacity to subsidize enterprises, make income transfers, and undertake capital investments;

(e) high inflation, varying in the 17-29% range in advanced reformers like Hungary, but reaching hyper-inflation in inverse proportion to the speed and depth of reforms: 131-256% in Romania, 92-1353% in Russia, 1610-1980% in Kazakhstan and 969-2200% in Belarus (data are for 1989-94 period, from De Melo, Denizer and Gelb, 1996).

(f) an explosion of poverty\(^2\), from 14 million in 1989, to 140 million in 1996, nearly 40% of the total population in transition countries;

(g) an increase in inequality in some countries, notably Russia, Lithuania, Estonia, Ukraine and Bulgaria. The bottom quintile of the population in these countries lost up to two-thirds of real income, making income distribution worse than in OECD countries. Income inequality did not change materially in countries like Hungary, Slovakia and Slovenia.

In addition to changes in the economic sphere, yet another development relevant to the topic of this paper has been taking place in transition countries: decentralization of political and economic power. Local and, in some countries, regional governments are now elected; have gained jurisdiction over many local services and ownership of land and infrastructure; have taxing and spending authority, and subsidy responsibility; and benefit from new financing arrangements in which transfers from the state are a diminishing proportion of total revenue. As with economic reforms, countries differ as to the speed and scope of decentralization: Poland, Hungary, and the Baltic states being in the forefront, while the FSU countries lag behind. Even in the advanced cases, where cities like Budapest, Warsaw and Krakow have been called asset-rich but cash-poor, the financial capacity of local governments has been slow to build. In less fortunate cases, cities are badly strapped for cash.

3. Urban Public Transport and Water Companies: the initial conditions

When the transition started, large differences existed between companies, cities and countries involved, and the changes taking place at different speeds have intensified these

\(^2\) Poverty threshold used here is an expenditure of $4 per capita per day in international dollars (based on purchasing power parity). This threshold is four times higher than The World Bank’s absolute poverty level (Milanovic, 1998).
differences. The main dividing line is between utility companies in Turkey, the Balkans, the Baltics, and East European “EU accession” countries on the one side, and the FSU countries on the other. Still, it is useful to sum up the features quite common to urban utility companies in all transition countries early in this decade, some of which have remained to the present:

(1) Organizationally, water and public transport services appeared either as municipal departments, or as public enterprises in state or city ownership, with no freedom to set prices and minimal degrees of managerial independence as concerns service policies and operational matters.

(2) Organizations tended to be top-heavy, and operational and management procedures were bureaucratic. There was a tendency towards self-sufficiency, e.g. by setting up internal units for the production of needed inputs, as opposed to buying these services from outside sources.

(3) Staffing was excessive, following generally from the full-employment approach practiced in socialist economies, and managers ability to fire on performance grounds was very constrained.

(4) Companies had over-age and technologically obsolete plants. Energy use was especially inefficient, in great part because fuel and electricity were significantly underpriced. To these should be added problems introduced by transition, notably difficulties in replacing spare parts and equipment, due to the breakdown of the industrial division of labor in the socialist block.

(5) Investment decisions were not based on economic criteria, but in response to centrally established norms. Because of budget constraints for maintenance, there was a tendency to overcompensate by overdesigning new investments. Quality of materials was often poor.

(6) Following from the preceding points together, costs of operation per unit of output were higher than they should be.

(7) Company accounts did not reflect full economic costs of operations. Some activities, such as barter trade, were not recorded. The depreciation accounting was not based on replacement value of plant and equipment, or was not calculated at all in some forms of ownership (e.g. when the service provider was a municipal department). Therefore, even if companies covered their accounting costs, this did not generate sufficient funds for replacement.

The term “company” is used throughout the paper even if the service provider was a municipal department.
(8) Another major source of deviation of accounting costs from economic costs was the distorted price of electric energy and other fuels, endemic in pre-transition period, and still prevalent in Russia and some other countries. This distortion was especially significant for water companies, and for urban public transport companies using electrically-powered vehicles.

(9) Generally, the approach to accounting was inconsistent with western practices or meant to mislead. Accounting was not meant for, and was never used as, a management tool. In some cases, different departments of the same enterprise kept separate accounts which never got fused into company accounts (Baku Water, Kazakh bus companies).

(10) Service levels, in terms of quantity and/or quality: a variety of cases, ranged from very poor to quite high. For example, services by Bucharest Water Company featured daily interruptions of water, variable water pressure, and out-of-order plumbing fixtures in households. On the high side, Budapest Public Transport Company (BKV) provided services whose availability, frequency and punctuality have been among the best in the world.

(11) Sudden and large up or down changes were experienced in demand levels due to various economic and political developments accompanying transition. This included such diverse cases as drops in water consumption and/or public transport usage due to large-scale closures of inefficient industries (water in Riga, metro in Yerevan); increases in water consumption due to a large influx of new population to cities (Yerevan, Tbilisi); drops in public transport usage in major East European cities, due to a removal of restrictions and rationing on gasoline, and increased levels of auto ownership; etc. Each of these had a major impact on both costs and revenues of service companies.

(12) Prices charged for services were low relative to the cost of supply, and sometimes zero (as for water in Turkmenistan, for example), reflecting policies pre-dating transition and various obstacles to change within the transition process. Utility prices were so low across the board in Russia that, as late as 1994, household expenditures on housing and related utilities (water & sewers, waste collection, heating, gas, electricity) added up to less than expenditures on tobacco and alcohol (Sewell, 1995).

(13) Prices were not structured right, in the sense that they were not related to economic or even accounting costs of provision to different customers, or to the amount of use. Cross-subsidies between client categories were common. In the water sector, for example, unit costs of supplying households were higher than supplying industrial and commercial customers, whereas prices charged were higher for the latter. In public transport, fares did not reflect different costs of supply of peak and off-peak travel, or short and long trips; in contrast, transfer travelers were as a rule penalized by having to purchase another

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4 A good example of this is the habit of distributing after-tax "profits" as wage bonuses by Russian water companies, to minimize tax paid on the wage bill.
fare. Public transport services in Bishkek in Kyrgyz Republic, for example, feature flat fares, and very long routes.

(14) Price discounts (off already low basic prices) and exemptions were rampant, typically favoring pensioners, school children and students, war veterans, the handicapped, as well as some government employees, military personnel, and the police. Russian law, for example, specified 42 categories of privileged public transport passengers. Price discounts and exemptions were available mainly in public transport services, but sometimes also for housing and other utilities, such as water and electricity.

(15) Price discounts and exemptions were typically mandated by national laws, and the question of expenditure responsibility did not arise in the then prevalent centralized system of local government finance. In the process of redefining jurisdiction, functions, revenue raising and expenditure responsibilities between national, regional and local governments, the mandate has sometimes stayed at the national level, whereas the cities were stuck with expenditure responsibility. In other words, the national government law would require a subsidy, but would not make the corresponding budgetary appropriations. Even when the same authority (e.g. city council) granted a tariff/fare discount or waiver, checks and balances of the requisite financial capacity on the local level did not exist.

(16) Legal provisions to adjust prices in line with inflation did not exist. Historically, price adjustments had been made rarely and ad hoc. For example, the first fare increase in the history of Budapest Transport Company (created in 1968) took place in 1985; the next one was in 1989, but then adjustments became annual.

(17) Revenue collection was poor, and there was a high incidence of non-payment by households and institutional clients in case of water, and illegal passengers in urban transport. Budapest Transport Company estimated the proportion of non-paying passengers at 10-17% depending on the degree of access control (e.g. higher in street buses and lower for metro). In Russia’s medium-size cities in 1993, it was estimated that 20% of passengers traveled without paying their fare. Bucharest Water Company collected only 68% of its billed revenue in 1995, and by the end of the year had four months worth of accounts receivable; main non-payers were public-sector customers. Non-payment may have been a matter of poor organization and performance of the company, a reluctance due to recognition that people cannot pay (e.g. in presence of months of unpaid wages and pensions, as in several FSU countries), a fear of social conflict, or a combination of all of these. It has often been stated that the elimination of illegal travel and fare exemptions alone would suffice to equilibrate the accounts of urban public transport companies in some FSU countries.

