REAL ESTATE MARKETS IN URBAN RUSSIA

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ABSTRACT

This paper provides a framework for analyzing the Russian real estate sector during the economy's transition to a market system, discusses the results that have been achieved, and offers suggestions for improving the situation. A stock/flow model of the real estate sector is used as the primary framework to identify the factors that are retarding the transition of the Russian real estate sector to a market system. The current state of the Russian real estate sector is illustrated with data for the city of St. Petersburg, as well as other Russian cities. Policy proposals are provided to accelerate the transition to a market system, to stimulate real estate production, and to create a real estate finance system. The ideas developed here may also be relevant to other markets in Russia and to other transition economies.

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1. INTRODUCTION

Central planning has left some of its worst legacy in the real estate sector, especially the housing sector of the Russian economy. In the urban centers, there are about 1.31 Russian families for each unit of housing (World Bank [1995])--with the excess living in terrible communal flats--as a result of insufficient production. Russian housing is generally of poor quality and under-maintained, reflecting state ownership and rent ceilings. Most Russian cities are an urban planner's nightmare, arising from distorted energy and commuting costs, with land allocations and building permits controlled by corrupt local agencies. All Eastern European countries have serious real estate problems, but the Russian problems are measurably worse.

Improved real estate markets will provide a number of positive externalities, as well as direct consumption benefits. New housing construction will stimulate aggregate output through a production multiplier. An enlarged housing supply will also allow labor to find vacant units and to move to areas of the country providing higher wages and productivity. New commercial construction will have similar macroeconomic effects and add to the productive capacity of the Russian economy. Finally, a developed mortgage system will stimulate saving activity by providing financial assets with positive real rates of return.

The Russian real estate sector has so far received few of the benefits that were anticipated as a result of the country's transition to a market economy. The low level of real estate production represents one major puzzle. Even though a large excess demand for housing is confirmed by a high level of house prices relative to income,[1] housing construction is still below 50 % of its peak level of a few years ago. The limited amount of privatization, and the corresponding limited

effects of privatization is another major puzzle. Less than half of the housing stock has been privatized, even though it can be done at virtually no cost.

Various factors are thwarting the economic incentives for real estate investment and privatization. Real estate production suffers from such factors as macroeconomic instability, unclear property rights, difficulties in obtaining land sites for construction, principal-agent contracting problems, and distorted building material supply conditions. Privatization appears unattractive to many households because it may imply the loss of large subsidies for rent, maintenance, and utilities.

Real estate finance is in an equally difficult situation. Even the term real estate *finance* is sometimes translated into Russian as real estate *subsidies*. More fundamentally, effective legal bases do not yet exist for private land ownership, bankruptcy, foreclosure, or eviction, placing severe constraints on any lending activity. At the same time, there is only minimal experience with any form of financial intermediation (the newly developing banks not withstanding).

This article provides a framework for analyzing the Russian real estate sector during the economy's transition to a market system, discusses the results that have been achieved, and offers suggestions for improving the situation.[2] Part 2 develops our framework and identifies the factors that are retarding the transition of the real estate sector to a market system. Part 3 discusses the current state of the Russian real estate sector. Part 4 develops policy proposals for accelerating the transition to a market system, stimulating real estate production, and creating a real estate

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[1] In early 1994, the ratio of home prices to mean income of nonpensioner households in seven Russian cities ranged from 5% to 21% (Struyk [1996]).

[2] The World Bank [1995] has recently published a book-length study of the Russian housing sector. Our article is comparable in intent, but covers all real estate and is focused on specific policy proposals.

finance system. The ideas developed here may also be relevant to other markets in Russia and to other transition economies.

2. A STOCK/FLOW MODEL OF THE REAL ESTATE SECTOR[3]

We begin with a stock/flow real estate model, which will be used for analyzing the specific issues that arise in Russian real estate markets. We first consider a market economy version of the model, and then a central planning version. In developing the model, we refer specifically to the housing sub sector of the real estate markets. The same basic principles apply, however, to commercial real estate.

2.1 A Market Economy Model

The rental market for housing services and the asset market for the stock of housing (including land) are distinguished. In the rental market, the real equilibrium rent R* is determined at the level at which the demand and supply of housing services are equal. In the housing asset market, the real equilibrium price P* is determined at the level at which the demand and supply of the housing stock are equal. The rental market and the asset market are linked together, however, because the asset price P must equal the discounted value of future rents, where the discount rate (sometimes called the user cost of capital) is determined by the market rate of interest among other factors.

