

Real Estate Markets

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Soviet central planning has left some of its worst legacy in real estate, especially urban housing. Significant improvements will require changes in the policies of local governments and further development of market institutions.

During most of the years of central planning, housing construction was a low priority. There were long waiting lists for small, low-quality apartments in poorly maintained buildings. Nominal rents remained fixed at levels virtually unchanged from those set by Stalin in 1928. Far below the market clearing value, the typical level of rent relative to income averaged about 2.5 percent in the USSR in the 1980s (Renaud 1992), compared with a typical value in the West of about 33 percent.

The size of the housing stock in Russia is well below Western standards. For example, adjusted for population, Sweden has twice as many housing units as Russia. The housing stock is meager even compared with many other former Soviet bloc countries, such as Hungary and Estonia (UN-ECE 1994). In Russia's major cities there are about 1.3 families per housing unit (World Bank 1995). The acute shortage of housing and the low level of affordability are reflected in very high prices relative to income (Struyk 1996). The level of residential construction is now only half what it was in the late eighties.

There is now an absence of clear institutions regarding private land ownership, bankruptcy, foreclosure, and eviction. This makes it virtually impossible to use real estate as collateral for borrowing investment funds. At the same time, there is minimal experience with any form of market financial intermediation, the proliferation of private banks notwithstanding. Even the term "real estate finance" is sometimes translated into Russian as "real estate subsidies."

This chapter is divided into two main parts. Part one describes in further detail the current status of the real estate market. Part two offers numerous recommendations to accelerate real estate investment.

Current Status of the Real Estate Market

Privatization

Privatization of real estate has progressed furthest in the housing sector as state-owned housing is transferred to individual citizens and to private enterprises. For the country as a whole, at least half of the housing stock has thus far been privatized (Klepikova et al. 1995).

The extent of the privatization of existing commercial and industrial buildings is not known in general. In St. Petersburg about 25 percent of total floor area in commercial buildings and premises was privatized by the end of 1996 (Kaganova 1998).

No urban land was privatized until recently, with the lone exception of small plots of land allocated to families for single-family homes or privatized by families living in already existing single-family homes. In 1995, after three years of repeated attempts, the privatization of land sites underneath privatized enterprises finally began by means of land purchases by enterprises. By December 1995, about 1300 enterprises across Russia had completed land purchases, and another 2300 enterprises had submitted applications (Limonov 1996). By the end of 1997, the share of privately owned city territory varied from 0.2 to 17.5 percent in 6 surveyed cities (Kaganova 1999). However, the process of land privatization is limited since Moscow and other regions, ignoring the constitution and presidential decrees, allow only long-term land leases.

Urban Housing Markets

There are striking geographical differences in housing markets, in part a reflection of sharp differences in municipal policies. According to a 1994 survey of several cities, mean income of non-pensioner households varies from about 5 to 21 percent of mean home price (Struyk 1996).

For a sample of six cities, Kaganova (1999) found that annual turnover rates (sales as a percent of privately owned housing stock) range from 5.0 percent to 8.7 percent, with new homes built accounting for from 19.4 to 49.3 percent of sales of existing homes.¹ Fees for infrastructure and other costs imposed by cities ranged from 9 to 33 percent of the total cost of housing development.

Initially most residences (apartments) offered for sale were provided by persons planning to emigrate. Currently, the supply primarily represents the redistribution of wealth and migration within Russia. Families leasing out their own residences accounts for at least 2 percent of the housing stock (Struyk 1996). Investments in rental residential properties have yet to occur in any significant amount.

New construction of housing is primarily of two types. First, there are high-rise apartments in multi-apartment blocs laid out in the Soviet era. Second, there are single-family luxury houses, a type of residential development without precedent except for the dachas of the nomenclatura. A less prevalent third type are townhouses which are meant primarily for foreign residents. Demand for entire buildings for renovation is growing in the center of St. Petersburg, and presumably central Moscow as well. A building yet to be renovated, with tenants already relocated, commands a higher price per square meter than a high-quality apartment in an unrenovated building (Kaganova 1995).

Housing prices are highest in Moscow. A typical three-room apartment of 70 square meters (750 square feet) sells for about \$80,000. Apartments renovated to Western-standards cost several hundred thousand.² Prices in St. Petersburg are about half those in Moscow for local-quality apartments, and about a third as much for Western-standards apartments. Given the low family incomes in Russia today, a home purchase is out of the question for the vast majority, especially given the absence of mortgages.

