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An Application of Private Sector Practices

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By

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In nearly all countries, municipalities own or control substantial amounts of real estate. Although municipal governments generally to the day-to-day operational needs of their real estate holdings, few such governments think of their holdings as a "portfolio" whose composition might be modified to better serve public purposes. This note hopes to persuade the reader that municipalities have much to gain from understanding and applying modern principles of asset management (AM) to their real estate holdings. More specifically, the analytical techniques, accounting tools, and practical approaches of AM, developed in the private sector (at non-real estate corporations), are generally applicable to most publicly owned real property. This note will also demonstrate the importance of an asset-oriented vision, based on the balance sheet approach (as opposed to the more traditional budgeting approach), for municipal finance, and the financial implications of municipal real property AM.

Real estate represents a major component of local public wealth. By some estimates, real estate accounts for 50% of assets of municipalities in the U.S., and this percentage may be greater than 90% in other countries. However, there continues to be a lack of basic comparable data such as the size of public land holdings which hinders AM (see table 1).

Table 1
Size of Public Land Holdings in Cities – Examples

City	Population (thousand)	Land in Public Ownership (percent of the total city area)	Vacant Land[a] in Public Ownership (percent of the total city area)	Comments on Availability of Data
Amsterdam (the Netherlands)	712	80+ percent	N/A	Estimates only (1992)
The Hague (the Netherlands)	576	77 percent	N/A	Estimates only (1992)
Columbus (Ohio, USA)	565	N/A	3 percent	One of three American cities that was able to provide complete land census data (1998)
Orlando (Florida, USA)	128	N/A	14 percent	One of three American cities that was able to provide complete land census data (1998)
Saskatoon (Canada)	207		26 percent (estimates for local government only; includes built up area)	The City Planning Department prepared data specially for this study
St. Petersburg (Russia)	4,700	94 percent	N/A	From a World Bank sponsored project for collecting real estate

				data (1998)
Taganrog (Russia)	289	82 percent	N/A	From a World Bank sponsored project for collecting real estate data (1998)
Kano Metropolitan (Nigeria)	Estimated as 2,500 to 5,000	100 percent		N/A

Notes:

[a] There is no commonly accepted definition of vacant land. However, the usual meaning is (1) usable land (i.e., excluding streets, rights of way, wetlands, etc.), and (2) unused or abandoned land, or land that supports derelict or ruined structures.

Sources: Extracted from research publications, World Bank reports, and material provided by the City of Saskatoon.

Municipal assets, balance sheet, and finance

The municipal balance sheet identifies all of a municipalities assets and liabilities that have financial value, and has the same accounting equation as one in the private sector:

Assets = Liabilities + Equity

In the public sector, the equation can be re-arranged to emphasize the idea that shareholder (citizen-taxpayer) equity is equal to the excess of assets over liabilities:[1]

Citizen/Taxpayer Equity = Assets - Liabilities

Understanding the municipal balance sheet is important to municipal finance analysis because:

- *The assets (and liabilities) of municipalities in developing and re-structuring countries often are very large compared to their annual budget revenues or expenditures.* Often, a municipality may have only a vague idea of the economic value of some of the most important assets it owns, or may have no clear conception even of the list of “things” that it owns. Municipalities frequently are startled to find the magnitude of the cash holdings they possess, once a thorough accounting of the cash on hand is taken into account. The City of Ostrava (population 325,000), in the Czech Republic, for example, discovered that it had 910 million Czech crowns in cash holdings at the end of 1996, or about US $34 million. These funds were scattered throughout city departments, many earning zero or nominal interest.

Local governments often have even less awareness of their liabilities. For example, the Novgorod Oblast in Russia as of July, 1997 had provided unconditional guarantees for the debt of other entities, primarily commercial enterprises, in the amount of R31.6 billion, or more than 10 times the Oblast’s own outstanding debt. Given that 46 percent of the region’s enterprises had been unprofitable in the previous year, the potential liability under these loan guarantees was substantial, but the Oblast had never

[1] Stephen J. Gauthier, The Balance Sheet: A Guide for Preparers of State and Local Government Financial Statements, Government Finance Officers Association (Chicago, IL: 1997).

undertaken an examination of its risk exposure, either before or after providing the guarantees.[2]

- *Municipalities usually have much more freedom of choice over their handling of municipal assets and liabilities than they do of municipal revenues.* While central governments in developing countries often impose rigorous limitations on the right of local governments to establish their own taxes, set their own tax rates, or borrow from the credit market, they rarely place any limitations on the rights of local governments to own, operate, acquire, or dispose of discretionary assets not critical to public service delivery.