There is also a market for the flow of net housing construction. In this market, the amount of new housing construction depends on the Tobin Q ratio, which equals the ratio of the real asset

[3] See Poterbo [1984] for a more formal and complete description of a stock/flow housing model.

price P to the real construction cost C. Specially, when Q exceeds 1.0, net housing construction is positive, and when Q equals 1.0, net housing construction is zero.

In the short run, the housing market will be influenced primarily by factors that change the demand for rental space (such as changes in income, immigration, or emigration) or that change the demand for the housing stock (such as changes in the user cost of capital). Specifically, if the demand for rental space or the demand for the housing stock rises, then the market rent and the asset price will rise. The increase in the asset price will raise the Q ratio, thus stimulating housing investment. As a result, the stock of housing will rise over time, causing market rents and asset prices to fall back toward their long-run equilibrium levels.

In long-run equilibrium, net housing investment must be zero, for otherwise the stock of housing would be changing. This implies that the asset price P must equal the construction cost C, for otherwise net housing investment will not be zero. As a result, if there is, say, an increase in the demand for housing services or in the demand for the housing stock, then the stock of housing will rise, but the asset price P will be unaffected (unless construction costs are also affected). Because the market rent R and the asset price P are linked, the market rent will also be unaffected (unless the user cost of capital is affected).

The mortgage market influences the housing market through the user cost of capital. For example, if a change toward a more efficient mortgage market lowers the user cost of capital, this will raise the demand for the housing stock. An increase in the stock demand, as just described, will then raise the asset price and housing investment in the short run, and will raise the stock of housing in the long run.

Similar considerations apply to the commercial real estate market. The demand for

commercial real estate, however, is generally more sensitive to macroeconomic conditions, causing commercial real estate prices and rents to be volatile than housing prices and rents.

2.2 A Central Planning Model

The Russian housing system under central planning operated in a very different manner than the market economy model just described. Four factors were primarily responsible..

2.2.1 Rent Controls

Nominal rents remained fixed at levels virtually unchanged from those set by Stalin in 1928, and were well below the market clearing value. The low levels of rent relative to income in the USSR and other eastern European countries in the last years of the Soviet system are shown in Table 1. In comparison, in most developed western economies, the rent income ratio tends to be about 33%. The low rents under central planning created a large excess demand for housing. The excess demand for housing forced Russian households to spend more of their income on other goods (expenditures on alcohol and tobacco actually exceeded those on housing).

The effect of low rents on Russian housing demand are complicated, however, because the housing subsidy was offset by low real take-home pay (the so-called socialist wage system). There were also complex spillover effects, reflecting rationing and queues in other consumer goods markets. Nevertheless, communal flats and long waiting lists for housing confirmed that there was a large and continuing excess demand for housing services.

2.2.2 Construction Activity

Under central planning, housing construction was set at low levels, independently of the Q ratio.[4] The ramification was that housing investment and the housing stock under Russian central planning were well below the values that would have obtained in a comparable market economy. Figure 1 shows the relatively low level of the housing stock in transition economies, especially in Russia, in comparison with the levels in developed western economies shown in Figure 2.

2.2.3 Qualitative Aspects of Russian Housing

The Russian housing stock was limited in quality as well as quantity. The low quality of Russian construction was reflected in the aesthetic monotony of large-panel units and poor insulation properties regarding sound and heat. Maintenance activity also received a falling priority over the years. New construction occurred primarily on the existing perimeter of cities, since large open spaces were required for large-panel construction techniques. Like a tree's cross section, the urban structure of Russian cities reflects alternating periods of residential and industrial construction, mirroring changes in central plan emphasis over time. Considerations of commuting time and energy efficiency played little role.

2.2.4 Housing Finance

It is not surprising that a mortgage market did not exist under central planning. For one thing, most of the housing stock was owned by the state or by enterprises that were owned by the state. Furthermore, Russian households retained important entitlements and rights of bequest regarding their primary housing units as well as their dachas (summer houses). These entitlements made eviction difficult and thus precluded the use of real estate assets as mortgage collateral.

[4] To determine the Q ratio, house prices P would have had to be measured as shadow prices, since market trading of real estate was not allowed under Russian central planning.

3. THE CURRENT STATUS OF THE RUSSIAN REAL ESTATE SECTOR

In this section, we review the current (as of mid-1996) situation in Russian urban real estate markets. We begin with the status of privatization efforts, looking at residential, commercial and industrial real estate, and land.

3.1 Privatization Across Real Estate Sub sectors

On an historical time scale, Russia's real property privatization and the development of its real estate market have started fast, but the process itself has been very uneven across sub sectors. There are three major sub sectors in urban areas to be considered: housing, commercial and industrial buildings, and land.