Due to the absence of institutional lending, prepayment by future homeowners is the primary source of finance for housing construction, while in commercial real estate, construction equity investment is very high. A recent study found that in Moscow and Rostov-on-Don, about

two-thirds of projects are financed 100 percent with the developers' own funds (Kaganova 1996). Much of the inflow of capital may be illicit in origin, since construction offers a way to launder money.

Commercial Real Estate

The market for commercial properties is very active: the annual turnover rates (sales as a percent of privately owned stock) is around 40 percent in some cities. Office rentals are also active. It is common knowledge that rental rates on office and other commercial space are impacted by the cost of mafiya protection, at least in big cities.

Office space at Western standards of quality is usually in reconstructed or new privately owned buildings and exists only in major cities. Its supply consists largely of business centers that function as foreign enclaves providing telecommunication facilities, apartment or hotel rooms, restaurants, and garages. In addition, there are three types of local-quality space: (1) low quality office buildings, often poorly managed, belonging to privatized enterprises; (2) premises used as income properties by municipal agencies; and (3) premises occupied rent-free by public institutions (state research institutes, state universities, defense institutions, etc.) which rent out part of their space to obtain revenue. These leases are often legally questionable since the premises are actually owned by the city or the State.

New businesses and foreign companies desire offices in prestigious central districts, but many office buildings are located far away from the center and are often in industrial zones. The difficulties in obtaining land sites limit the ability of private developers to fill this gap.

In Moscow the average net rent for offices of Western standards was about \$825 per square meter in January 1996 with a total occupancy cost of about \$1050, ranking the city sixth highest in the world for office rents (Ellis 1996). Rental rates are substantially less in other Russian cities.³

The cities themselves are the largest owners of commercial and other nonresidential properties. In St. Petersburg, authorities of inner-city

districts hold about 13,000 active lease contracts on nonresidential premises, and about another 10,000 contracts are held by other city authorities. There is still no private management for municipal properties. Lease terms are standardized and rents are calculated by a formula or, for smaller spaces, are determined by officials who often can be bribed. The municipalities are not responsive to market conditions, either losing revenue because of below-market rents or losing tenants because of rents and terms less attractive than those offered by private owners. Only St. Petersburg has begun implementing more objective methods (mass appraisal) for setting up rent rates for municipal commercial property.

Retail space is generally less expensive than office space, unlike in cities with developed real estate markets. There are several reasons. First, demand for retail space is a function of the public's overall purchasing power, which is low. Second, in the process of privatization restrictions were imposed on many retail and service-sector premises with respect to permitted activities. Third, the commercial real estate market is still a long way from equilibrium, and the unsatisfied demand for office space exceeds that for retail space.

Industrial Property

In all industrialized Russian cities, industrial buildings and warehouses are available for lease or purchase as the result of privatization. Vacancy rates are high because of the economic depression as well as lack of fit to the requirements of potential renters. In St. Petersburg the typical annual rent for industrial properties is from \$30 to \$60 per square meter.

Land Markets

As should be clear from our discussion of privatization, the market for urban land is very thin and consists mostly of family owned sites zoned for housing or gardening. As a rule, such sites are not provided with a full set of utilities (sewage, gas, electricity, water, etc.), making them

unsuitable for construction. As one would expect, turnover of land sales on sites privatized by enterprises is high in some cities; we discuss later the potential consequences of allowing the privatization of industrial land in the absence of other privatized urban land.

Proposals

Real estate markets depend on the ability to exercise and transfer well-defined property rights. In the current context, property rights require that Russian law guarantee: (1) the rights of owners of individual residential apartments, and the rights of enterprises and developers holding long-term land leases, to make appropriate use of owned, or leased, real property; and (2) the right to sell, rent and mortgage these property rights. Property rights are not meaningful unless there are clear and effective mechanisms to ensure that local authorities, courts and police are willing and able to enforce these rights. One basic component is an effective system of property recording (title registration).

Legislation passed in the last several years has helped to clarify property rights, but contradictions remain at various levels of Russian law, and implementation has not been consistent or strict. Although the constitution states that land relations are regulated by federal law, primarily through the land code, many presidential decrees challenge this constitutional provision by addressing a number of areas related to land rights and registration. Also, although the constitution states that juridical entities may own land in fee simple, and privatization laws state the same, many cities in Russia, including Moscow, refuse to grant anything but land leases.