(18) Bills were often based not on actual consumption but on norms. This was especially the case with water bills, where only the total output leaving the production plant was metered, then “allocated” between various groups of users using standard coefficients. Similarly, subsidy calculations for monthly and other discount passes and exemptions in public transport were based on normative usage rates rather than travel surveys.
(19) In some countries, billing and collection was not done by the service companies but by specialized local agencies for several or all utilities together; the resulting revenue was "allocated" among service companies independent of costs or output measures.

(20) As a consequence of items (12) through (19) together, business revenue (from individual and institutional clients) was with few exceptions lower than direct operating costs (DOC), not to mention the total operating costs (TOC)\(^5\):

<table>
<thead>
<tr>
<th>Company (year)</th>
<th>Revenue/DOC (%)</th>
<th>Revenue/TOC (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia: Nizhniy Novgorod Bus Co. (1993)</td>
<td>13</td>
<td>n.a.(^6)</td>
</tr>
<tr>
<td>Latvia: TTP Tram Co. (Riga) (1994)</td>
<td>79</td>
<td>73</td>
</tr>
<tr>
<td>Latvia: Imanta Bus Co. (Riga) (1994)</td>
<td>67</td>
<td>59</td>
</tr>
<tr>
<td>Latvia: Daugavpils Water (1994)</td>
<td>91</td>
<td>86(^7)</td>
</tr>
<tr>
<td>Turkmenistan: Dashkhovuz Region (1997)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Poland: Bielsko-Biala Water (1993)</td>
<td>147</td>
<td>81</td>
</tr>
<tr>
<td>Poland: Krakow Public Transport (1992)</td>
<td>n.a.</td>
<td>56</td>
</tr>
<tr>
<td>Poland: Warsaw Public Transport (1992)</td>
<td>n.a.</td>
<td>80</td>
</tr>
<tr>
<td>Poland: Gdansk Public Transport (1992)</td>
<td>n.a.</td>
<td>47</td>
</tr>
<tr>
<td>Azerbaijan: Baku Water Supply (1994)</td>
<td>130</td>
<td>114(^8)</td>
</tr>
</tbody>
</table>

(21) Subsidies were provided by the local and/or higher levels of government to make up the gap between business revenues and costs. In the aggregate, subsidies have figured prominently in local governments expenditures. Even for individual companies, subsidies may have been so large as to be among the largest items in the government's financial statements. In 1990, subsidies to BKV in Budapest, always scrupulously paid by the city and the national government, amounted to HUF 11,197 million ($177 million), equivalent to 0.5% of Hungary’s GNP in that year, and also to about 15% of total revenues of the City of Budapest.

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\(^5\) Direct operating costs include wages, energy, materials, payments for external services. Total operating costs include direct operating costs and depreciation. Business revenue may include results from activities other than the primary activity. Some data may include taxes and long-term interest costs in total costs.

\(^6\) Depreciation and financial costs were either not recorded in the accounts of Russian public transport companies, or were negligible.

\(^7\) Based on an estimate of deferred costs.

\(^8\) Total costs include profit tax. Without it, total cost recovery ratio would be 123%.
(22) Total revenue (business revenue plus subsidies) may not have covered total (accounting) operating costs. In case of critically impoverished cities, total revenues may not even cover direct operating costs. Reasons for these accounting losses were different. Primarily, the level of subsidies required was not affordable to the government, the latter being under pressure financially from several sides. In certain ownership arrangements (e.g. service providers as budget units of the local government), balancing the accounts of individual units was not considered important. Subsidy payment may have been gauged to cover direct operating costs exactly, as has been the case in the case of Riga, Latvia. The government then would decide on ad hoc basis whether and when to provide funding for replacement investments.

(23) The funding gap gradually added up to poor financial state of companies, especially lack of working and investment capital. Different methods were used in response. Depending on the magnitude of financial problems, the array of adaptive actions included reducing/eliminating expansion investments, then postponing replacement, deferring maintenance, reducing services, not making contributions to social funds, borrowing short-term (if facility available and legal), not paying bills owed their own suppliers, and eventually not paying salaries. In this last stage (non-payment of salaries), adaptation (in the case of public transport) meant that drivers and/or conductors would dip directly into the fare box. In the case of urban public transport, if this process lasted long enough, as it did in several Central Asian countries, municipal companies became defunct and the market was taken over by less regulated private providers.

4. The Structure of Bank-financed projects involving urban utilities

The Bank-financed projects involving urban public transport and water utilities have had a dual focus, aiming first to sustain services deemed essential for the population and local economy, but also to restructure the service suppliers to ensure their financial sustainability and to improve their efficiency. The approach was to try to promote a commercial orientation and to introduce organizational, technical and financial improvements with this objective in mind. Project structure has followed directly from the foregoing diagnostic statements about utility companies. The hard, investment part of any given project invariably has involved the replacement of and to a lesser degree additions to equipment and infrastructure. The soft, reform part consists of actions generally falling into some or all of the following five categories.

A. Internal restructuring of service companies:

- re-organization for higher efficiency;

9 Even in cases where there has been no nominal funding gap, e.g. for urban public transport companies in Poland, companies idled parts of the fleet, effectively reducing services in order to meet cost ceilings.
- elimination of departments supplying non-core services, either through outright closure or first by setting them up as subsidiaries then offering them for sale to private parties;

- introduction of new work methods and tools (e.g. information technologies), accounting standards, and financial management;

- staff downsizing and/or changing the skills mix; upgrading knowledge and skills of managers and staff; and

- a shift in investment and development policies, to ground them on economic criteria.

B. Legal changes involving service companies:

- changes regarding the status, and ownership of service companies typically by setting them up as public-owned but separate companies operating under commercial law;

- re-allocation of decision authority between service companies and the local government in matters such as service parameters, prices and remuneration, staffing, wages, budgeting, and operations-oriented matters; and

- introduction of a performance (service) agreement, as a common instrument to detail the new relationship between service providers and the local government;

C. Demand-oriented changes:

- changes in output, e.g. redesign of services and service networks in urban public transport, or, in the water sector, a change from emphasis on quantity produced to quality of services delivered; and

- reform in pricing/subsidy and revenue collection policies.

D. Market-oriented regulatory reforms

- reforms meant to break up the monopoly of traditional service suppliers and enable private sector entry, by introducing subcontracting, multiple service suppliers, and concessions; and

- introduction of private sector operators through management contracts, with a view towards privatization of service provision in the future.\textsuperscript{10}

\textsuperscript{10} Management contracts, leases or concessions are still a rare item in a Bank-financed urban public transport or water project in ECA transition economies. Interestingly, first franchise arrangements for urban public
E. Local government reform:

- building institutional and financial capacity of the local governments so that they could handle new functions, decision powers and responsibilities given them by decentralization.11

Project make-up varied depending on the sector features; initial conditions in the market, company and the government; the strength of the forces for change; and the capacity to implement it. Short-term objectives depended very much on what are locally the most critical “bads” and the most desired “goods”. In Russian medium-size cities and in Dashkhovuz region in Turkmenistan, the focus was on restoring services considered essential to local economy and/or households, and increasing sustainability by lifting user charges from abysmally low (even zero) levels. In Bielsko-Biala, Poland, the key reform objective was to change the tariff structure of the water company and increase tariffs in real terms to catch up with accounting costs redefined to reflect economic costs. In Budapest, where the public transport system had faced falling demand, the approach involved a combination of down-sizing of the company (divestiture of auxiliary activities, staff reductions), reduction of service network and standards, increases of internal efficiency (through investment among other things), and shifting the burden of financing towards users.

\[\text{transport services, based on competitive bidding, were not introduced under Bank projects in EE countries but in Kazakhstan and Uzbekistan.}\]

11 There was not one project in the portfolio which had a primary focus on water or urban public transport while also involving major local government reforms. This last was typically done through municipal development projects, some of which had smaller-scale water or urban public transport investment components, without associated reforms of service companies.
5. Building blocks specific to price/subsidy and revenue-related issues

This paper now turns to its main subject, the actions under Bank-financed urban public transport and water projects, which address price/subsidy/revenue aspects of utility companies. The objectives here were twofold: (a) set the service companies on the road to financial health, independence and sustainability; and (b) shift the revenue burden away from government budgets towards user charges.