The reallocations of the existing housing stock can be traced with the help of government statistics. There have been two major channels of reallocation: the privatization of the government-owned stock (both enterprise-controlled and municipal) and the transfer of the enterprise-controlled stock into municipal property. As a result, during five years of reform, the share of the urban housing stock owned by natural persons has increased from 15 to 31 percent, and the share of housing stock controlled by enterprises has decreased from 44 to 15 percent (Table 2).

There have been several additional processes. First, there has been the conversion of fully paid-off cooperative apartments into private property (this process is not represented in Table 2). For example, in St.Petersburg, where 18 percent of the total housing stock was initially cooperative, more than 95 percent of the former cooperatives have now been converted. Second, housing owned by private or mixed public-private companies has appeared (3 and 9 percent,

respectively; see Table 2).

The extent of the privatization of existing commercial and industrial buildings is not known. The level of informational uncertainty can be illustrated by the case of St.Petersburg. Estimates of non-residential buildings privatized by the fall of 1995 vary from "not less than 30 percent" (Report of the EBRD) to 75 percent (Chairman of City Property Committee). Given the unknown exact number of existing non-residential buildings, the number of privatized buildings can be from 5,300 to 13,000 (Kaganova [1995]).

No urban land was privatized until recently. The lone exception was a small amount of land that has been allocated to families for single-family homes and garages or privatized by families living in existing single family homes. In 1995, after three years of repeatedly failed attempts, the privatization of land sites underneath privatized enterprises has finally started. By December of 1995, about 1300 enterprises across Russia had completed purchases and another 2300 enterprises had submitted applications (Limonov [1996]). This process is quite uneven geographically: few cities and regions, such as St.Petersburg, Orenburg, Saratov Region, Krasnodar and Primorsky Territories make more than 50 percent of these transactions and applications. About 40 percent of "federal entities" (regional administrative units) had not begun land sales to enterprises at all. Moscow authorities steadily ignore the Constitution and Presidential Decrees about land privatization, and allow only long term land leases (up to 49 years, sometimes with an option for a prolongation on the second term). Other 17 "federal entities" have the same local policy adopted through local legislation.

Delays with the privatization of land results in the absence of a land market for private developers. Possible negative consequences will be discussed below.

3.2 Urban Real Estate Markets

3.2.1 Housing markets

There is an active market for transactions involving the privately owned stock of urban dwellings. A survey conducted in seven Russian cities in 1993 indicated that the annual turnover rate ranged from 2.4 to 9.3 percent, approximating the turnover rate of existing homes in the U.S. (Kaganova [1996]).

Early in the market's development, many of the existing homes offered for sale (in cities they were mainly apartments) were provided by people who planned to emigrate from Russia. Currently, the supply of homes for sale primarily represents the ongoing redistribution of wealth in the society and migration within Russia. The number of homes offered for sale is higher than the number of transactions (by a large factor in some cities). In fact, since 1994, signs of oversupply in this sub market have appeared in many cities. A major problem is that the existing apartments offered for sale do not fit the quality requirements of the effective demand.

The market for newly constructed housing has less diversity. Two main types are offered. First, there are apartments in multi-apartment blocs begun under the socialism regime. These projects resemble in design and location the large-panel high rises of socialist housing. Second, there are single-family luxury houses--a type of residential development without precedent in the socialist era except for the dachas of the Nomenklatura. Townhouses are a more recent product. In major cities such as Moscow and St.Petersburg, a portion of the new apartment projects are designed to "Western standards" and are meant primarily for foreign residents.

The number of new home sales varies widely across cities, compared with the number of

existing home sales. In seven cities surveyed in 1993 - 1994, new homes sold constituted 8 to 80 percent of the transactions on the secondary market.

The highest sale prices for housing are in Moscow. In the fall of 1995, the average price for existing apartments in the capital was about $1,170 per square meter, varying between $950 and $1,330 per sq.m. for the most typical low- and high-quality apartments. So, a typical three-rooms apartment of 70 square meters would cost $66,500 to 93,100. Prices for “elite” apartments or on apartments at “Western standards” can reach $ 3,000 - 4,500 per sq. m. At the same time, average prices on the secondary apartment market in St.Petersburg varied from $450 per sq.m. for low-quality to $ 620 per sq.m. for high (“local standard”) quality apartments. The typical two-rooms apartment of 55 square meters would cost $24,800 to 34,100. Prices on apartments renovated to “European standards” can reach $1,000 per sq.m.