Municipal Policies

Municipal policies should be changed to take into account the reality that private funds are now the main source of construction and reconstruction financing. Authorities in many cities, including Moscow

and St. Petersburg, do not sufficiently realize that the private investor/developer of today and the municipal contractor of Soviet times are not the same and need to be treated differently. Currently, the authorities offer investors contractual relations for a construction period, and the prototypes for these investment contracts are contracts with hired contractors. Investment contracts assign no property rights to investors and allow the cities to dissolve the contract unilaterally, should the developer violate the terms.

The official policy of many cities is to attract as much foreign investment into real estate development as possible. The mayors of Moscow and St. Petersburg travel across the world to market their cities. Nevertheless, the total number of projects with foreign participation and the amounts of investment are surprisingly small. Even in Moscow, with its high real estate prices and office construction boom in 1995, foreign investment is negligible.

A study conducted by Kaganova (1995) of St. Petersburg in 1995 identified the main obstacles to foreign investors: (1) lack of secure property rights during the construction period, since titles and long-term land lease agreements are available only after construction is completed; (2) unreliable real property registration systems; and (3) uncertainty concerning the expense requirements imposed by the city. A less frequently cited concern was the general political and economic instability in Russia.

Russian investors are apparently less concerned about these problems, although the absence of mortgageable rights during construction is an issue for them as well. The courage of Russians to invest under uncertain and unclear conditions can presumably be explained by their relative inexperience and, in some cases, the priority of money laundering over investment return.

The Russian construction industry remains highly inefficient, with a great deal of power remaining with the large *kombinat* enterprises inherited from the Soviet past. Their power lies in relationships with the municipal agencies that provide land and construction approval, and in priority access to construction materials, both from established networks

and from direct control (vertical integration). To increase competition in the construction industry, new entrants should have equal access to land, building permits, and construction materials.

Property Registration and Professional Services

Many countries are offering technical assistance to federal and municipal governments and to private business and professional organizations. While generally constructive, this assistance can undermine efficiency and fairness when local circumstances differ from those under which recommended models evolved. Technical advice is often contradictory as well.

The recording of real property and the guaranteeing title are important illustrations. Under the European model,⁴ a government registrar checks the validity of each property transfer before recording it. The government then takes responsibility to guarantee title. If someone were to establish the validity of a conflicting claim, then the government would resolve the conflict according to law and pay any and all compensatory damages.

There is a strong rationale for favoring instead the American system. Rapid privatization over geographically vast territories, the rapid development of local markets, and the absence of a strong and effective centralized administrative system are all factors in the evolution of the American system which exists in Russia today. These factors may be interpreted as typical for a “frontier society”.⁵

The American system relies less on government and more on the market. Government recording of transactions is done without the registrar establishing the validity of the recorded documents other than to check that they are notarized. The recordings are voluntary, and the government bears no responsibility. Private title insurance is the mechanism for ensuring the validity of ownership transfers and other property rights. In practice, the American system is faster but more expensive for users than the European system.

St. Petersburg now has an European system but without legislation specifying how the government should adjudicate conflicts and provide compensatory payments. Thus privately provided title insurance is developing as well, leaving St. Petersburg with a slow and expensive hybrid.⁶ Even more to the point, real property registration remains unreliable. The evolution of this unsatisfactory hybrid model has so far been completely ignored by legislators at both the federal and municipal levels.

Land Policy

Under central planning, construction was primarily on the existing perimeters of cities. Like a tree's cross section, the urban structure of Russian cities reflects alternating periods of residential and industrial construction that mirror changes in central planning emphasis. Considerations of commuting time and energy efficiency played little role.⁷ For many years, large-scale, high-rise housing construction was assigned to raw land remote from the city centers. Old industrial lands located close to the city center have yet to be recycled. This spatial evolution of cities reflects the absence of a land market as an instrument of land redevelopment (Bertaud and Renaud 1997). As a result, transport systems are lengthy and costly to operate.

Currently, there is a municipal monopoly on land, which allows the authorities to dictate to developers both the financial terms on which lots are provided and the location of projects. The administrative mechanism for allocating sites is not sufficiently sensitive to market demand. In these circumstances, bribery can be rationalized as a mechanism for making officials attentive to the market. Further development of the housing and building market in the absence of land privatization may proceed under two negative scenarios.