Based on a review of project documents for the current portfolio, the following actions appeared as the most common strategic building blocks used, listed here in the order of ascending complexity.

**Improvement in revenue collection.** Because this activity required little change in the existing framework, it was used in most projects. In urban public transport companies, it focussed on passengers traveling without valid ticket, involving improved inspection, employing conductors with a double role of ticket sale and control, increased fines, and improved enforcement of fines. A first-ever survey of illegal travel was carried out for the Budapest Transport Company.

In water companies, improving revenue collection involved much more than improving the accounting and billing service, and introducing sanctions. It was as a rule linked with changing the price structure, which in most cities had been based on flat per capita rates, to reflect actual consumption. The key technical problem here (other than affordability) has been that apartment houses, in which most urban population live, did not have apartment-specific meters, and installing them would have been prohibitively expensive. Also, there are endemic problems of broken meters (in case of industrial customers) and user-side leaking fixtures. Once consumption based bills are introduced, even at the apartment-block level only, user-side leaks acquire considerable importance. Social assessments in Baku, Azerbaijan indicated that households did not have enough funds to repair leaky faucets and valves, pursuing instead a “monthly leakage control” of stop-gap measures, cheaper than a one-time complete repair. Another problematic dimension of introducing metering and consumption-based billing for water has occurred where collection is done for several municipal utilities on a common bill, as in Russia, for example. This may require a wider-scope reform, which is typically more difficult to achieve than for one sector at a time.

**Improving accounting systems and standards.** Most commonly, this has been an attempt to improve basic information in service companies, regarding output, demand, costs and revenues. This may have been as basic as introducing accounts where none existed (as in Turkmenistan water companies). Going a notch higher, the change involved moving from government-type accounts (e.g. annual budget, no balance sheet, no depreciation of equipment used by individual budget units of a city) to those conventionally used by well-run public enterprises. In some countries, accounting standards and practices were being overhauled in line with new national laws for commercial companies. In countries preparing for entry into the European Union (Poland and Hungary, for example), new accounting rules
for companies operating under the Commercial Code conform to internationally accepted accounting standards, whereas this is less the case with new laws in FSU countries. When the divergence between the existing or new national standards was substantial, as for example in Russia, the approach in Bank-financed projects has sometimes been to recommend two sets of accounts, one legally mandated and another in line with international practice, the latter expected to reflect better the real costs of operation (cf. Russia Water and Wastewater Sector Study). Finally, in parallel with adopting new accounting standards, companies may have been required to carry out an asset valuation and balance sheet restructuring, so that the new accounts reflect better the real costs of the operation.

Increasing prices. Tariff/fare increases were included as loan covenants in nearly all water projects, but only in some urban transport projects. Covenants would typically specify annual price increases: (a) according to specific rates, or (b) according to a formula based on changes in one or more official price indices plus agreed real increases (as for example in Bielsko-Biała Water Project). Alternatively, to add flexibility to the reform package, price increases were not stated as loan conditions, but placed in action programs and/or performance agreements, the overall adherence to which was included as a loan covenant.

Changing price structure. In the water sector, this mainly involved changing tariffs from flat, norm-based rates to consumption-related, with or without block tariffs, and/or shifting the balance of cost recovery from one class of users to another, typically from institutional users to households. In some projects, changing the price structure was an up-front loan condition, or it was only required to commission a study to develop a new price structure (as in Turkmenistan, where water price had been zero).

None of the urban public transport projects in the portfolio included a loan condition related to price structure. Coming closest to addressing this subject is the Budapest project, with an undated loan covenant referring to the creation of a Regional Transport Association. This would, by definition, require a reform of currently separate price structures of the three major operators (national railways, inter-city bus company, and the urban transport company) and their amalgamation into a unified, area-wide transport system, with transfer privileges for passengers.

Comprehensive approach to company finance. A set of overall financial targets for the water or public transport companies included in the project was defined, the fulfillment of which would indicate their reaching good financial health in terms generally accepted in western countries. Indicators were most often related to cost recovery (working or operating ratio, or their inverse), but may also have addressed the level of working capital, debt, net income, or return on assets. Some projects used "contractual" cost recovery targets without separate and additional references to costs or prices. The Borrowers were left to decide which weight to place on revenue increase and which on cost reduction. Overall, given low initial

\[ \text{\footnotesize \textsuperscript{12}} \text{ Compare to Bank-financed public transport projects in Chinese cities where a reduction in annual subsidy in nominal or real terms was also included as loan conditionality.} \]
cost recovery scores, the judgement underlying financial conditionality has been that the scope for cost cutting was much more limited than the scope for price increases. In the Russia Urban Transport Project, no fare targets were specified, but project documents left no doubt that improved cost recovery would come mostly from the revenue side (higher basic fares, reduced exemptions, better collection). In Budapest Urban Transport Project, the contractual indicators were overall cost recovery ratios and percent of illegal travelers, in addition to some productivity indicators. No specific fare increases were cited in the Loan Agreement, though supervision reports leave no doubt as to the focus on fares. In Budapest, however, a comprehensive action program to reduce company costs was agreed, though without any numerical targets on unit costs or staff levels. In Riga, urban transport companies agreed to a wide-ranging set of targets, with separate references to fares, various aspects of productivity, and overall financial indicators.

The agreed increases in cost recovery range from modest to considerable. In Budapest, cost recovery (relative to total operating costs) is expected to move from the initial 38% in 1995 to 50% in year 2000, a change of 32% over 5 years. In Russia Urban Transport Project, the initial cost recovery was 12% in 1994, and the target was 60% to be reached by the end of 1997. This represents a change of 400% over 3 years, albeit measured relative to direct operating costs only. Underlying such different magnitudes of change are different initial positions between the Hungarian and Russian cases, but also different cost structures of companies. BKV, Budapest is a very large company with a considerable amount of specialized infrastructure (for tramway, metro and suburban railway lines), whereas Russian companies operate only street-based bus lines, without any specialized infrastructure.

Introducing alternative suppliers. Generally, the overriding objective behind this approach is to expand/improve services through the mobilization of private capital and know how. It is included here because it may also be directed at cost recovery in the sense that a portion of the market will be carried without subsidy. The latter may occur because a competitive setting induces private operators to achieve lower operating costs and/or because they are less willing to accept uncompensated fare privileges and exemptions. In the EE/FSU portfolio, this approach has so far been used as part of project design only in two urban public transport projects. Under the Kazakhstan Urban Transport Project, it was agreed to open the public transport market in Kazakh cities to any qualified entrant, subject to fare regulation. In Budapest, a more modest pilot program to tender some lines to private operators was included as part of the loan conditionality, the objective being to demonstrate a potential for cost reduction to both the Municipality and Budapest Transport Company, hitherto the monopoly operator.

In addition to the above building blocks, the following three aspects of the projects in the urban public transport and water portfolio were related to price and subsidy issues.

Affordability analysis. The common approach to affordability in project preparation has been to check the level of prices agreed to under the project against some level of household or per capita income for the area. Monthly household expenditures for public transport and water, based on an assumed frequency of travel, or consumption rates,
respectively, were expressed as a percentage of average household income and compared to rule-of-thumb benchmarks graced with the name of “international standards”. If transport expenditures were less than 10-12% and water expenditures less than 2-3% of the average household income, the prices were considered affordable. Under some projects, affordability analysis was extended to check the impact of future prices on lower income households, including people on minimum wage and minimum pension, with and without changes in consumption level. Bielsko-Biala Water Project, for example, made such an affordability check for six income/consumption scenarios. Older projects tended to be skimpy in this regard, whereas the newer projects evidently have profited from the numerous poverty studies done for ECA transition countries and/or city/regional social assessments commissioned in tandem with specific lending operations. Social assessment were mainly done for the Central Asian FSU countries.

- Willingness to Pay. Under the more recent projects, affordability analyses were complemented by exploring the users’ willingness to pay, using information collected in social assessment surveys.

- Public Education. Since social assessments have indicated the degree of public ignorance about the real cost of services and their link to prices, some projects have included a public education and dissemination components. Bielsko-Biala Water Project in Poland, for example, included campaigns focusing on water conservation, costs, charges and the level of service.