The current structure of effective demand for residential properties in downtown St.Petersburg is undergoing substantial change, and we assume that this change is typical for other major cities as well. The first wave of demand for large apartments for occupancy, created by the "nouveau riche" or for office usage, is subsiding. A subsequent wave of demand is oriented toward average-sized apartments for occupancy (two to four rooms) and toward real estate intended not for owner occupancy, but as an investment to generate income. This new type of demand for residential properties is geared toward the acquisition of entire buildings for renovation. The demand by investors to acquire entire buildings can be confirmed quantitatively (Kaganova [1995]): a building which is prepared for renovation (with tenants relocated), but has not undergone any repairs, can sell for $1,200 per square meter (while an high-quality apartment but in a not renovated building will go for $ 1,000 per square meter).

The rental housing market is based on individual families leasing out their apartments. Such leases account for not less than 2 % of housing stock (Struyk [1996]).

Investments in rental residential properties have not yet occurred in any significant amount. A rapid development of this sub sector could be expected if the municipal policy of allocating land for construction or buildings for renovation were more flexible.

3.2.2 The Market for Commercial Real Estate

To date, not many sale transactions of office buildings have occurred, but the rental sector is quite active. The supply of office space for rent has several major components:

a) Privately owned space at "Western standards of quality", usually in new or reconstructed buildings with private management; this kind of office space exists only in major cities, and the first wave of the supply of this type consisted of "business centers" (buildings with offices, telecommunication facilities, apartment or hotel rooms, restaurants, garages).

b) Privately owned space of "local level of quality"; these are usually office buildings built in the Soviet period (with low quality of design, construction materials, construction work and often with bad management even after privatization) and belong to privatized enterprises and institutions;

c) Municipal buildings and premises used as income properties by municipal agencies;

d) Buildings and premises, municipally or state owned and occupied by public institutions (state research institutes, state universities, defense institutions, etc.) which rent out a part of the space to obtain revenue; these lease are often legally questionable.

In St.Petersburg, the average rent on renovated offices offered by real estate brokers (type

(b) from above) fluctuates within the range of $190 to $370 per square meter per year (data of the fall of 1995). In business centers (type a)), rents range from $370 to $800 per square meter per year, although there is now an emerging trend toward lower prices in business centers located in low-prestige areas. There is growing competition in the office market, because the amount of space in types (a) and (b) has expanded through privatization, new construction, and reconstruction.

In Moscow the average net rent (presumably for type (a)) was about $825 per square meter per year in January of 1996, and the total occupancy cost was about $1050, making Moscow the city with the sixth highest office space costs in the world (Ellis [1996]).

In many cities, the rental prices on commercial space include the cost of mafia protection.

All cities are the largest owners of commercial and other non-residential properties. Thus, in St.Petersburg authorities of inside-of-city districts are holding about 13,000 active lease contracts on non-residential premises and buildings, and about other 10,000 contracts is been held by city authorities. There is clear evidence that authorities are not able to keep on the cutting edge of market development. There is still no private management for municipal properties, municipal rents are calculated by a formula or, for smaller spaces, are determined by corrupted officials, and the lease terms are standardized. As a result, the municipality is always losing something: either revenue (if “formula” or “negotiated” rents are lower than market rents) or tenants (if municipal rents are higher than market rents or if the terms of the standard lease agreement are less flexible than those offered by private owners).

In all Russian cities, there is a gap between the spatial distributions of supply and demand

for offices. On one hand, the effective demand for offices created by new businesses and foreign companies (in major cities) is very sensitive to location and strongly oriented toward prestigious central districts. On the other hand, many office buildings constructed in the Soviet time and offered now on the market are badly located (in industrial zones, for example). In addition, the absence of a land market and the difficulties in obtaining land sites for construction from the city's authorities limit the ability of private developers to fill this gap.

In St.Petersburg and other cities for which we have relevant information, the average prices for retail space do not exceed the prices for office space. This is quite atypical of cities with developed real estate markets, where retail space is usually more expensive. This fact is attributable to a combination of factors: 1) during privatization, rather long-term restrictions were imposed on many retail and service-sector premises with respect to the permitted activities; and 2) the commercial real estate market is still a long way from supply and demand equilibrium, and the unsatisfied demand for office space exceeds that for retail space (it should be borne in mind that demand for retail space is to a significant degree a function of the public's overall purchasing power, which is currently rather low for a sizable segment of the population).

3.2.3 Industrial Property Markets

In all industrialized Russian cities, many industrial buildings and warehouses are available for lease or purchase as the result of privatization. Many of these structures are in very poor condition, being, in fact, dead assets with negative values for owners (because the taxable value of the structures, based on depreciated replacement cost, is higher than the market value). The vacancy rate in such properties is high because, as for the market for existing homes, the supply

does not fit the quality requirements of the effective demand.