Scenario one: local authorities block land privatization and the private ownership of land other than individual housing tracts. The inertia of the bureaucratic patterns will continue to push urban development to land leases of raw land (with bribed exclusions). Given the shift to a system

in which users pay for infrastructure operating costs, this scenario will impose high costs on the final consumers. Once better land becomes available, there will be a rapid decline in market values for improvements built in bad locations.

Scenario two: local authorities allow the privatization of lands controlled by privatized enterprises, while other land follows scenario one. This situation would result in construction activity on industrial lands converted to housing use.

Rational and prudent development of Russian urban real estate requires that municipal land policy be more sensitive to market demand. Cities should direct development toward more central locations and introduce mechanisms that are responsive to locational preferences.

Public Utilities

The location of new construction in city outskirts is largely predetermined by the technologies of the urban utilities developed during the Soviet era. These technologies are behind those available in developed Western cities. The further evolution of Russian cities depends critically on the transformation of the outmoded urban utility systems.

The centralized supply systems do not now provide individual metering or adjustments for heat, water, and gas. These systems are costly to build and operate and have sizable internal losses. Moreover, because they are monopolies which are often privatized, these enterprises lack incentives to improve efficiency and the quality of service.

A new policy of capital financing and the management of public utilities is needed. Eliminating monopolies and creating incentives for new technologies should be key. However, in view of the political influence of monopolies and urban utilities, such a policy may be difficult to implement.

Real Estate Finance

It is not surprising that mortgages did not exist in the Soviet era. Since most housing was owned by the state or by enterprises that were owned by the state, Russian households did retain important entitlements and rights of bequest regarding their primary housing units as well as their dachas (summer houses), but these entitlements also made eviction difficult and thus precluded the use of real estate assets as mortgage collateral.

A system of real estate finance is needed to fund the construction of new structures and to finance the purchase of existing properties. As with many of the proposals made here, a consistent set of laws is needed in a number of known areas: property rights, collateral, eviction, and foreclosure. In addition, it is now apparent that the Russian banking industry is unlikely to take the lead in creating a mortgage market. Their attention is focused on highly profitable, short-run, trading markets. Jaffee and Renaud (1996) offer an alternative strategy: a government-sponsored mortgage credit institute could take the initiative that the commercial banks have failed to provide.

Conclusion

Economic depression, political uncertainty, and a lawless environment are jeopardizing the functioning of real estate markets. Moreover, real estate finance is primitive, limiting the potential for real estate investment. Nevertheless, further legislation and more realistic municipal policies could strengthen construction activity in a manner responsive to social needs. Property rights need to be clearly established, property registration must be reliable, policies regarding utilities revamped, and both land ownership and land leases made more available to developers.

Improvements in the real estate sector are important for the entire economy. New housing and commercial construction would stimulate aggregate output through a macroeconomic multiplier. More housing

would also facilitate relocation of the population to the relatively more prosperous urban areas, allowing workers to be more productive and earn higher wages. New commercial construction would enhance the productive capacity of the economy. Also, a developed mortgage system for real estate would provide financial assets with positive real rates of return, which would help bolster private savings and thereby strengthen the underpinnings for non-inflationary growth.

Notes

1. Not all new housing construction was for sale. Some portion was built from public funds for various state programs.
2. Data are from a fall 1995 survey by Kaganova (1996). In Moscow, most apartments sold for between \$950 and \$1,330 per square meter for local-quality apartments, and \$3,000 to \$4,500 for those of Western standards.
3. In St. Petersburg, annual rents in 1995 for local-quality offices ranged from \$190 to \$370 per square meter compared with \$370 to \$800 for Western-standard offices (Kaganova 1996).
4. The conventional view among real estate economists is that the European model (or Australian or Torrens model) is more progressive, though reportedly the European system was disbanded in several American cities because of its inefficiency.
5. Implications of the “frontier society” to real estate were outlined by Peter Colwell during an on-line conference on land and real estate issues sponsored by the World Bank (November–December, 1998).
6. In mid-1995, registration of an apartment sale in St. Petersburg took, in the best case, two days, at a cost of 0.2 to 0.4 percent of the sale price, with title insurance costing another 1 to 3 percent (Kaganova 1996). In the United States, recording of a home sale would take minutes and cost 0.05 to 0.08 percent, while title insurance would cost another 0.6 to 0.8 percent.
7. Bertaud and Renaud (1997) found this pattern to be common in other socialist countries as well.

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