6. Evaluation of experience

Most urban public transport and water projects started in the early 1990s are still being implemented, so the results are of intermediate nature and have not been systematically gathered. The reported experience indicates that best progress has been achieved in maintaining essential services and improving company organization and assets. As regards price/subsidy/revenue reforms, the results are mixed and, on the whole, less than expected. The best results appear to have been achieved in countries which have made the largest overall progress in transition. The water company in Bielsko-Biala, Poland, is on target for overall cost recovery and other financial indicators, having increased tariffs as agreed. Poland, of course, has been one of a few transition economies which has posted considerable economic growth in recent years, 7.1% in 1995 and 5.9% in 1996 in GDP terms. Companies in Romania, Bulgaria, Latvia and Azerbaijan have fallen behind relative to the targets, and in Turkmenistan all reform is at a standstill. In Baku Water Project, for example, overall collections were approaching 70% towards the end of 1998, short of the initial (80%) and revised (75%) targets for that year; the collection rate for residential users is still only 25%.13 The sheer number of households attached to a single meter makes conservation measures and

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13 These revenue collection targets were not agreed under the Bank-financed project, but under the parallel EBRD-financed project. Various sources disagree on the starting position with regard to revenue collection rate, some quoting 10% and others 55%.
bill enforcement very difficult. For all water projects in the Caucasus region, tariff increases are essential but are overshadowed in the short term by the need to improve on low collection.

One of the reasons for some companies to fall behind in cost recovery has been that water usage decreased sharply, so revenues decreased in spite of higher tariffs and improved collection (e.g. in Daugavpils, Latvia). The change seems to be due much less to price elasticity of demand than to the reduction of industrial demand arising from economic contraction and to the fact that better numbers are available. What was previously called demand was often largely leakage and waste. Better readings are becoming available now with the introduction of metering at the consumption site, though still at the apartment block rather than apartment level. Beforehand, billing had been based on metering at the point of production, then allocated between industrial, commercial and residential customers using standard and arbitrary consumption coefficients, without regard to possible leaks. Though unsettling in the project implementation context, this is a positive development, since it is providing incentives for better system maintenance and paying more attention to price structure. Moreover, in some cities, the newly discovered downward trend in consumption has led to the identification of spare capacity in water and sewage processing plants, and to shelving of expansion plans.

In the public transport sector, companies in 9 out of 13 Russian cities have met the cost recovery target of 60-65% (based on direct operating costs only) agreed for end-1997. Five cities now recover 90% or more. In the worst case (Rostov-on-Don), the company made it to 46%. In Kazakhstan, the companies have met and exceeded the loan covenant expressed as the ratio of single-fare price to its “economic costs.” Cost recovery, however, is lagging because most travelers use season passes, so the weight of single-fare tickets in total revenue is not high.

The successful performance of the Russian urban public transport companies as regards cost recovery may be due in large part to the approach used to qualify cities for inclusion in the Bank-funded project. In contrast to the usual approach of preparing an investment project in a given city and then negotiating the depth and scale of the reform program, the team working on the Russian project first selected the parameters of the reform agenda, then worked to prepare investment projects in cities which had made formal commitments to that agenda. This process of self-selection worked in stages, with increasing cost recovery targets set for appraisal, negotiations, tendering and a mid-project date. More cities than could be accommodated in the initial operation had been willing to meet the terms, and numerous cities have since expressed interest in the next lending operation.

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14 Unrelated to Bank-financed projects, drops in the quantity of water billed of 30-70% were recorded in Poland and East German cities.

15 The cited numbers are time specific, with considerable variation from one year to the next. Altogether, they should be treated as indicative only. Utility companies in FSU countries are still unable to produce accounts good enough for the total cost recovery to be measured with confidence.
In Budapest, BKV has been transformed from a state enterprise into a joint-stock, limited-liability company, still in public ownership but governed by a board of directors. It has streamlined the organization, reduced staff drastically, pruned its service network, reduced service frequencies on some lines, divested secondary activities, and increased fares regularly. Efforts to increase revenue collection have given some modest results: Budapest has stepped up its inspection and enforcement program for public transport, and reports a decrease of illegal travel from 11% to 7% on metro and suburban rail lines. Unfortunately, there has been no change in high rates on tramways and buses (13%) and trolley-buses (15-18%), which are much harder to control. The system average at 11% remains much higher than the target of 7%. The action on the reform of the price structure, in the framework of establishing Budapest Transport Association, is stalled because of difficulties in agreeing the revenue allocation among the three operators involved. The focus is now on achieving an intermediate step, a mini-association covering only passengers who use more than one operator for their daily commute.

For 1997, BKV’s cost recovery was on target, reaching 43%, helped in part by one-time sales of real property. Unfortunately, the estimates for 1998 indicate sliding back towards 40%, against the target of 45% for that year, and 50% in the year after. Worse yet, BKV’s accounts are in the red by substantial amounts. The municipal government in Budapest has been firm about reducing its own operating subsidy to BKV in real terms, (down 53% in real terms since 1992) because it is trying to make the city credit-worthy on capital markets. The national government on its part discontinued its block subsidy to the Budapest company in 1997, though it has continued paying compensation for non-economic fares. In another legal development, in January 1998, the Government reduced the threshold age for free passes to 65 years, without appropriating funds to pay full compensation for this. The matter is not helped by the fact that the annual performance agreement is specific on services, but non-specific on productivity increases, staff cuts and remuneration for services. The municipality prefers to make occasional, item-specific capital grants to BKV, but these have not resolved the funding gap. BKV have resorted to bank overdrafts, payment arrears, and short-term loans to pay for capital investments. With fare increases reaching their ceilings in terms of the extra revenue expected (because of price elasticity and political resistance by households), BKV will be pushed towards deeper cost cuts and service reductions. The funding gap is largely a measure of how painful these actions will be.

The experience with urban public transport in Riga is of special interest. Three public sector companies provide services, two running street-buses and one running tramways and trolley-buses. Due to a three-way tug-of-war between the city administration, its elected council and the electorate heavily weighted with residents enjoying fare discounts, fare increases did not take place regularly or to a sufficient magnitude to keep the companies on the agreed recovery track. There was no fare increase between January 1996 and June 1998, while the inflation rate was about 25% per annum.16 The three service networks have

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16 When the City Council of Riga finally raised fares of single-ride tickets by 28% in 1998 (see below), it also adopted a policy of regular fare increases in subsequent years, until a 15% profit margin is reached.
overlaps the removal of which could bring some economies, but each operator resists being the one to cut services. Cost recovery stayed within the range of 59-74%, and none of the formal financial targets was reached. The subsidies paid by the city to public transport companies cover more than variable costs, but not enough to permit the agreed pace of financial recovery and increased independence, with its own positive effect on the efficiency of operation. The accounting loss in 1997 was about $4.8 million; if asset depreciation were accounted for properly, the loss would have increased to about $14 million. As in Budapest, Riga City Council approved some additional capital subsidies to the operators, which go some way towards maintaining service levels and reducing costs. Since the companies remain in poor financial health, the Bank took a tough line and by the end of 1998 fares were increased to a satisfactory level. However, the issue of fare discounts to selected groups of riders still remains an unresolved problem.

It is of interest to place the cost recovery experience in Budapest, Riga and medium-size Russian cities, achieved using the leverage of Bank-financed projects, alongside that of Polish cities, which had no such loans. In the largest Polish cities, with systems including both tramways on separate right-of-ways and street-based buses, cost recovery ratios are 50-66% (Warsaw has 64%, excluding the results for its new metro line). In smaller cities, which tend to have only street-based buses, the cost recovery range is 70-100%. Poland, that used a "shock therapy" approach to transition, has achieved economic growth better than most transition countries, has the highest auto ownership among them, and also has a highly evolved social assistance system.

7. Where do these trends lead?

It is fair to say that, overall, the track record on price and cost recovery increases in Bank-funded urban utilities has been modest, the results in Russian transport and Polish water projects notwithstanding. It is useful to distinguish two different levels of the problem of persistently low cost recovery. If subsidies are paid fully at a level sufficient for the company to be considered in good financial health, then all other things being equal the key negative consequence of the low cost recovery fall on the subsidizing authority.