In St.Petersburg the typical rent for industrial properties is in the range $30 to 60 per square meter per year.

3.2.4 Land Markets

As should be clear from the section about privatization, the market for urban land is very thin and consists almost only of sites owned by families and zoned for single-family homes or gardening. As a rule, such sites are not provided with a full set of utilities (sewage, gas, water, etc.) and this is unlikely to change in the near future. So these lands cannot provide a basis for market-oriented construction.

One should expect the appearance of land sale transactions on sites privatized by enterprises. Below, we will discuss the potential consequences of allowing the privatization of industrial lands in the absence of other privatized urban land.

3.3 The Likely Evolution Of Real Estate Markets In Russian Cities

3.3.1 Diversity Across Cities And Inside Cities

An important feature of the transitional situation in Russia is a very high inter-city diversity among the characteristics related to real estate markets.

The simplest example is the differing privatization and land policy of cities, resulting in different levels of privatization of commercial properties and different levels of construction activity across the country. Another example relates to the “infrastructure fees” and other charges imposed by cities on developers for the right to build. Those charges constituted 2 to 61 percent

of the total cost of housing development, according to the developers' survey in seven cities, including Moscow and St. Petersburg, in 1993- 1994 (Kaganova [1996]). By comparison, in the central areas of two major metropolitan areas in the US -- Sacramento, California and Orlando, Florida -- the contribution of land cost and all development-related payments to the municipality in the sale price of a single-family dwelling in 1990 was 28 to 29 percent (Lowry, Ferguson [1992]).

High diversity is also typical for private sector activity. For example, financial schemes for housing construction vary greatly from city to city. In many cities, due to the absence of institutional construction lending and the shortage of equity funds for developers, prepayments by future homeowners are the main source of construction financing. Thus, more than 90 percent of the projects surveyed in 5 cities (including St. Petersburg) used prepayments, and the amount of financing provided by this source varied greatly. Equity investments by developers were used in about 55 percent of projects, with the average contribution being about 23 percent of the total financing. At the same time, in two cities, Moscow and Rostov-on-Don, about 90 percent of the projects used equity investments, and about 63 percent of the projects were financed entirely with the developer's own funds.

The marked difference between Moscow and Rostov-on-Don and the other surveyed cities may be presumably explained (there is indirect evidence supporting this explanation) by an inflow of capital that is of illicit origin, which is to say that investments in housing construction are being used to launder money.

The differences among cities will be reduced over time, in particular through the exchange of information among municipal organizations (such as the Union of Russian Cities and the Union

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of Small Towns). However, in the immediate future, *the private real estate industry and land and real estate policy will be factors creating and maintaining a level of inter-city diversity unknown in the socialist Soviet Union.*

A highly skewed income distribution is another important fact of current Russian reality. In 1995, this process stabilized at the level where the ratio between the incomes of the top and lowest deciles was 13:1. The differentiation among businesses is no less dramatic. Both processes will have a long-term influence on the real estate sector, creating an inevitable tendency toward spatial differentiation. Many city authorities do not yet recognize the problem and therefore implement policies which result in mixing families from opposite ends of the income scale in the same multi-apartment building. This situation creates a potential for significant economic losses and social tensions in the future, and dissatisfaction is already evident for all the parties directly involved (i.e. developers and inhabitants from all income groups).

The near-term evolution of Russian cities will continue toward spatial differentiation, and whether this process goes gently and under some control will depend on municipal policies.

3.3.2 Institutional Infrastructure Of The Real Estate Market: Tendencies From The Bottom And Intentions From The Top

Russia is developing real estate markets in the unique situation where it can learn from countries which are far ahead. Many countries have provided technical assistance to Russian governmental organizations and to private businesses in order to establish components of the

institutional infrastructure for the real estate market (certainly, there is competition among developed countries to provide assistance). The process of transferring ideas and models is very positive in general, accelerating the development of the required infrastructure. But *sometimes, in the general rush of donors and recipients, it is forgotten that the market has its own powerful forces of organization, and that it could be useful to understand these forces for development "from the bottom", before transplanting models "from the top". When the local model and the transplanted one come in contradiction, the total efficiency of the system is reduced, and the final consumer pays the cost.*