- *For many of the financial choices that municipalities must make in developing or restructuring countries, a more useful instrument of analysis is the municipal balance sheet.* A municipality that re-considers its appropriate mix of asset ownership, in light of its service priorities and its mission, may decide to sell off some of the housing stock or municipal enterprises that it owns, in order to re-invest the sale proceeds in assets (like the public water and wastewater system) that are more critical to its mission. It is possible to consider this choice within a budgetary framework, but it seems more natural and useful to analyze it as a portfolio choice. Decisions about municipal borrowing likewise often need to be made in the context of the balance sheet. In countries other than the U.S., including some countries in Western Europe, the equivalent of general obligation borrowing is balance sheet borrowing, where municipal debt is secured by all of the assets owned by a municipality

The Definition and Framework for Municipal Real Property Asset Management

The meaning of the term "AM", when it refers to public real property or public management, varies substantially. One approach for analyzing this term is to compare it with private sector real estate AM.

In the private sector, real property AM is the decision making process about acquiring, holding, and disposing of real property, which may be held for a company's use or as an investment. Asset (or portfolio) management is among the core business activity, supported by rapidly developing methodologies and advanced financial techniques. Its goal is to maximize corporate value (or profits).

In contrast, the traditional public sector goal of real property AM is to supply the right quantity of property for public goods and services at least cost compared with all alternative feasible arrangements including private sector provision. The more recent non-traditional goals are to support local economic development and obtain revenues from alternative sources.

A successful framework for managing municipal real property assets can be demonstrated by the Denver model (see Box 1 and the next section) which is based on the corporate real estate AM prototype. Although the framework is generally straightforward, it involves several conceptual and methodological issues that are still under debate.

[2] George E. Peterson, *Measuring Local Government Credit Risk and Improving Creditworthiness*, World Bank, March,1998

Box 1: Framework for Real Property Asset Management

Inventory Level

•Develop/maintain comprehensive records of properties

Property Management / Accounting Level

•Develop/maintain a property management & accounting system on a property by property basis
•Include the value of each property in the accounting database
•Use private sector property management approach for improving public property management

Asset (Portfolio) Management Level

•Formulate a strategic role of real estate in attaining municipal goals
•Develop classification of property and apply it while conducting an inventory
•Develop class-specific financial tools and performance standards for each property
•Implement portfolio management approach within the real estate and public assets portfolio
•Develop and implement policies aimed at rationing property demands and consumption

Strategy Implementation Level

•Establish a centralized real estate authority with overview or direct control over AM
•Devise written policies and decision roles for acquisition/holding/disposition of assets
•Develop in-house expertise to derive maximum financial returns from certain property
•Set up incentives for better AM within the municipality

For example, a fundamental concern at the Property Management / Accounting Level is how to combine accounting requirements for municipal financial reporting and for efficient real property AM. An accounting system that uses book value of the property may be satisfactory for reporting financial results. However, this is not sufficient for rational decision making regarding real estate assets which should be based on market value of the asset.

Best Practice Model of Municipal Real Property Asset Management

The best practice models for strategic AM involves categorizing the portfolio of local government assets by use: government, social, surplus, and specifying a different financial goal for each category, as shown in Table 2.

Table 2
The Denver Portfolio Classification Model

Asset Use	Financial Goal	Example of Activity or Property	Financial Information Needs
Government	Maximize Efficiency and minimize costs	City hall, fire or police stations, sewage treatment plants	Expenses, internal rent, value-in-use
Social	Quantify and minimize the subsidy	Housing, parks, economic development	Expenses, subsidy, market value
Surplus	Maximize financial returns	Land lease, fee parking lots, small land/building parcels	Expenses, revenues, market value

Source: Adapted from Utter (1989).[3]

[3] Marilee A. Utter. "Public Asset Management." *Economic Development Commentary.* 1989: 4-11.

Government Use Assets

The financial goals of maximizing efficiency and minimizing the costs of assets used directly by the government can be achieved by:

- Increasing the efficient use of facilities, by requiring governmental departments to justify their demand for space.
- Minimizing operating costs.
- Locating government offices and services in functional, not prime, areas.

Social Use Assets

The financial goal for these assets is to quantify and minimize the subsidy. For example, in the case of public housing, the difference between the market rent and the actual rent paid is the subsidy to the program. The term "social use assets" refers to property used to satisfy social objectives of the government and usually not utilized for its "highest and best use." The financial goal for social assets can be achieved by:

- Presenting true expenses to facilitate best decisions.
- Generating program alternatives to reduce the subsidy as much as possible while still accomplishing the mission.