The consequences are substantially worse if the agreed subsidies are not paid (leading to an accounting loss) or if the level is not sufficient for the company to operate normally. This is the case for all urban water companies in EE/FSU countries east of Hungary and for all public transport companies included in Bank-funded projects.

A policy of un-funded commitments, i.e. forcing the service provider to charge uneconomic prices while paying him less than adequate compensation, if pursued over a longer term, leads to a progressive and un-managed decay in services and the physical plant

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Annual increases would be at the discretion of the City Administration, but subject to a ceiling of 5% above inflation.

17 Unusually, the tramway company has the highest cost recovery, in spite of having massive infrastructure.
of the utility in question. The system tends to the level of service which the funds made available can pay for. An extreme case of this process has been observed in Lahore, Pakistan. Funding gap started through a pay dispute with the staff of the state-owned transport operator. Gradually, all non-current expenditures ceased, then most non-salary expenditures also ceased. The company lingered on for some 10 years after it had effectively ceased to provide (urban) services, its vehicles having been immobilized for lack of parts, down to some 45 buses (in a city of 5 million population). Only the employees’ union remained active, until a collective severance package was agreed in 1997.

What happens as the traditional utility company decays is different in urban water supply than in public transport. Water is a natural monopoly in urban areas, so customers have few other options available. In Odessa, Ukraine, cost recovery of the water company was 40% in 1996, and other utilities were in a similar situation (Davis and Whittington, 1998). The total funding gap for all communal services in Ukraine was estimated at about 50% of the difference between non-recovered operating costs and the budget available for subsidies. The residential water bills in Odessa would have to increase three to ten times to fully cover the costs of provision, but this is out of the question. Pensions (relevant to 45% of the population of Odessa) are set at the poverty level, and government employees are often paid with long delays. The system has deteriorated through ‘strategic disinvestment’ to a point where water has become unsafe for drinking, is available for roughly one-third to one half of the day, and pressure is variable depending on location within the city or the floor height. Losses to leakage are probably enormous (and unaccounted for). Well-to-do households buy bottled water, but most households adjust by storing piped water, and treating it themselves.

In urban public transport, options for travelers within and outside this travel mode are several. In the above cited example of Lahore, owner-operated minibuses used unimpeded market entry to fill the supply gap left by the public operator. Mini-bus operators did not allow any fare discounts, and received no subsidies. Given that minibus fare was set very low, the resulting level of services in terms of frequency, reliability, safety and comfort has been abysmal. Faced with poor services and severe street congestion from mini-buses, the authorities are now attempting to introduce a competitive franchising system for large private operators or operator associations, this time facing the resistance of thousands of minibus owner-operators.

Similarly, the funding gap and the deterioration in the public-owned transport services in transition countries are often accompanied by market developments in the private sector, some by design and some spontaneously. In Kazakhstan, where the private sector enters by tendering for specific routes, this appears to be a largely positive development since there had been under-supply of services. Likewise, in Riga, the city administration is issuing permits to taxi-buses in large numbers, without an explicit regulatory design. Taxi-

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18 If, however, the existing downward pressure on the regulated fare persists, Kazakh cities may resemble Lahore before too long.
buses are said to provide higher-priced, higher-quality services, finding a large demand niche in the growing, but as yet car-less, middle class. A two-tier public transport system evolves with the “regular” operator, whose services are going down in both quantity and quality, retaining low-income captives and exemption/discount holders. This practice may gradually turn the policy of granting fare/tariff privileges on its head.

The evolution of a parallel private supply market may provide service relief for some segments of the population, reduce need for public capital investment, and demonstrate the case for greater cost-effectiveness in service provision, especially if based on competitive tendering and contract enforcement. The key aspect of this development, though, appears to be that private providers generally do not accept (or are not forced to accept) fare discounting and exemptions. Allowing a parallel system can thus be seen as an effective instrument to get rid of politically sensitive privileges.

Whatever the benefits of parallel systems, their introduction should not imply a laissez-faire attitude towards the deterioration of the existing public-sector companies, left to provide services matching the level of tariffs paid by their “privileged” passengers. This is an approach costly in public finance terms, not to mention that some of these companies may have just purchased new vehicles from Bank-supplied funds, which they have difficulty maintaining for lack of working capital. The example of this is in Almaty, Kazakhstan, where the growth of alternative modes is accompanied by a persistence of grave problems in the traditional public company, which is not strong enough to prevent the emergence of competition and is being financially starved by the local government. It may be much better to terminate such a company, even if it had just been financed under a Bank project, than let it linger indefinitely. It would of course be much better to gauge the survival capacity of the

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19 Private operators in Riga charge a flat fare of 25 sants, compared to 18 sants for the three public transport operators (after a fare increase in June 1998); the latter also have heavily discounted seasonal passes, used by most passengers.

20 For one example of evolution towards a two-tier public transport system and its impacts, see the study of public transport reforms in Casablanca and Rabat, Morocco (World Bank, 1989). Yet another twist on the two-tier approach is in Turkey, in cities such as Bursa, where the paratransit services co-exist with a reasonably efficient public-sector operator. The latter, however, charges lower prices, and therefore requires a public subsidy, without any claim to serve a poorer segment of the market.

21 The franchising program in Kazakhstan has been implemented, in parallel with the Bank-financed project propping up the public-sector operator, an operation for which the jury is still out. Similarly, in Guangzhou, China, 6 private joint ventures provide 1,400 buses out of the city’s total of 4,500 vehicles, and appear to have stimulated the public operator to better performance. These developments are in striking contrast to Budapest, where the pilot to subcontract some lines to private providers has been delayed by about two years, and is only now in the tendering stage. The delay is due to the reluctance of BKV, the beneficiary of the Bank-financed project, to relinquish any part of its dwindling market, even if the sub-contracts would involve just 5% of its services. The company is aware just how difficult it would be to convert benefits of subcontracts into explicit cost savings, not least because of strong resistance by the union to further staff reductions.

22 See the case of Rabat in the above cited Morocco study (World Bank, 1989).
public-sector provider before the loan has been approved. More importantly, the experience in London shows that the evolution of parallel private and public provision may be an entirely positive development if it is done within a framework of for-market competition, in which both private and public-sector operators thrive.

8. Sources of resistance to pricing reforms

The resistance to change is generally strong. Because all the main actors in this context push more or less in the same direction generally, back into the past, it is quite difficult to initiate and sustain change.

Local governments resist pressure to increase prices of services deemed essential because of a combination of motives: (i) a genuine concern for affordability; (ii) fear that their constituents will vote them out of office, especially in the presence of large bodies of marginally employed workers, pensioners and veterans; and (iii) expectations that price-induced demand drop may generate problems elsewhere, for example a shift to automobiles in urban transport, or excess labor and/or system capacity, which they wish to avoid dealing with. Similarly, they may resist changes in the scope and standard of services because they themselves may have instituted these services in response to pressure from their constituents.

The resistance by local governments to paying full compensatory subsidies to a given utility company may come from simply not having enough funds. Local taxing authority and the tax base are both very constrained and unable to cope with the sudden expansion of responsibilities being devolved to them under the rubric of decentralization. The competition for subsidies at the local level is fierce. There is also a visible tug-of-war between city and national governments when it comes to inherited subsidies, especially in capital cities, where non-payment by the city may be a tactical move. Also, good financial planning is being learned slowly. In some cities, even the basic “western” concepts of municipal and company accounting have yet to be fully understood and assimilated, even though they have been nominally adopted. Alternatively, less-than-full payment of subsidies may be a part of a sophisticated financial policy (as in Budapest).