The real property recording/registration system in St. Petersburg provides an illustration. Two conceptually different models exist in the world. In the first one ("European", or "Australian", or "Torrens") the state assumes responsibility for guaranteeing real property rights upon their registration. This means that if someone subsequently establishes a valid claim to a given piece of real estate, the state, acting in accordance with the law, will conduct a procedure to resolve this conflict, with full compensation of damages to the injured party. A registrar must check the legal validity of each transaction before its registration. Such systems are considered to be inexpensive for users, but slow and bureaucratic. In the second, "American" model the recording of a real estate transaction is voluntary and the state bears no responsibility for the quality of the transaction. Private title insurance is the supplementary mechanism for protecting property rights. The American system is considered to be fast but expensive for users. The prevailing view among specialists is that the state registration model - "European" or "Torrens" - is more progressive than the "American" model. At the same time, in some American cities where the "Torrens" system was introduced in parallel to the traditional recording system, "Torrens"

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turned out to be inefficient and it was discontinued in some places. Nevertheless, following the prevailing point of view, the extensive technical assistance that St. Petersburg has received in this area from various countries and organizations for almost five years now (since 1991) is oriented toward the creation of a “European” registration system in the city. However, there is no legislation providing a state guarantee for registered property owners.

At the same time, the process of establishing real estate markets in present-day Russia are very similar to the history of this process in the US (such as rapid privatization over geographically vast territories, the rapid development of local markets, and the absence of a strong and effective centralized administrative system), so adopting the mechanisms that arose historically in the US seems natural and inevitable. Indeed, title insurance has already appeared in some cities, including St.Petersburg. As a result, St. Petersburg has a hybrid of the two internationally known models, which unfortunately means it is borrowing the shortcomings of the two "pure" models: the slowness of state registration and the high cost of title insurance. Indeed, in the middle of 1995, registration of a standard apartment transaction in St.Petersburg took 2 days, cost 0.2 - 0.4 percent of the market value of an apartment, and title insurance would cost another 1 - 3 percent. In the US, recording a home sale transaction would take minutes, cost 0.05 - 0.08 percent of the home market value, and title insurance would cost another 0.6 - 0.8 percent.

Unfortunately, the tendency of the Russian real estate market to follow a hybrid model has so far been completely ignored by legislators at both the federal and municipal levels, even though "legitimizing" a hybrid system could substantially enhance the efficiency of the registration system as a whole.

The other interesting feature of the new institutional infrastructure is the tendency of

professional organizations to monopolize the market of professional services by referring to the protection of consumers' interests. Development of this policy involves lobbying for federal laws concerning appraisal, brokerage, etc. The largest professional organizations (such as the Russian Society of Appraisers) try to promulgate a legislation which would allow the state licensing of professionals only for members of these organizations. Given the very high levels of membership dues and training costs provided by these organization, the success of such policy would result in remarkable increases in real estate transaction costs in Russia.

3.3.3 Housing and Building Markets Without a Land Market?

Alain Bertaud, after studying land use patterns in socialist cities across the world, has demonstrated that the same patterns have been wide spread (Bertaud, Renaud [1993]). In socialist cities, for many years, most of the population has been "ejected" to the city outskirts, and large-scale high-rise housing construction was assigned to raw lands remote from the city centers. Old industrial lands located close to the city center have never been recycled. This spatial evolution of cities resulted from the absence of a land market as an instrument of land redevelopment. As a result, engineering and transport systems are very long and extremely costly to operate, and the average amount of time the population spends on intercity travel, including travel to work, constantly increases.

Currently, market-oriented developers operate under a total 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 sensitive to market demand, and bribes to municipal officials is probably the main instrument for

making this mechanism more attentive to the market. *Further development of the housing and building market in the absence of a full-scale land market may proceed under two scenarios, both of which will create long term negative results for the urban economy.*

1. Local authorities will continue to block any land privatization, and the inertia of the socialist patterns will continue to push urban development to raw land (with bribed exclusions, of course). Given the shift to a system in which infrastructure users pay all operating costs, and in which time is valued, this scenario will impose high costs on the final consumers. Then, as better land becomes available, there will be a rapid decline in market values for improvements built in bad locations. Not only the owners, but also the economy in general will lose as a result.

2. Local authorities will allow the privatization of lands controlled by privatized enterprises (this process was discussed above), but other lands follow scenario 1. This situation would probably result in more construction activity on industrial lands and in their conversion to other uses. It is certainly positive for the industrial areas themselves. On the other hand, given the historical and cultural significance of the central areas in many Russian cities and the locational advantages of such areas for all cities, the preferential influx of investments toward industrial land redevelopment seems not the best solution.