The decision to subsidize is usually political and can change, or other alternatives can be considered, if quantified information on the amount of subsidy are presented to decision makers along with the program.

Surplus Property

These are properties not needed for city use or social programs. They are declared surplus and either held for generating recurrent revenue from lease or sold. The goal for these assets is to maximize their financial return (which requires the highest and best use of the property, if possible), and to control costs. This can be achieved by:

- Leasing surplus property to generate revenues.
- Privatizing surplus property to generate sale revenues and property taxes.
- Reducing maintenance costs and liability on the property if it cannot be leased or sold.

Overall, strategic AM of public assets yields multiple benefits:

- Local governments can capitalize on property location and / or development potential by selling or leasing this property to *generate revenues*. The government can also reduce maintenance expenses by disposing of surplus property and rationalizing property use by governmental agencies and social programs.

- Surplus or foreclosed properties can also be recycled for socially desirable uses such as housing and recreational facilities to *increase social benefits* to citizens.

- Public investment in land and infrastructure can lead to *job and income growth* in the private sector.

- Local governments often compete with each other in attracting businesses and industry by providing land and financial subsidies. The optimal use of real estate holdings can be important for achieving a *higher employment and property tax base* for the city.

Current Practices and Problems of Municipal Real Property Asset Management

Despite many national differences in municipal AM, there are some features that are common for most cities across the world:

- With the exception of a very few countries and cities, municipal real property AM lags far behind AM in the private sector.
- Public real estate in any particular city, is usually owned and managed by several independent agencies.
- Even when cities have a strategic or at least a pro-active approach to real property AM, it is usually focused on some narrow sub-sector of real estate, while the rest of local public property is managed inefficiently.

Specific problems associated with municipal real property AM are:

- Inadequate valuation standards and practices regarding public real estate for effective AM even in developed countries like the US, UK, and New Zealand
- Absence of revenue and expenditure data on a property-by-property basis, which restricts efficient use of the property and strategic holding/disposition decisions.
- Financing of land acquisition for public purposes on an emergency basis in many developing countries, which results in higher purchase prices of the land.
- Sales of surplus land for covering current budget deficit which is a short-sighted solution to budget problems.
- Privatization of land and dwellings to reduce subsidies to households and agriculture, and decrease the current account deficits of the local government (for example Hungary).
- Illegal squatting and development of urban public land, and the emergence of informal land markets. Caused by inefficient public land management, this results in lost potential revenues, depending on a government's ability to evacuate the squatters (without compensation) and find alternative use for the land, and/or recover some payments from the current users of land.

Implications for the World Bank

The World Bank, as a leading think tank and a major lender to the public sector, can assist client countries develop their real property AM agendas and facilitate progress in this area. We envision several specific activities, where the Bank might play a constructive role:

1. Add the real property AM dimension to more traditional urban issues such as:
    - Land management in developing countries.
    - Government decentralization, municipal finance, and privatization reforms in countries in transition.
    - Public-private partnerships for land development and redevelopment.

2. Assist client countries to develop an enabling AM framework at the national level. In particular:

- Amend existing laws that regulate local government activities, and are currently obstacles for pro-active municipal real property AM.
- Establish standards of accounting and reporting for public property that are cost-efficient and useful.

3. Develop recommendations for client countries on surplus property issues:
   - What criteria should be used for determining an optimal size of surplus public property in cities?
   - Which governments - central or local- should own urban surplus real property in countries where public property has not been finally divided yet?
   - What is the rationale for the region-wide trend in countries in transition to shift surplus real property from direct municipal ownership to assets of municipal enterprises?

4. Launch a program of accumulating knowledge, promoting general awareness and disseminating best practice experience on public real property AM. The program should be targeted at various users, in particular: (1) Bank and other donors' country staff across the world, and (2) central and municipal officials, policy makers, and legislatures in client countries. It should comprise of:
   - Formats for data gathering on public real property holdings and public AM.
   - Collection of such data through both Bank urban projects in various countries and specialized international information projects (such as Urban Observatories, OECD surveys, etc.).
   - Case studies regarding best practices in both donor and client countries.

5. Identify and support technical assistance that will improve local public real property AM and benefit interrelated areas, such as municipal finance, property privatization, etc.

6. Use urban loans as a lever for improving local public real property AM.