Apart from the capacity to pay, local governments may prefer to retain the position of dominance over the newly “autonomous” service companies, especially the power of deciding on capital investments, an essential part of the old patronage system. Dominance would diminish as the financial position of enterprises improves and managerial prerogatives of enterprise managers increase. There is yet another facet of this issue: at a stage where financial controls are weak in many countries, there is reluctance to inject cash into companies with low debts for fear that it will not go into best uses. Hence the governments’ targeting of the subsidy payments to the level of direct operating costs only. For this reason, in situations of excess capacity and low debt, present more in water and power sectors than in urban public transport, it has been recommended that financial restructuring swaps equity for debt (Gray, 1995). Debt payments are then seen as payments for past investments in infrastructure and equipment.
Many variations on the above themes are present in practice. Local politics and generally the political economy of reforms in the utility sector have been neglected aspects of Bank-financed projects, in spite of well-known maxims such as the governments’ preference for the short-term over the long-term, or the prudence of tapping revenue sources in the order of increasing political sensitivity (Dillinger, 1994).

National governments are generally less present on the local scene than before, especially as regards urban utilities (in contrast to, say, public education). Still, some national governments cling to the practice, so popular under socialism, of granting preferential tariffs and exemptions for essential services to some categories of people. They have, at least in some countries, managed to pass expenditure responsibility to lower-level government, but retained the mandate authority, hence a costless political/moral credit. In Russia, this matter has taken on some peculiar forms. The mandate for privileged public transport fares has been given up formally by the federal government, but the local governments are reluctant to make the appropriate changes in pricing rules, awaiting “instructions from above”. In other cases, as the political merry-go-round turned from one election to another, one national government may give up the mandate and then another one would vote it back in, as cited above for Hungary. Finally, some resistance to price increases may come from ministries of finance, because of the concern that price increases will lead to a stronger pressure for general wage increases. In some transition countries, Hungary for example, public transport fares are included in the basket of consumer goods used to calculate official inflation indices, which are linked automatically to wage increases. Yet another twist on this theme, also present in public transport in Hungary, is that government subsidies to service providers are linked automatically to fare levels.

Utility companies themselves may be against price increases, as it is evidently much easier to have to rely on government funding than to have to be financially self reliant. Depending on the elasticity of demand, price increases may lead to demand and business revenue reduction, intensifying the pressure to reduce services and ultimately the ranks of their staff. A similar resistance exists with regard to cutting costs, because of a general reluctance to reduce staff which this often involves. Enterprises also resent being pushed to make new efforts when their owners (local government) are not holding to their side of the bargain, e.g. paying agreed subsidies. As individuals, also, company managers and staff resist working harder after years of erosion in their own standard of living (falling real wages and benefits).

Households in transition countries have the strongest motives to resist tariff/fare increases in essential services like water and urban public transport.

First, real wages have fallen drastically and --in some countries-- are still falling. Also, what is called “discounted/preferential prices” in this paper had not been perceived as such by citizens, but as a part of a seamless cash and non-cash wage (World Bank, 1994). So, a fall in a cash component of the package has been accompanied by a fall in the non-cash part. Even worse, in some FSU countries, nominal wages and pensions may not be paid on time, sometimes for months or longer. The situation of the new poor, especially large
families with unemployed adults, has been particularly precarious. As cited above, as many as 40% of total population of transition countries have fallen below the poverty threshold.\(^2\) All in all, some people simply could not and did not pay for services.

Second, a transition from enterprise taxes to personal income taxes is still at an early stage of concept and implementation, so the link between subsidies for services and personal income taxes has yet to be established in people’s minds. Conversely, the relation between service charges and personal incomes always was and still is all too obvious.

Third, people are often being asked to pay more for worse services. This is more the case in FSU countries, and less the case in EE. Moreover, the evidence of inefficiency of providers conveys the impression that the fare hikes may not be fully justified.

Fourth, price increases for many essential services (and often essential goods too) may be concurrent. Taken together, these require bitter adjustments and trade-offs, especially for the poor. In this light, measuring affordability for individual utilities against “international standards” expressed as typical shares of household budget is pointless. It is the affordability of the “basket” of goods and services purchased by households that needs to be assessed.

Fifth, especially strong resistance to increased prices is from those who have enjoyed a preferential status, of which the pensioners and various veterans (even if not poor) are the most numerous and best organized as a political force in some countries (e.g. Latvia).

Sixth, the demand may be quite inelastic, particularly in the short run, because choice is very restricted. This is easily understood in the context of water supply, but in EE and FSU countries it also holds for urban public transport. Auto ownership has been and remains relatively low in many cities, implying a high dependence on public transport and walking by a great many people. Adding to this, accessibility patterns in socialist cities have a number of peculiarities. The location of residence has not been a matter of choice but of allocation. Residential and job mobility were and still are very low compared to Western Europe and the U.S..\(^2\) Planned socialist cities have residential density increasing at the urban periphery, where large-scale, high-rise apartment complexes were built, unfortunately without many services. This tends to increase the length of both journey to work and for all but the most essential shopping and other services. Rationing and shortages endemic in early stages of transition also intensified the need to make multiple trips. Another common feature, which is relatively unknown in the West, is travel to vegetable patches, stemming from the

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\(^2\) This number includes both urban and rural poverty, with the latter being more significant in most countries.

\(^2\) Many people commute to work from the hinterland of large cities, even from other cities in a 100-km radius. This was made possible in the past through low intercity fares, requiring large subsidies to state railways and bus companies. Low intercity fares in addition to flat fares within urban areas has discouraged densification of cities. Dismantling these arrangements is underway in many countries, in the context of restructuring and privatizing inter-city carriers, with battles being fought at the national government level.
government practice of giving people small plots of agricultural land at city margins (not necessarily close to their residences) where they were free to grow food for own use and for sale. Pensioners, for example, who normally do not need to make the daily journey to work, may have to make a daily trek to buy food, work in vegetable patches, seek medical care, etc. For most, reducing the frequency of travel is not an option.

Resistance to price increases may take several forms. Once the higher prices are introduced, people may behave like “rational economic actors”, reducing their use of the services involved, i.e. use less water, travel less by public transport or switch to walking or another mode. Or, they may refuse to pay water bills, and/or travel without a valid ticket. On the political front, given that most transition countries now have electoral democracies, the citizens may try to prevent price increases from being adopted. If increases are adopted, the citizens may vote the current government out of office. In Riga, for example, the failure to increase public transport fares in either nominal or real terms stemmed from a reluctance of a party in power to do so in the year preceding municipal elections; the opponents won anyhow, but were reluctant to increase fares because their electoral platform promised that they would not.

9. An Agenda for future Bank lending

When the set of initial conditions listed above is juxtaposed against the list of blocks used to build the first batch of Bank-financed urban public transport and water projects and the relevant implementation experience, the following aspects are seen to dominate the agenda for future projects: (1) the capacity of the local government to fund their subsidy commitments; (2) the tactic of leveraging price/subsidy reforms; (3) unbundling of subsidies from the questions of financing basic services; (4) a deeper and more inclusive focus on affordability; and (5) longer-term pricing considerations at the high end of cost recovery: how far should it go? In addition, the agenda is supplemented by brief statements on subjects deemed essential though outside the narrow subject of this paper: (1) the cost dimension in cost recovery equation; (3) the relation between service levels and costs; and (3) use of markets and private providers as instruments to increase financial sustainability of supply and improve services.

Ensure local capacity to pay agreed subsidies

While the process of reforming the service companies and their pricing and subsidy system continues, the non-payment of agreed subsidies accelerates the deterioration of both services and productive assets. It also slows down the reform process, as was illustrated above by the case of public transport companies in Riga and Budapest, where non-payment flies in the face of the reform objective to achieve autonomy for service companies, and slows down their drive towards efficiency. Last but not least, the non-payment of operating subsidies may undermine the proper maintenance and use of the very equipment and infrastructure that the Bank project financed, thus leading to a failure of the investment part of the project. These points are entirely independent of what magnitude of subsidy reduction or cost recovery had been adopted under a Bank-funded project.
In the current batch of projects, the focus of the financial analysis commonly has been on the public utility, the ultimate recipient of the loan, much less (if at all) on the relevant local government. When municipal finances were subjected to scrutiny, this was commonly from the point of view of the credit-worthiness of the city as a borrower of capital funds. In Budapest Urban Transport Project, for example, loan conditions include a debt ceiling (relative to revenue) for the Municipality of Budapest. This is of course more an issue of capacity to repay the Bank loan than a full-scale analysis of municipal revenues, current costs, aggregate subsidy loads, capital investments, etc. In the portfolio, there is not a single project where such a full-scale financial analysis of the local government has been done. To correct this lacuna in project preparation, projects should be required to: (a) pay greater attention to the financial capacity of the local government, and (b) use covenants to ensure that agreed payments are actually made. As noted above, the insistence on paying agreed subsidies is not an expression of preference or support for subsidies as such, but rather a matter of ensuring that project objectives are met.