3.3.4 Real Estate Markets May Stagnate Due To Public Utility Monopolies

The existing system of public utilities in Russian cities conflicts with the development of the real estate market and with the very idea of private ownership of real estate. The technologies of centralized supply systems do not provide metering or adjustments for the consumption of heat, water and gas by individual apartments or suites, thus limiting one of the fundamental rights

associated with real estate ownership, the right to control one's property. These systems also have sizable internal losses and they are economically inefficient (in particular, costly to build and operate). Because they are monopolies (and often privatized monopolies), these enterprises lack incentives to improve efficiency and the quality of service.

The inertia of urban plans with respect to the location of new construction in the city's outskirts is largely predetermined by the technologies of the urban utilities developed during the socialist period. These technologies are far behind those available in developed cities with market economies based on intensive city land use.

The further evolution of Russian cities and urban real estate markets will depend critically on the transformation of the urban utility systems.

3.3.5 Is There Room For Foreign Investment In Urban Russian Real Estate?

The official policy of many cities authorities, including those in Moscow and St.Petersburg, is to attract as much foreign investment in real estate development and redevelopment as possible. In particular, the mayors of Moscow and St.Petersburg travel across the world to market their cities. Of course, *there are some real estate projects with foreign participation in Russian cities, but the total number of such projects and the amount of investment are surprisingly small.* Even in Moscow, with its very high real estate prices and an some construction boom in 1995, there is almost no foreign investment.

The explanation is that Russian and foreign developers and investors assess the "investment climate" differently, and current conditions are unacceptable to foreign investors. The special study conducted in St. Petersburg in 1995 showed that for foreign investors the main

obstacles to participating in construction and reconstruction were (Kaganova [1995]):

- The lack of long-term property rights during the construction period (titles and long term land lease agreements are available only upon construction completion);

- Unreliable real property registration systems;
- Uncertainty concerning the expense requirements imposed by the city (this uncertainty was ranked higher than the general economic instability in Russia).

The same reasons are relevant to many other cities, certainly in Moscow.

Russian developers and investors are less sensitive to this lack of clarity, though the absence of mortgagable rights during construction is an important problem for them also. We think that the courage of Russians to invest under unclear conditions is explained by several simple reasons: inexperience with the problems created by badly defined property rights (the market is only 5 years old!); no experience in estimating economic feasibility; the priority of money laundering over investment return (for some projects); and a belief that real estate investments are a good shelter from inflation. There is no doubt that Russian real estate practitioners learn very fast, so their investment decisions will soon evolve toward the Western form (mafia motivations excepted, of course). However, in this beginning stage, the aforementioned lack of clarity freed Russian investors from foreign competition.

4. POLICY RECOMMENDATIONS

4.1 Property Rights

Efficient real estate markets require well defined property rights with regard to both land and the improvements (structures) on the land. *Well defined property rights* in this context require that Russian law guarantee the right to private ownership of land and improvements, and also provide mechanisms for individuals and enterprise to enforce their rights (that is, a workable system of title registration). Legislation passed in the last several years has helped to clarify property rights in land and improvements, but contradictions remain in various levels of Russian law and in implementation. For instance, although the Constitution states that land relations must be regulated by federal law, primarily through the Land Code, a recent presidential decree challenges this constitutional provisions by addressing a number of areas related to land rights and registration which should be covered in the Land Code. It is not clear how contradictions between this decree and the yet to be enacted Land Code will be resolved. Also, although the Constitution states that juridical entities may own land in fee simple, and privatization laws state the same, many cities in Russia (most notably, Moscow) refuse to grant anything but land lease rights to juridical entities.

4.2 Land Policy

The economically rational and prudent development of the Russian urban real estate market urgently needs a market-oriented municipal land policy. By "market-oriented," we mean a policy that, if it does not introduce a mass market in land rights (it appears that the authorities of many cities are not prepared for this), would at least direct development toward more central locations and introduce mechanisms to meet the locational preferences of developers, investors, and users of

real estate of all types, including housing.

4.3 Public Utilities

A new policy of capital financing and the management of public utilities is needed. Eliminating monopolies and creating incentives for new technologies should be the key part of this policy. In view of the current monopoly power and political power of urban utilities, we predict that the new policy will be even more difficult to implement than to implement a market-oriented land policy.

4.4 "Investment Climate"

The municipal policies addressed to private investors in construction and reconstruction should be radically redefined, considering the new realities:

- private funds are already the main source of construction and reconstruction financing;
- investment resources are limited, and the cities directly compete among themselves and with other branches of economy for funds.

The fundamental mistake of authorities in many cities, and especially in Moscow and St.Petersburg, is that they do not realize that a private investor and a municipal contractor in Soviet time are not the same, and they need to be treated differently. Currently, the authorities of both major cities offer investors contractual relations for a construction period, and the prototype 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 a number of terms.