Subsidy payment covenants traditionally use: (1) specific annual or quarterly amounts, typically in real terms, fixed or variable, usually at a descending rate; (2) a subsidy formula specified in a service agreement (or directly in the loan agreement), for example an amount per passenger carried or bus-km (or a combination) in public transport; or (3) an unspecified amount sufficient (in addition to business revenue) for the company to avoid an accounting loss or maintain a specified level of working capital, operating ratio or some alternative financial indicator.

Covenants with unspecific sanctions tend to be ineffective against violations, such as non-payment of subsidies. It may be necessary to take a leaf out of the arrangements for Bank-financed infrastructure loans which have faced the problem securing adequate flow of counterpart funds for investments. As part of the conditionality under some of these projects (e.g. municipal loans in Georgia), it is required for the government to deposit agreed amounts in bank accounts accessible by project implementing agencies before the procurement of sub-projects is allowed to proceed. An extension of this thinking is for service providers to honor discounts and exemptions only if prior payments have been made (this in fact was applied in one of the cities participating in the Russia Urban Transport Project).

**Leveraging reforms**

It is generally agreed that keys to a successful reform lie in the provision of incentives and the “selling” of the reform to the potential gainers and losers. As noted above, reforms in pricing of essential services of the kind pursued by Bank-financed projects encounter much resistance because it appears that most actors lose in the short run if the reforms are

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25 That municipal finances have not figured prominently in so many projects has been due to the fact that many cities in FSU countries were only making first steps towards financial autonomy, and there was very little to analyze.
implemented. The provision of incentives and the explanation of why and how the short-run losses will be converted to benefits become even more important in this context. The success in reaching cost recovery targets in the Russian Urban Transport Project and a lack thereof in the Riga case indicates that the concept of self-selection and up-front reforms holds much promise on both of these counts. “Up-front reforms” means that the incentive of loan funds remains intact until some hurdle in the reform process has been overcome. Leaving this to be done in parallel with the implementation of the physical part of the project, or at its end, reduces/removes the incentive.\(^2\) As for self-selection, it must mean that the city mayors did their own “selling” of the reforms before committing them under the project.

Another valuable aspect of the Russian project is that self-selection bypassed the analytic approach to the problem of affordability. Normally, the project team would have looked at the prices implicit in the desired cost recovery rates, calculated them in terms of monthly household budgets, and judged them “affordable” for average income recipients. The implicit assumption is that because some price level is “affordable,” the probability of the price increase being adopted is acceptable.\(^2\)\(^7\) There was no such affordability analysis in the Russian project, (at least not in the Project Appraisal Report). The self-selection approach let the city leaders do their own calculation of what was acceptable to their people.\(^2\)\(^8\) That this was apparently done by unfairly overloading regular users as opposed to those enjoying preferential prices and exemptions does not take away from the efficacy of the tactic. If this method worked for cost recovery at the worst time for households in Russia, it may work for different policy initiatives and different conditions elsewhere. It is understood that a variant of this approach has been built into the forthcoming Russia Water Project.

Un-bundle subsidies from public transport and water services pricing

The discussion of subsidies often takes the form of whether they are desirable in principle, and/or how rapidly they can be eliminated given the purchasing power of the population. This is not the most useful “framing” of the problem of subsidies in the context of urban services in transition countries. A better framing may be to start from the objectives and instruments of the regulatory reform in the sectors being discussed here, in parallel with objectives and instruments for subsidies, then think through a better linkage between the two sets.

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\(^2\) The crisis in service delivery in client cities, often the stimulus for a Bank project, tends to take a strong hold on the project preparation process to the detriment of the reform, which tends to be almost an afterthought, certainly so in the eyes of our clients.

\(^7\) This is generally not a good assumption; following a widely accepted theory of collective action, small groups of potential gainers and/or losers can push through or stop major policy initiatives whatever its aggregate welfare score. (Olson, 1965).

\(^8\) It would be of interest to study why some of the cities in the Russian project managed to meet the second-stage cost recovery targets in contrast to those which did not.
It is assumed in this paper that the objectives of the regulatory reform on the supply side are to help the municipal service sectors reach efficient production and financial sustainability, while providing service levels in line with their customers' demands and willingness to pay. This will call for a specific price structure and levels. There may be economic reasons justifying subsidies, such as the presence of "externalities". For example, access to water has direct health implications as does a traveler shift from public transport modes to autos. The level of efficient subsidy in these cases can by and large be estimated numerically. On the other hand, it may be that subsidies are largely driven by social considerations oriented towards re-distribution and politically determined. They should be implemented using the most cost effective instrument, and the government should have expenditure capacity to pay for them. Not for or against any particular subsidy, then, but for having explicit motives, carefully selected practical arrangements, and an overall coherence. The subsidies in water and urban public transport as they are now applied in most transition countries have several problematic aspects.

First, and the simplest, the subsidizing authority may lack expenditure capacity, which as we have seen above leads to the funding gap, as in the case of Riga City Council. Or, also as seen above, the subsidy authority and expenditure responsibility may be vested in different institutions, as in Russia (or may be believed to be so).

Second, the subsidies which are nominally meant for low-income people are in fact based on categories which are not necessarily correlated with low incomes, much less poverty. Prominent among beneficiaries of subsidies are pensioners, but pensioners may be a small proportion of the poor. For example, only 3% of the poor in Hungary are pensioners; the majority of the poor (60%) are the unemployed (Milanovic, 1998). Price discounts in public transport are also given to government employees, soldiers, police and school children. These correlate with poverty even less than the pensioners. Conversely, some truly poor people do not get price discounts on public transport. In Estonia, the largest category of the poor (32%) are from single-parent families, which do not show on fare discount schedules. If the objective is to support poor people, then the current systems of utility price discounts may not be getting to them, while they may be "leaking" to those who are not truly needy.

Third, the arrangement whereby service companies subsidize users and the government subsidizes service companies is evidently not a very good one, since it exacerbates the preceding two problems.

The subsidies to preferential price holders reportedly account for a lion's share of revenue losses. Moreover, because of the uncompensated preferential prices, ordinary customers are asked to pay even more, an unfair and hard to afford cross-subsidy. In the light of all this, it may be tempting to conclude that a part of the price system reform for water and public transport services should be to eliminate subsidies for those people who "do not

29 In Bulgaria and Russia, the pensioners account for more of the poor: 35% and 26%, respectively.
deserve” them. A recent Bank report on urban transport in Russia states with approval that the federal parliament is set to vote the elimination or at least the reduction of many categories of privilege. It may be tempting for a Bank project to get into deciding who deserves to be subsidized. An alternative view would be to leave the judgement of who deserves to be subsidized to the political system of the transition countries, stressing instead the budgetary coherence and the method of administering subsidies. The latter would consist of getting the subsidy out of the relation between the government and the service provider, especially the provider’s balance sheet. In many, perhaps most cases, the subsidy is best handled directly between a social assistance authority and the beneficiary of subsidies. In other words, let the pension administration buy monthly transport passes at a price negotiated with the service company, then sell them to the pensioners at any discount deemed fair and affordable to that authority; let the school administration do the same with students’ tickets, etc. That this is a sensible approach can be seen from the way means-tested social assistance is passed to poor households. There are no special bus fares for the poor or the unemployed, but they receive assistance (more in some transition countries than in others) in cash or in kind (including vouchers) directly from specialized agencies, after passing the means test to establish eligibility. 

Re-examine affordability

The whole concept of affordability, in connection with water and public transport pricing, defined against fixed shares of total incomes or expenditures, should be examined. Data from household expenditure surveys in transition countries show drastic variations from country to country in how expenditures are allocated between uses (Braithwaite et al, 1998). In Russia, for example, housing expenditures are $6 (in purchasing power parity dollars) from a total of $271, or 2%; clothing is $42, or 15%. In Hungary, housing is $129 out of $412, or 31%, and clothing is $28, or about 7%. What should one make of a public transport expenditure amounting to 12% of the total household spending budget? Needless to say, it is not whether the transport budget with the new price of a particular service remains under 12% of the total that matters, but what will the change in price do at the margin. If several prices change at the same time, the entire incremental change needs to be looked at.

The aggregate impact and affordability of initiatives to increase cost recovery in several or all urban infrastructure and utilities at roughly the same time has been terra incognita of Bank-funded projects. Not one project in the current urban water and public transport has gone beyond simple, single-sector affordability checks against “income share” norms. This has been hardly doable given poor state of information even on the supply side, much more so on the demand side. The problem has also its in-house aspects, given persistent difficulties of cross-sectoral interaction. The client countries themselves have in fact taken the lead in this matter. The Russian family allowances program allows for drastic

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30 This does not exclude the possibility of incremental pricing schemes meant to support low-income people but prevent leakage. The so-called “life line” pricing of household essentials has a low price for a basic block of electrical energy or water quantity per month, and all consumption above that level is at an economic price. Household-based metering is of course essential to this approach.
push towards cost recovery on the supply side, but caps household payments of aggregated utility bills to a certain proportion of their monthly incomes, compensating the suppliers accordingly. Some 7% of Russian families were recipients of this allowance in 1997. Similar programs, sometimes just available for housing and at other times including a basket of services, have been applied in advanced EE countries (Poland, Hungary, Slovenia, with 10-20% coverage), but also in Moldova, Ukraine and Lithuania (The World Bank, 1998). The fiscal ability to pay these compensations drives the pace of the push for cost recovery, with 25-30% of households recommended as the limiting reach. It has been estimated, for example, that reaching full cost recovery for housing in Russia by year 2000 would make a prohibitively high 40% of the households eligible for allowances (The World Bank, 1998).

It would be quite useful to distinguish the problem of poverty-related subsidies (discussed above) from that of regular (non-preferential) prices. Generally, if households at (say) average incomes cannot afford to buy a service at an economic price (in the absence of externalities and second-best considerations), it is not evident why that service should be subsidized. In transition countries, the fact that people with average incomes have difficulties paying economic prices for water or street-based bus transport (the cheapest form of urban public transport) is mainly due to the above cited fall of output and the way it has been handled - by reducing real wages drastically rather than by laying off people in massive numbers. Subsidized, but non-preferential prices for these services are thus a form of hidden unemployment compensation, a temporary phenomenon.

What is the maximum rate of increase in cost recovery from regular, non-preferential tariffs? One possible answer was provided in the preceding section: let the local political leaders sound their electorate and negotiate with them the magnitude of any increase associated with a proposed Bank investment. Another answer comes from the work done outside water and public transport sectors, which links the prospect of subsidy elimination to introducing liberal labor market policies and allowing real wages to adjust to changes in the cost of living. This even includes one-time wage increases, thus converting old traditional benefits into cash, as done in some housing projects in China (The World Bank, 1998). In words reminiscent of Henry Ford’s thinking about the link between auto sales and wages of auto workers, it is suggested that savings from improved cost recovery should at least in part filter down to wages, thus starting a virtuous cycle.

**Longer-term considerations**

Should cost recovery go all the way to 100% of total costs, and even beyond? In the water sector, the long run objective is to have a water utility with a regulated profit, so the answer is - yes: full cost recovery is the target. It is already being achieved in Poland, and in time it will be achieved elsewhere. More precisely, as the level of cost recovery increases, and better accounting systems become available, the attention should shift to more sophisticated cost and price considerations, couched in terms of short- and long-run average and marginal costs.
In urban public transport, the situation is different. This is a sector where there are externalities and second-best considerations in connection with pricing for the chief alternative mode - the private car. While the level of motorization is low, and the public transport system consists of street-based services (i.e. right-of-way shared with other vehicles) with no scale economies, it is realistic to aim for full cost recovery at the speed suggested above, in line with an increase in average wage level. As motorization increases, and city size and density rise, public transport systems may have to acquire travel-ways of their own, be it at grade, elevated or underground, with significant scale economies and benefits spreading beyond the travelers. At that stage, it would become necessary to evolve a pricing policy for the entire urban/regional transport system, public transport as well as the individual motor vehicles. This may well involve less than full cost recovery for the former travel mode (World Bank, 1995).

The focus on cost dimension

With prices grabbing most attention, due to their unusually low starting level in transition countries, there is some danger that inefficiencies on the production side would be passed on to service users and/or city treasuries. As noted above, some projects did introduce performance targets as covenants. Other projects may have included them indirectly, as key elements in the service agreements which in turn were subjects of dated covenants. Also, by combining price covenants with cost recovery covenants, some pressure is exerted on costs as well. Still, it is valid to say that costs have received less attention. Not a single Bank-funded project among the dozen reviewed here has included an economic costing study at the preparation stage, to establish the status quo and cost benchmarks against which progress in cost recovery can be measured. This can be excused by the endemic inadequacy of company accounts in some countries, as found at the beginning of project preparation. Some water projects, but not one urban public transport project, have included such a study, to be carried out in parallel with project implementation. This aspect should receive much more attention in the next batch of projects.

Focus on service levels

Repeating the theme of the preceding heading, the focus on prices and on cost recovery leaves service levels less well attended. Low incomes and affordability are indeed matters of prime concern, but so is the service. In some cases, the level of services available in socialism is simply not sustainable any more, and should be reduced. This is clearly the case in public transport in Riga and Budapest. Some of the lessons and prospects, however, point in the opposite direction. Social assessments undertaken in connection with Bank-funded projects in Central Asian republics revealed that low-income households ranked the quality of public transport services as a matter of higher concern than fare levels, in spite of

31 It may also have to do with the fact that cost and performance analysis is relatively complex for all activities where the production unit differs from the sales unit, and there are multiple outputs. Both features apply to urban public transport, but not to water supply.
sharp increases anticipated in the latter. In the better-off EE countries, which face rapidly increasing motorization, service levels in public transport will eventually become pivotal in retaining “choice” customers, as those who own automobiles make their selection of the mode for daily travel.

**Foster the growth of market-based supply**

Under this heading is the entire issue of the regulative and institutional design underlying the reform process, specifically the entry of private suppliers and the introduction of competitively bid service awards. The above review indicates that, in Bank-financed public transport and water projects, much more effort has been spent in reforming the public-sector service suppliers than in fostering the evolution towards market-based approaches. Developments in Kazakhstan appear to have come less by design than by the sheer hopelessness of maintaining the status quo. The focus on the public sector may have been due to emergency-like context of some lending operations, where the key objective was to maintain basic services. Second-generation projects will have to adopt a different emphasis, perhaps using a self-selection technique to ensure that a market-based institutional design is adopted from the outset.

Introducing market-based, private operation may well hold the largest potential for cost (and subsidy) reductions in both urban transport and water/sanitation sectors. Potential cost savings on the order of 30-50% are cited informally in the circle of private operators of public transport services. The same is likely to be the case with regard to service improvements. Finally, the fact that the scope of local government responsibilities has tended to increase, nay explode, as a result of decentralization initiatives, argues also for the transfer of service provision responsibilities to the private sector, when and where viable. This of course, will require many changes if it is to happen in a manner that will be beneficial to the population.

Much of the preceding discussion has served to highlight the close link between political issues, generally at the local government level, and pricing decisions. Private involvement in sectors such as these, which provide services which have prices that are subject to close political scrutiny, will depend very significantly on the trust that potential investors will have that pricing rules will be honored. Transparency in the franchising or concessioning criteria, true competition for the market and well designed regulatory frameworks will therefore prove essential. The World Bank could play a very valuable role in disseminating best practices, assisting in the development and implementation of regulatory reforms, and improving the credibility of the government’s commitments. Guarantees against the political risk of governments failing to follow their obligations to adjust prices when conditions warrant it, may be a useful instrument for this purpose.

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This paper has a biased sample in that it is limited to projects made by one Bank department, while the responsibility for private initiatives is located in other departments, and/or in the International Finance Corporation.
References and Bibliography