4.5 The Tendency Toward Spatial Differentiation of Income Groups

An enlightened municipal policy should seek to channel spatial differentiation in a direction that will minimize the losses to the city economy and maximize social stability and the dignity of city residents from all socioeconomic groups. As a first approach to this long-term challenge we offer:

- Initiate discussion of this issue, enlisting researchers, developers, and politicians;
- Study the experience of urban development since World War II in Italy, West Germany, Finland and Sweden to draw lessons for Russia.[5]

- Conduct local experiments, such as earmarking revenues to the city budget from "ghettos for the rich" project (for example, by auctioning the development rights).

In any case, deliberately formulated and locally tested policies, even if their results prove unsatisfactory, would be better than the current haphazard practice of unstable spatial mixes.

4.6 The Construction Industry

The Russian construction industry remains highly inefficient, with a great deal of power remaining with the large kombinant enterprises inherited from the Soviet past. One part of their

[5] We are skeptical, however, of the possibility of directly transplanting developed country experience in this regard to Russian soil, primarily because the directions of movement are diametrically opposite. Outside Russia, spatial differentiation based on income has long been present in one form or another, and the objective is to ease or modify it. In Russia, by contrast, there has been neither private property nor non-uniformity, and the objective is to allow them to emerge, keeping the negative consequences under control.

power is their network relationship with the municipal property agencies, which provides these enterprises with priority access to land and construction approval. Another part of their power results from priority access to construction materials, both from established networks and from direct control (vertical integration). It will require a determined effort to encourage competition in the construction industry, by providing new entrants with equal access to land, building permits, and construction materials.

4.8 Real Estate Finance

Last but not least, a system of real estate finance is needed to fund the construction of new structures and to finance the trading of existing properties. As with many of the proposals we are making here, a consistent set of laws are needed in a number of well 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. An alternative strategy is needed. For example, in a recent paper, Jaffee and Renaud [1996] suggest that a government sponsored mortgage credit institute could take the initiative that the commercial banks have failed to provide.

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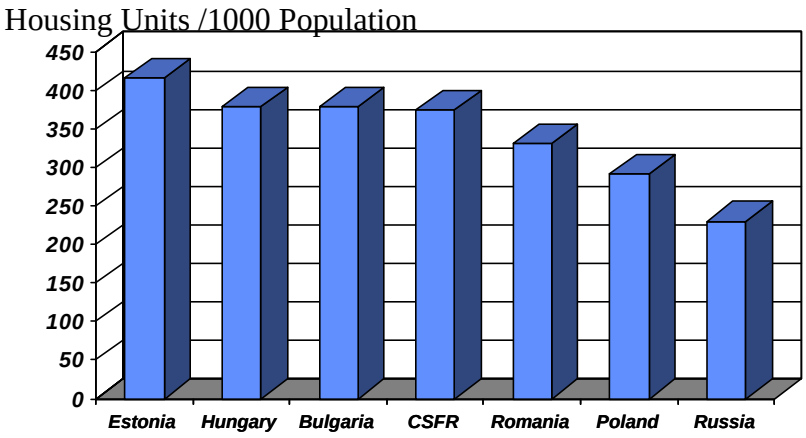
TABLE 1: RENT/INCOME RATIOS IN TRANSITION ECONOMIES			
COUNTRY	**YEAR**	**TOTAL %**	**RENT %**
BULGARIA	1988	12.1%	7.6%
HUNGARY	1987	8.7	1.6
POLAND	1986	4.4	2.0
ROMANIA	1989	4.4	3.0
YUGOSLAVIA	1988	9.3	2.8
USSR	1989	2.5	1.0
Source: Renaud [1992].			

Table 2: Housing Stock in Urban Russia by Ownership Type (percent)

Form of Housing Ownership	**1990**	**Form of Housing Ownership**	**1995**
Total housing stock	100	Total housing stock	100
State-owned, including:	79	State-owned, including:	52
State organizations controlled	44	State organizations controlled	15
Local Soviet controlled	35	Municipal	37
Private property, including:	20	Private property, including:	39
Individual property of citizens	15	Private property of citizens	31
Housing cooperatives	5	Housing cooperatives	5
		Private organizations owned	3
Public organizations owned (trade unions)	1	Mixed forms of property	9

Source: E.Klepikova, N.Kosareva, A.Suchkov [1995]. "Structure of Housing Finance. Country Report. Russia". Institute for Urban Economics, Moscow.

FIGURE 1: Housing Stock in Transition Countries, 1991



Source: UN-ECE, Annual Bulletin of Housing & Building Statistics, November 1994

Figure 2: Housing Stock in Developed Economies, 1990